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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/74

10:00 a.m., May 17, 1985

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	L. K. Doe
	D. C. Templeman, Temporary
	H. G. Schneider
B. de Maulde	X. Blandin
M. Finaish	T. Alhaimus
H. Fujino	M. Sugita
	B. Goos
J. E. Ismael	
	L. Leonard
	G. W. K. Pickering, Temporary
	H. A. Arias
H. Lundstrom	
	A. Abdallah
	M. A. Weitz, Temporary
	E. M. Taha, Temporary
	E. M. Ainley, Temporary
P. Pérez	
J. J. Polak	J. de Beaufort Wijnholds
	H.-S. Lee, Temporary
	R. Msadek, Temporary
	A. S. Jayawardena
	T. A. Clark
	N. Coumbis
Zhang Z.	Wang E.

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

Also Present

R. Westebbe, Western Africa Regional Office, IBRD. African Department: R. J. Bhatia, Deputy Director; G. E. Gondwe, Deputy Director; E. L. Bornemann, E. A. Calamitsis, R. O. Carstens, S. E. Cronquist, G. Devaux, I. A. H. Diogo, A. Jbili, M. Sidibé, I. C. Tandeciarz, U. Wilson. European Department: L. A. Whittome, Counsellor and Director; P. B. de Fontenay, Deputy Director; P. Beaugrand, 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, E. H. Brau, M. Xafa, K. Yoshinari. External Relations Department: G. P. Newman, H. P. Puentes. Legal Department: W. E. Holder, J. V. Surr. Treasurer's Department: C. D. Pham. Advisors to Executive Directors: D. Hammann, J.-C. Obame, T. Sirivedhin, A. Vasudevan, K. Yao. Assistants to Executive Directors: H. Alaoui-Abdallaoui, Bo T., M. B. Chatah, A. K. Diaby, G. Ercel, C. Flamant, V. Govindarajan, G. D. Hodgson, E. Olsen, J. K. Orleans-Lindsay, W. K. Parmena, D. J. Robinson, J. E. Rodríguez, M. Sarenac, A. A. Scholten, L. Tornetta.

1. TOGO - 1985 ARTICLE IV CONSULTATION, AND STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1985 Article IV consultation with Togo together with Togo's request for a one-year stand-by arrangement in an amount equivalent to SDR 15.36 million (EBS/85/94, 4/15/85; and Cor. 1, 4/22/85). They also had before them a statistical annex on Togo (SM/85/125, 5/3/85; and Cor. 1, 5/14/85).

Mr. Doe made the following statement:

> The performance of the Togolese economy was satisfactory in 1983 despite the effects of a persistent and more severe recession coupled with a weak demand for Togo's exports. The overall fiscal deficit was substantially reduced, external payments arrears were lowered through cash payments, credit expansion was small, and the external current account deficit declined. These achievements took place in the context of a coordinated adjustment effort initiated by the Government and supported by the Fund, the World Bank, official and private creditors, as well as aid donors. To consolidate the gains made in stabilizing the economy, the Togolese authorities launched in 1984 another program at the expiry of the preceding one.
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> The 1984 economic and financial adjustment program placed emphasis on a further reduction in payments arrears and on the restructuring of public enterprises. The external current account deficit--excluding grants--was originally targeted to fall by 4 percentage points to the equivalent of 15 percent of GDP in 1984, and the overall fiscal deficit--also excluding grants--was expected to remain unchanged at about 7 percent of GDP. Inflation was to fall by 2.5 percentage points. The attainment of these quantitative macroeconomic targets and objectives was predicated upon a reversal of the downtrend in real GDP and a resumption of export growth. In support of these expectations, courageous but unpopular measures enacted in 1983 were maintained. These include the freeze on salaries and promotions, a virtual ban on recruitment into the civil service, and the imposition of an additional 5 percent tax on salaries. Studies to guide the Government on the restructuring of public enterprises were also pursued.
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> As to the outcome of the 1984 stabilization program, the performance criteria were all observed as reported by the staff, and in the event, major progress was made in further stabilizing the finances of the country. On the basis of provisional estimates, the external current account deficit decreased by more than the programmed amount, to less than 13 percent of GDP, and domestic payments arrears were reduced by nearly CFAF 2 billion more than envisaged. The Government honored its external financial obligations within the framework of the Paris Club

and London Club agreements. On the other hand, despite a reduction in current expendture in nominal terms in 1984, a substantial shortfall in tax revenue, combined with a slightly higher level of capital spending, led to a fiscal deficit equivalent to 7.3 percent of GDP, compared with the 7 percent program target. The shortfall in government receipts reflected the impact of the regionwide slump in economic activity and the closure of the Nigerian border, and the higher capital expenditure was occasioned by the need to provide, on an emergency basis, electrical power following unforeseen large cutbacks in the supply of this service by Ghana. Inflationary pressures appear to have abated markedly in 1984, as the increase in the GDP deflator, estimated at 4.6 percent, was well below the 8.5 percent envisaged under the original program, owing partly to the effect of the recession. Domestic credit expansion was also slower than forecast, reflecting in particular unexpected favorable developments in the financial position of two of the largest public enterprises and a temporary buildup of government deposits.

Sight should not be lost of the adverse, if not hostile, environment in which the aforementioned results, and more specifically the financial improvement, took place. The appreciation of the U.S. dollar, in which one third of Togo's outstanding debt is denominated, together with the persistently high interest rates in major foreign markets and the higher charges applied to the rescheduled debt, have weakened the balance of payments position and aggravated the debt service burden. The growth of imports and re-export activities and related customs duties has slowed, as the Nigeria-Benin border remains closed and the long-awaited vigorous upturn in the economy of the neighboring countries has yet to materialize. The favorable impact of the recovery of agricultural output on overall economic activity in 1984 was offset by the negative effects of the restrictive fiscal measures and the closure of several enterprises, notably the multinational clinker plant, CIMAO. Consequently, real GDP is estimated to have fallen by nearly 1 percent in 1984 in contrast with the 2 percent growth initially programmed. The satisfactory implementation of the 1984 program under such unfavorable circumstances is a clear indication of the degree of awareness of the Togolese Government and its resolve to continue to take steps to restore the principal equilibria in the country's economy. It can only be hoped that in 1985 the economic environment for Togo will be more propitious to growth so that the adjustment under way can proceed without a further deterioration of the social and economic fabric of the country.

The Government of Togo intends to make additional progress in 1985, and to this end has adopted another adjustment program in support of which it is requesting Fund assistance. My authorities intend to reinforce the financial improvement under way by implementing structural policies in support of which they are also seeking assistance from the World Bank in the form of a structural adjustment credit. They have also requested the cooperation and understanding of private and official creditors in connection with the large debt service obligations forecast.

The objectives of the Fund and Bank-supported programs are essentially similar to those pursued in 1983 and 1984: to promote financial and economic reforms, especially in the agricultural and parastatal sectors. On the assumption that total output remains virtually stagnant at the 1984 level and the terms of trade improve markedly, the macroeconomic objectives envisaged under the Fund-assisted program call for a further decrease in the overall fiscal deficit in 1985 and no accumulation of payments arrears. On the other hand, the external current account deficit is expected to rise, reflecting a deterioration in the trade balance partly on account of imports associated with the Nangbeto hydroelectric project.

In the real sector, the rural development policy will continue to be geared toward raising living standards and income, hence providing incentives for young persons to stay on and contribute to the goal of ensuring food self-sufficiency and stimulating export crop production. The steps for achieving this objective include raising the producer prices of several cash crops--by 34 percent for coffee in 1984/85 relative to 1982/83, 28 percent for cocoa, and 38 percent for cotton--improving the supply of better seeds, and assisting farmers to build and use small-scale low-cost irrigation units. As reported by the staff, further substantial price increases are planned for the 1985/86 crop year--in particular, cotton, coffee, and cocoa prices are to be raised by about 17 percent, 16 percent, and 10 percent, respectively. It is the view of the Togolese authorities that while remaining committed to improving the living standards in rural areas by increasing producer prices, they cannot lose sight of the repercussions of this policy on, inter alia, the supply and demand conditions of cash crops and consumer goods, as well as on budgetary resources. According to the Government, a judicious balance needs to be struck between raising farmers' income and meeting the financing requirements of the Treasury, especially in light of the large burden of the country's debt service.

On the fiscal front, the projected deficit of central government operations equivalent to 7 percent of GDP reflects principally an increase in capital spending associated with the construction of the Nangbeto hydroelectric project. The stagnation of total output forecast for 1985, the continuing closure of the Nigeria-Benin border, and the projected sharp decrease in cocoa export earnings are expected to affect adversely revenue performance this year. The nominal increase in government receipts is forecast to arise chiefly from the effect of the broadening of the tax base in the context of the new tax code which was put into effect in January 1985. Regarding expenditure, the policy of restraint continues to be pursued. For instance, the last general wage increase, 7 percent, was granted in January 1982 and none is forecast for 1985. On the other hand, the consumer price index is estimated to have increased cumulatively by 16 percent over the past three years and is projected to rise further by 12 percent this year. The depressing impact of this wage freeze on income was worsened by the imposition of an additional 5 percent solidarity tax on income effective January 1, 1983. In addition, employment in the government sector remains severely curtailed. The social impact of such stringent employment and wage policies is all the more severe considering the extremely limited employment opportunities in the modern private sector and the fact that in many developing countries like Togo the income of each wage earner serves to sustain the life of a family not narrowly but broadly defined. According to my authorities, these considerations should not be ignored when recommendations on fiscal policy and in particular public employment policy are offered.

Concerning Togo's external debt obligations, the Government acknowledges the cooperation that many creditors have shown in the past and in particular appreciates the understanding that some official creditors have demonstrated by canceling some of their claims. However, the debt service burden, especially its interest component, places a severe limitation on the Government's ability to generate savings for increasing productive capacity and thereby stimulating economic growth. The impact of the economic retrogression, especially in 1983, together with the effect of unforeseen and damaging exogenous phenomena such as drought and border closures, have considerably weakened the economic growth potential of the country. To lay the basis for sound and sustained development and growth of the economy, the Government is actively seeking the financial and technical assistance of friendly countries and multilateral institutions. To this end, a new Investment Code designed to attract foreign investors has been enacted and a five-year development plan containing economic scenarios through 1990 has been prepared. The steps to secure effective international support for his plan are to be highlighted at a Donors' Conference scheduled to take place in Lomê June 26-28, 1985. The Togolese authorities are hopeful that the offer of assistance that will be made during this meeting will be commensurate with the adjustment effort undertaken thus far and large enough to help place the Togolese economy on a firm growth path.

Before concluding, I wish to say a few words about the format of the document (SM/85/125) that accompanies the staff report. As Executive Directors might recall, in SM/84/44 prepared for the Board on surveillance matters, it was suggested on page 31 that staff reports on recent economic developments might take the form of a set of tables. This chair then expressed serious reservations about this proposal, on the grounds, inter alia, that (a) the evolution of macroeconomic aggregates and of policy changes needed to be extensively explained even in the absence of major institutional changes; (b) the staff report on recent economic developments might be the only source of comprehensive and relatively coherent descriptive information available on a regular basis for many countries; and (c) the national authorities might find the communication of such reports less objectionable while the confidential nature of a staff report on consultation discussions precludes its wide circulation. These reservations apply to the present additional paper on Togo, and on behalf of my authorities I would be grateful if serious consideration could be given henceforth to their strong preference for a comprehensive staff report on recent economic developments for all Article IV consultations with Togo.

To conclude, I would like to extend my appreciation to the Fund management and staff for the cooperative spirit with which they have approached the discussions and negotiations with the Togolese authorities. The diligence with which the staff report has been prepared and circulated for timely consideration by the Board is also noteworthy. My gratitude also goes to the members of the Executive Board for the constructive and supportive comments that they made during the examination of the Togolese request for a stand-by arrangement in May 1984 and subsequently during the review of the program.

Mr. de Maulde remarked that during the previous two years the authorities had adhered strictly to the Fund-supported programs despite the extremely unfavorable external environment: the drought in 1983 had adversely affected agricultural production; Nigeria's decision to close its borders with its neighbors had hurt Togo's services sector in general and its commercial and transport activities in particular; and a large cement factory jointly owned by Togo, Ghana, and Ivory Coast had been closed, mainly because of the insufficient supply of electricity from the Akosombo dam in Ghana, and partly because of the depressed world market for cement and the dumping practices of a number of foreign countries. In the circumstances, the reduction in the budget deficit from 7 percent of GDP in 1982 to about 2 percent in 1984 was remarkable. That achievement had been due to the implementation of tax reform measures recommended by the staff and to the severe restraint on personnel expenditures. The strict fiscal policy and supportive monetary policy had led to favorable external payments developments in 1984, including a sizable decrease in the current account deficit.

The strenuous adjustment efforts had unfortunately been accompanied by a continuous decline in real GDP--10 percent over the previous three years--despite various actions to increase agricultural production, Mr. de Maulde commented. That outcome clearly underscored the need for additional supply-oriented measures, and the World Bank's involvement in Togo in close cooperation with the Fund was welcome. It had already resulted in the formulation of a structural adjustment program supported by a structural adjustment credit. A second such credit was likely to be approved soon, with part of the financing coming from the Special Facility for sub-Saharan Africa. The first structural adjustment program had achieved good results in the public enterprise sector, particularly through the closure, restructuring, and sale to private concerns of unprofitable enterprises. While those actions had been required, they would not contribute significantly to increasing production in the industrial and mining sectors, where, with the exception of phosphate mining, Togo apparently did not enjoy a significant comparative advantage.

The authorities were well aware that the basis for economic recovery in the long run was the agricultural sector, which still employed more than three fourths of the total work force, Mr. de Maulde went on. The previous adjustment programs had already reversed the internal terms of trade between farmers and urban residents through sizable increases in producer prices, and the 1985 program provided for further increases in the prices of export crops, such as cocoa, coffee, and cotton. Nevertheless, those prices were still low in absolute terms and in comparison with international prices, including the prices in neighboring countries. For example, the farm gate price of cocoa in Togo was just 30 percent of the international price. Farm output in Togo would undoubtedly respond favorably to higher domestic producer prices.

The staff scenarios on the medium-term evolution of the balance of payments, the debt service, and government operations showed that even if the adjustment effort were continued, debt service payments would remain high in terms of both exports and government revenues until at least 1988, Mr. de Maulde commented. That outlook clearly suggested the need for continued support by the international community of Togo's policy reforms.

In its report the staff noted the need to tackle the problem of desertification mentioned in the letter of intent, where the authorities had underscored the priority that would have to be given to the implementation of reforestation projects, Mr. de Maulde said. That major problem was obviously of particular interest to the World Bank, but he was pleased that the Fund was concerned about it. A comment on the World Bank's intentions with respect to Togo's reforestation effort would be helpful.

Mr. Taha said that he agreed with the staff appraisal and accepted the proposed decision. Despite the drought and declining regional trade, Togo had successfully implemented two Fund-supported programs during the previous two years. A large measure of financial stability had been restored through the authorities' commendable adjustment efforts. Moreover, with World Bank assistance good progress had been made in dealing with the structural imbalances.

As to the 1985 program, he fully supported the authorities' intention to sustain adjustment and to lay the foundation for growth, which had been negative in recent years, Mr. Taha went on. Adjustment and growth should go hand in hand. To that end, the authorities must increase productive investment and improve production incentives, particularly in the agricultural sector. Hence, the parallel involvement of the World Bank and the Fund in Togo through the structural adjustment program and stand-by arrangements was welcome. The structural adjustment program should strengthen the institutional framework for investment and help to expand the economy's productive capacity.

The 1985 program appropriately provided for continued restraint in public finances, particularly current expenditure, Mr. Taha noted. As the scope for new revenue measures was limited, the authorities were attempting to restructure public enterprises; those efforts should not be relaxed, even though the results would not be evident in the short term. In the medium term, successful restructuring of public enterprises would reduce the financial imbalances in the economy and generate much-needed domestic savings.

The unfavorable balance of payments situation and medium-term prospects were a cause for concern, mainly because of Togo's heavy external debt burden, Mr. Taha commented. He was pleased that the authorities intended to refrain from additional commercial borrowing. They should be urged to focus their investment policy in the coming period on productive sectors in order to expand and diversify exports.

In principle, he agreed with Mr. Doe that it was preferable to prepare a full-fledged report on recent economic developments in a member country rather than the kind of statistical annex that had been prepared for Togo, Mr. Taha said. At the same time, he understood that the staff viewed the statistical annex as merely a temporary arrangement that was not intended to replace the preparation of conventional reports on recent economic developments in the future.

Mr. Abdallah considered that the proposed stand-by arrangement would contribute to the authorities' consistent efforts to achieve sustainable growth. Since 1979 Togo had negotiated a series of stand-by arrangements with the Fund and structural adjustment programs with the World Bank to correct imbalances arising mainly from ambitious policies pursued during the prosperous 1970s and from the world recession, which had ravaged developing countries in general and African countries in particular. In Togo the abrupt change in the economic environment had resulted in a widening of the fiscal and external deficits, growth of the debt burden, an increase in domestic and external arrears, and a decline in national income.

Since 1983 the authorities had been making a strong and determined adjustment effort with the support of the Fund, the World Bank, and the donor community, Mr. Abdallah noted. The proposed stand-by arrangement was actually a continuation of the two stand-by arrangements approved in

1983 and 1984, which had focused on arresting the deterioration in the fiscal and external sectors and on eliminating production bottlenecks. The authorities were to be commended for recognizing at an early stage that the correction of the broad-based deterioration of the economy required continued implementation of sound policies that could attract substantial external support. Togo had met all the performance criteria and had made all the scheduled drawings under the stand-by arrangements.

In the fiscal field, Mr. Abdallah went on, the authorities had made a greater effort than expected. Despite the substantial adverse effects of major unforeseen factors on economic activity in 1984, the authorities had managed to reduce the budget deficit from 7.7 percent of GDP in 1983 to 7.3 percent in 1984, compared with the target of 7.9 percent. Moreover, they had eliminated virtually all the domestic arrears of the Government and most of the arrears of the public enterprises. Increases in the output and prices of the main exports, namely, phosphates and cocoa, together with prudent government policies, had attracted considerable capital inflows in the form of grants; 1984 had ended with a large balance of payments surplus and an increase in gross official reserves to SDR 202 million, equivalent to eight months of imports.

The authorities were to be commended for making parallel use of Fund and World Bank resources in order to address adequately the problem of declining production, Mr. Abdallah commented. An IDA credit of SDR 37 million had supported a structural adjustment program to increase agricultural production and improve the state enterprise sector and investment programming. Considerable progress had been made in stimulating food and cash crop production and in rehabilitating state enterprises. Moreover, negotiations for another structural adjustment credit of SDR 30 million had reached an advanced stage. Despite the progress made in crop production, overall output had not fully recovered, as GDP had declined by 5 percent in 1983 and 1 percent in 1984. A further comment on the prospects for overall growth in 1985 and 1986 would be useful.

The stand-by arrangements had played a key role both in the structural adjustment program negotiations with the World Bank and in the debt rescheduling negotiations with the Paris Club and private creditors, Mr. Abdallah remarked. The proposed stand-by arrangement was intended to enable the authorities to carry on the adjustment tasks they had started despite the difficult conditions in the country. The debt service ratio was still very high--62 percent--and was expected to drop to just 27 percent by 1990. Moreover, the fiscal deficit was to be further narrowed to 7 percent of GDP in 1985, or 4.6 percent excluding expenditure on the large Nangbeto hydroelectric project.

A large overall external deficit was expected in 1985 and, although it would be gradually reduced, it would not be eliminated until 1990, Mr. Abdallah noted. As he understood it, the authorities expected to close the financing gap in 1985 through Fund resources, debt rescheduling, special assistance resulting from the Donors' Conference, and by drawing down reserves. A comment on how the authorities intended to finance the gap in 1986-90 would be helpful.

He supported Togo's request for a stand-by arrangement, although the progress made thus far had been slow, Mr. Abdallah commented. The projections indicated that the fiscal and external imbalances would persist in coming years. Moreover, although the decline in GDP seemed to have been arrested, positive overall growth had not been recorded. A further comment on the slow response of the economy to the continuous effort to encourage GDP growth would be useful. In any event, repeated debt rescheduling in conditions of persistently high interest rates and a strong U.S. dollar would make Togo's debt burden in coming years difficult to bear. Such an outcome, together with the programmed prompt elimination of arrears, would take up savings that could otherwise be invested to increase productive capacity. The authorities should take a closer look at the possible relief through debt rescheduling.

He agreed with Mr. Doe that for most developing countries a statistical annex was not an adequate substitute for a staff report on recent economic developments, Mr. Abdallah commented. The staff should continue to prepare descriptive reports on recent economic developments for all countries that were using Fund resources. Finally, the proposed decisions were acceptable.

Mr. Goos said that he broadly agreed with the staff appraisal. The proposed decision was acceptable. He was pleased that the cursory development efforts of the late 1970s had given way to the much more consistent and comprehensive efforts of the previous two years that had already resulted in a sizable reduction in the domestic and external imbalances. That success was particularly commendable because it had been achieved despite an unfavorable external environment. The authorities' impressive commitment to adjustment was also clearly reflected in the achievement of all the performance criteria under the previous stand-by arrangement; indeed, some of the criteria--particularly those concerning the fiscal deficit and domestic arrears--had been met with comfortable margins.

The new adjustment program together with the proposed structural adjustment credit from the World Bank constituted a good basis for consolidating financial stability and pushing further ahead the significant structural reforms in agriculture and the public enterprises, Mr. Goos considered. Still, much remained to be done to restore a viable economic position. The medium-term outlook for the balance of payments and debt service remained very difficult, and Togo would have to rely upon exceptional external financing for a number of years. However, he was confident that if the authorities were to maintain the present adjustment efforts, the prospects for receiving the required exceptional financing would be good.

The authorities were well advised in giving the highest priority to rural development and infrastructure investment, while allocating a relatively moderate share of total investment to the industrial sector, Mr. Goos said. In that context, the authorities' concern about environmental problems was impressive. Their program for controlling desertification and encouraging reforestation contrasted sharply with the poor management of natural resources in other developing countries that had often contributed to declining agricultural production and famine.

The Government's ambitious investment program should have a considerable impact on the budget and the external current account, Mr. Goos considered. An efficient allocation of investment resources would be of paramount importance for Togo's development prospects, particularly in light of the unsatisfactory experience with the CIMAO clinker plant and other ambitious undertakings, such as those in the tourist sector. While he felt reassured in that respect by the close collaboration between the World Bank and the Fund in providing assistance to Togo, he wondered why outlays under the World Bank-approved public investment program for 1984, which presumably had been formulated in cooperation with the Fund staff, had had to be curtailed by 20 percent. Similarly, the failure of the Fund staff to take into account the phosphoric acid plant project approved by the World Bank in the staff's medium-term projections was puzzling.

The staff report gave the impression that the agricultural development strategy was centered on encouraging cash crops, Mr. Goos commented. Apparently there was a separate market for food crops that was protected by export barriers. A further comment on the apparent dichotomy in Togo's agricultural sector and on the rationale for the export barriers--which seemed to be a peculiar device for a country that had a chronic shortage of foreign exchange--would be helpful.

In 1984, as in earlier years, credit allocations to the priority sectors had fallen short of the targets, Mr. Goos noted. The shortfall was attributed to the Togolese banks' aversion to risk. Accordingly, diversification of the risks involved, by establishing the credit guarantee fund under consideration by the authorities, could be helpful. However, the banks should not be relieved of all credit risks; having them bear an appropriate share of the risks would help to ensure that credit would be allocated effectively. The reasons for the termination of the previous credit guarantee fund should be explored; the exercise might well provide useful lessons for the design of a new and effective guarantee scheme.

Mr. Wijnholds observed that the authorities had made a considerable adjustment effort during the previous two years. All the performance criteria under the stand-by arrangements had been adhered to, and some of the targets had been met with a considerable margin. He agreed with the staff that Togo warranted continued Fund support through a new stand-by arrangement even though the proposed purchases would considerably exceed Togo's scheduled repurchases, thereby increasing the volume of outstanding Fund credit to Togo. The country's good record warranted such an approach.

That negotiations on a structural adjustment credit from the World Bank Group were well advanced was welcome, Mr. Wijnholds went on. The problems facing the economy were largely structural and developmental in nature, and the World Bank's active involvement in solving them was highly desirable.

The staff had made a convincing case for permitting Togo to make the first purchase under the proposed stand-by arrangement even though all the external financing likely to be required in 1985 had not yet been fully secured, Mr. Wijnholds said. Adjustments that might be needed because of smaller than expected financial assistance from creditors and donors should be considered during the scheduled midterm review under the stand-by arrangement.

The trend of negative economic growth was expected to be halted in 1985, but further adjustment would be needed to establish the basis for positive growth in subsequent years, Mr. Wijnholds remarked. The prospects for sluggish growth and stagnant exports were traceable mainly to the closure of Nigeria's borders, which was expected to continue throughout 1985. Exports to Nigeria had constituted 10 percent of Togo's total exports in 1980.

Togo had also suffered a loss in export proceeds owing to the cessation of clinker production, Mr. Wijnholds noted. However, since the production costs of clinker in Togo were nearly twice the world market price, he wondered whether resuming production would be in Togo's best overall interests. He hoped that the important Nangbeto hydroelectric project, which was supported by IDA and had been carried out jointly with Benin, would have a net positive impact on the balance of payments starting in 1988, as the staff expected.

The staff's debt service and balance of payments scenarios showed that a combination of sustained adjustment and adequate financing on concessional terms would permit Togo to reach a sustainable external debt position by the end of the 1980s, Mr. Wijnholds commented. Creditors and donors would have to maintain their present positive stance if the projections were to prove to be accurate. Continued good performance by Togo under the new stand-by arrangement would undoubtedly be a crucial factor in generating adequate external finance.

Mr. Clark said that he agreed with the staff appraisal and supported the proposed stand-by arrangement. The trade and current account projections--especially those for 1986 and 1987--in the present staff report were appreciably less favorable than those included in the previous staff report on Togo. For example, according to the latest projection, the trade account would register a deficit of CFAF 17.4 billion in 1986, compared with the previous projection of a surplus of CFAF 4.9 billion. The deterioration in the outlook was due partly to the closure of the CIMAO clinker plant, but the reduction in clinker exports did not fully account for the deterioration; the fall in those exports would be partly offset by a decline in energy imports used in the production of clinker. The staff's comments on the other factors involved would be helpful.

The staff had reported that the amount of nonrescheduled debt was declining rapidly, Mr. Clark noted. Although creditors had displayed considerable flexibility, the trend in Togo's nonrescheduled debt was a cause for some concern, and the staff could usefully provide more detailed information on the amount, including the amount due to institutions that normally did not reschedule debt. The staff should also comment further on the relationship between Fund and World Bank operations in Togo. The authorities' strong efforts to restore balance to the economy were welcome and had resulted in some clear successes. The authorities should be encouraged to continue along what was bound to be a long road.

Mr. Jayawardena said that he agreed with the staff appraisal and accepted the proposed decisions. Since the economic difficulties of the mid-1970s, Togo had been making a serious effort to correct its financial imbalances and to restore sustainable economic growth through successive Fund arrangements and with World Bank support. The authorities had made considerable progress in containing the fiscal imbalance--which appeared to be the main problem facing the economy--by increasing revenue and curtailing expenditure. Togo's tax and savings efforts were commendable for a low-income country; the per capita income was just SDR 245. He hoped that further progress could be made on the expenditure side, especially through a rapid reform of the public enterprise sector. The slow growth of the economy was a cause for concern, and the implementation of strong supply-side measures might help to start the economy moving.

Given the continuing high debt service ratio and the difficult circumstances in the region and elsewhere, the authorities would have to persevere in their adjustment efforts, Mr. Jayawardena considered. Accordingly, the proposed stand-by arrangement was welcome. Further assistance from the international community might be necessary, and he was pleased that Canada, France, and the Federal Republic of Germany had canceled Togo's debts to them. Togo was one of the least developed countries, and he was pleased that donor support for the country was being mobilized.

In the absence of considerable new data on a member country, the reports on recent economic developments might well tend to be repetitive, Mr. Jayawardena said. However, a new report could focus on a wide range of economic issues even when a minimum of statistics was available. Such reports could prove invaluable for members such as Togo that had undertaken major economic reforms. In those cases, the provision merely of a set of tables should be seen as only a temporary expedient. He strongly agreed with Mr. Doe that reports on recent economic developments should always be provided for countries that found the reports to be particularly valuable to them and were implementing Fund-supported programs.

Mr. Msadek commented that the proposed stand-by arrangement, which covered 1985, was a logical continuation of Togo's efforts to deal with a number of structural adjustment issues related to the fiscal deficit and the balance of payments. Unfortunately, the two previous successive stand-by arrangements had failed to promote economic growth for the third consecutive year owing to internal and external factors.

The deterioration in Togo's external position had been caused by the appreciation of the U.S. dollar, high interest rates abroad, and the growing charges on rescheduled debt, Mr. Msadek noted. In the domestic economy, some of the tax measures introduced in 1984 had helped to reduce somewhat the budget deficit, but other tax measures had clearly contributed to the sluggishness of the economy at a time when employment opportunities in the private sector had been very limited and the outlook for regional trade had been gloomy because of the closure of Nigeria's borders. The freeze on wages and promotions as well as the cuts in personnel and the ban on hiring were creating substantial social pressures and were fundamentally inconsistent with the Government's objectives.

In complying with the implementation of the adjustment program supported by the Fund and the World Bank, the authorities had maintained fiscal restraint in an effort to consolidate the financial position and restructure the public enterprise sector, Mr. Msadek remarked. While the overall fiscal deficit had been reduced as a result of public expenditure cuts, it was not clear to him how much further public expenditure could be reduced without jeopardizing the basic functioning of the Government. Moreover, the scope for introducing new revenue measures seemed limited in light of the already high ratio of tax collections to GDP. The recently created Ministry of State Enterprises had planned to turn some industries over to the private sector and to conduct a study on the enterprises that should remain under government supervision with a view to limiting the drain on the budget of unprofitable enterprises, such as the steel mill and the oil refinery.

The only major increase in capital spending in the recent past had been related to the Nangbeto hydroelectric project, which was likely to adversely affect the external balance for many years, Mr. Msadek commented. As a result, Togo would be totally dependent upon the support of creditors and donors for some time; their attitude would determine the extent to which the country would be able to continue to make economic progress. In that connection, the June 1985 conference in Lomé on multilateral aid was certain to be of crucial importance.

Real GDP had declined by 5 percent in 1983 and had stagnated in 1984 despite the recovery in crop production in that year, Mr. Msadek observed. The staff had noted that the outlook for 1985 was a cause for concern because of the heavy debt service and the uncertain prospects for economic growth and exports. It was true that the sharp drop in regional trade, the cessation of the clinker project in 1984, and the increase in energy costs had been the primary causes of the poor GDP performance, but the programs supported by the Fund and World Bank had been initiated in a period when drought had further hampered the agricultural sector and world commodity prices--for example, the prices for cocoa and phosphate rock--had been declining. A flexible attitude toward adjustment was warranted in light of the severe impact of adjustment on the social structure. In addition to the emphasis on rural development--which was long term in nature--private small and medium-scale enterprises should be encouraged so that the private sector could help to ease the social pressure created by the ban on new government employment. In that connection, the adoption of a new Investment Code was welcome, and he wondered whether measures had been adopted to attract capital flows from other members of the

West African Monetary Union. Togo should liberalize exports to neighboring countries on the assumption that the border situation would return to normal. Incentives could be offered to those merchants in Lomé who apparently controlled a sizable share of total trade activity, particularly in luxury imports.

The main problem facing the authorities in 1985 was the external debt service, which amounted to 55 percent of exports, Mr. Msadek commented. Export prices were expected to remain low throughout 1985, and the external current account balance was likely to deteriorate sharply by the end of the year. Accordingly, despite the restrictive demand management policies, the external current account deficit--excluding official transfers--was projected to increase from 12.3 percent in 1984 to 18.3 percent in 1985. Because of those developments and the declining capital inflows, the balance of payments was expected to record a deficit of SDR 32 million in 1985. Togo urgently required concessional assistance in coming months. The long-standing cooperation between Togo and the Fund as well as the World Bank, and the fact that Togo had met all the performance criteria under two successive stand-by arrangements, gave him reason to hope that a concerted approach toward multilateral assistance would be made so that Togo could continue its efforts to achieve economic independence. Finally, the proposed decisions were acceptable.

Mr. Templeman commented that Togo had satisfactorily implemented two stand-by arrangements. In 1984 all the performance criteria had been met easily and most of the targets had been reached, although real economic growth had been well below expectations. The tighter than programmed control of current government expenditure in 1984--owing partly to the stringent control over the wage bill--was particularly impressive. The 1985 economic and financial program maintained the emphasis on demand management, and the structural adjustment loan from the World Bank should help to ensure that progress in structural adjustment would be maintained; apparently the recommendations of the Fund and the World Bank were meshing well. Still, the continued large external current account deficit and the weak medium-term outlook were causes for concern.

Periodic adjustments in producer prices had increased the real return to agricultural producers, Mr. Templeman continued. Further liberalization of food exports under the new stand-by arrangement should provide additional incentives to producers. The stress on rural development under the new arrangement was appropriate not only because it would strengthen the productive base, thereby contributing to more rapid economic growth, but also because it could help to stem internal migration, thereby reducing the need for job creation in the urban centers.

The authorities' fiscal efforts in 1984 had been impressive, Mr. Templeman commented. Current expenditure had been tightly controlled, primarily through reduced expenditure on personnel, and the ratio of the overall fiscal deficit to GDP--excluding grants--had been 7.3 percent, compared with the revised program target of 7.9 percent. The authorities apparently were committed to maintaining tight control over personnel expenditure in 1985, when, as in 1984, no wage increases were to be granted to public employees. Given the World Bank's endorsement of the public investment program and the availability of concessional funding, the planned resumption of public investment spending in 1985 was appropriate, as it would establish the foundation for future growth. However, he was concerned about the balance of payments impact of such spending, particularly on the large hydroelectric project. He also inquired about the extent of export development in the investment program. The reduction of internal and external arrears was welcome.

The improved performance of the public enterprises, especially the privatization of the steel mill, was also welcome, Mr. Templeman remarked. The World Bank was helping to rationalize the public enterprise sector through privatization of enterprises and through price increases to cover higher costs. There was a welcome declining trend in government involvement in the economy, as indicated by the steady decline in current expenditure as a percentage of GDP over the previous several years from a high of 27 percent in 1982 to a projected 24 percent in 1985.

He continued to have some reservations about the usefulness of the credit allocation system, which could inhibit the prompt reallocation of resources in response to changing internal and external demand conditions, Mr. Templeman commented. In 1984 real interest rates on deposits had been positive owing to the low inflation rate. In 1985, however, a much higher rate of inflation was expected, and the authorities' plans not to increase interest rates could discourage domestic savings and harm the capital account of the balance of payments. Interest rates in the coming period should be closely monitored.

The current account deficit expected in 1985 and the poor prospects for a substantial improvement in that account over the medium term were a cause for concern, Mr. Templeman stated. Large external imbalances had remained even though Togo apparently had made good progress in containing aggregate demand and had made a start on a broad-based structural adjustment effort with the support of the World Bank. Furthermore, the volume of imports was expected to increase by 15 percent in 1985. While that development was due partly to the capital imports needed for the hydroelectric project, the large balance of payments impact over the coming years of the projected rise in imports was a cause for concern. Table 10 of the staff report showed that the fall in energy and capital goods imports following the completion of the hydroelectric project would have only a small effect on total imports. The Fund was supporting Togo's adjustment process, and a further comment on the balance of payments impact of the hydroelectric project would be helpful.

He wondered whether the sources of the short-term capital inflows that had occurred consistently over the previous several years could be identified and whether medium-term projections of such flows were available, Mr. Templeman said. Given the projected financing gaps, continued debt relief by creditors apparently would be required. The prospect of having to reschedule debt that had already been rescheduled was unwelcome. Even with the debt relief projected for 1985, the debt service burden would be equivalent to 47 percent of exports.

According to the staff's analysis, the adverse effect on Togo's exports of a depreciation of the U.S. dollar would exceed the favorable impact of the depreciation on Togo's debt-servicing costs, Mr. Templeman commented. However, in his opening statement Mr. Doe had argued that the appreciation of the U.S. dollar had weakened Togo's balance of payments position. He wondered whether those views could be reconciled.

Togo was already a prolonged user of Fund resources, although Togo had used less Fund credit than most other prolonged users, Mr. Templeman remarked. Although the projected financing gaps raised the question of the appropriate role of the Fund in Togo in the rest of the 1980s, the proposed stand-by arrangement was acceptable, and the suggested access to Fund resources under that arrangement was appropriate. Given Togo's comfortable level of reserves, there should be no difficulty in closing the financing gap for 1985, although he looked forward to learning during the scheduled review under the stand-by arrangement about the outcome of the Paris Club discussions and of the donors' meeting. Finally, he was pleased by the broad cooperation and interaction between the Fund and the World Bank in Togo.

Mr. Pickering commented that the authorities had made substantial progress over the previous two years despite the largely unfavorable external factors. The previous stand-by arrangement had been fully implemented and the program targets had been met and occasionally exceeded. The stringent fiscal measures and the introduction and continuation of important structural adjustments with the support of the World Bank had been particularly commendable.

Despite that progress, Togo's balance of payments position was unsustainable, Mr. Pickering went on. Debt rescheduling and donor assistance were essential if even the modest economic growth targets were to be achieved.

In light of the measures that had already been introduced or were to be adopted under the 1985 program, the proposed stand-by arrangement was acceptable, Mr. Pickering said. The 1985 program appropriately focused on the structural adjustment efforts needed to support the Government's development priorities. He had no major difficulty with the new program.

The Ministry of State Enterprises, established in the fall of 1984, had been given far-reaching powers to undertake reforms, Mr. Pickering noted. However, the staff had not provided a detailed description of the state enterprise sector nor in either the present or previous reports; for example, a list of the enterprises in that sector had not been provided, and it was difficult to ascertain the financial position of individual enterprises. Since members' parastatal sectors often caused financial difficulties, future staff reports could usefully provide more detailed information on them. The Government in Togo had engaged consultants to conduct an inventory of the debt of state enterprises, and he wondered whether any information was yet available.

The reduction in domestic arrears over the previous two years was impressive, Mr. Pickering commented. However, an accurate assessment of the remaining arrears of the state enterprises had not yet been made by the consultants engaged by the authorities, and he wondered whether the staff had a firmer idea of the magnitude of the domestic arrears. He hoped that a more detailed assessment might be available by the time of the scheduled review under the stand-by arrangement.

At first glance, the projected deterioration in the balance of payments position during 1985, the large scale of the Nangbeto project, and the proposed amount of Fund resources to be used by Togo had been a cause for concern, Mr. Pickering remarked. The staff had suggested that there was a clear link between the expected deterioration in the trade balance in 1985 and the implementation of the Nangbeto project, which involved a sizable volume of capital goods imports. Despite the statistics presented in Table 6 (EBS/85/94), it was difficult to judge precisely the likely final outcome for the overall balance of payments position because of the uncertainty about Paris Club rescheduling and donor assistance in 1985. The staff had indicated that reserves were likely to fall by CFAF 15 billion. It would be useful to have a further comment on the adequacy of reserves at the end of the new program period. He wondered whether Fund resources should be used to maintain reserves at the present level. The medium-term outlook clearly showed that Togo would require substantial financing over the coming several years, and he hoped that the Donors' Conference in 1985 would result in the provision of more generous support of Togo's adjustment effort by the international community.

He supported Mr. Doe's request for a full staff report on recent economic developments for the next Article IV consultation with Togo, Mr. Pickering said. After all, the Fund was prepared to undertake enhanced surveillance at the request of members that wished to increase the usefulness of surveillance. After two or three years, the Fund could again consider whether a full report on recent economic developments was still in the best interest of Togo and the Executive Board.

Mr. Zhang stated that the proposed decisions were acceptable.

The staff representative from the African Department said that the Fund staff had cooperated closely with the World Bank staff to encourage a change in the internal terms of trade. Producer prices in Togo were equivalent to about one third of the relevant world market prices. As a result, the supply response in the agricultural sector had been fairly small.

There had been little economic growth in the recent past, and the prospects for 1985 were not good, partly because agricultural production in 1984 had been exceptionally strong following the improvement in weather conditions, the staff representative continued. Accordingly, even if the favorable weather conditions were to continue, a further significant increase in agricultural output in 1985 was unlikely and any economic growth in that year would have to come from other sectors. In subsequent years, the staff expected moderate growth of 4-5 percent a year in real terms.

The projected financing gaps were based on the assumption that there would be no exceptional financing and no new drawings on Fund resources; therefore, the projections were probably unduly high, the staff representative said. However, the authorities fully understood that the projected gaps underscored the need to maintain the adjustment effort and to seek additional financial assistance from donors. Also they recognized that, with the effort to foster growth and to develop export industries, they had reached a new stage in their stabilization process.

The Fund staff had fully cooperated with the World Bank in assessing Togo's investment program, the staff representative remarked. The figure of CFAF 38 billion in the 1985 budget for public sector investment was based on available financial resources and was fully consistent with the investment program agreed between the World Bank and the authorities. The cost of the phosphoric acid plant had not been reflected in the various projections because it was not expected to be of any significance in the coming five years.

The closure of the borders with Nigeria would negatively affect the region, the staff representative stated. It would of course undermine cooperation among the members of the Economic Community of West African States. All Nigeria's neighbors were concerned about the possible continuation of the border closure.

The worsening of the trade account was traceable to several factors, particularly the closure of the CIMAO clinker plant, the staff representative said. The plant presumably would reopen in 1987, but the prospects were not good. The Nangbeto hydroelectric power project would have a significant adverse effect on the external current account over the coming several years. Moreover, a considerable increase in consumer goods imports--an essentially welcome development--was expected with the projected resumption in economic growth in Togo in 1986.

The staff expected only some CFAF 4 billion to be rescheduled in 1987, the staff representative remarked. The amounts in subsequent years were likely to be even smaller.

The staff of the Fund and the World Bank regularly exchanged views on policy developments in Togo and often undertook parallel missions to the country, the staff representative explained. The staff usually took a mutually agreed position on all the major policy issues concerning Togo's economy.

The authorities had recently adopted a new Investment Code to encourage capital inflows, the staff representative commented. The Code had improved conditions for investors, particularly smaller investors, mainly through the provision for the free transfer of profits.

The authorities as well as the Fund and World Bank staff were fully aware that in Togo export development was synonymous with rural development, the staff representative said. There was a need to develop not only the traditional exports--coffee, cocoa, and cotton--but also other products, and to that end the authorities were considering an increase in export liberalization.

The investment program was the key to future economic growth, the staff representative remarked. The authorities, in cooperation with the World Bank, had made considerable progress in formulating an investment program, partly in preparation for the coming Donors' Conference; the program would cover the coming six years.

Real interest rates in 1984 had been positive owing to the relatively low rate of inflation, the staff representative commented. However, it was important to remember that the moderate inflation had been due partly to the good harvest, which had caused a strong decline in food prices and the consumer price index. The rate of inflation in Togo was likely to increase in 1985, although somewhat less strongly than was suggested in the staff report because of the improved performance of consumer prices in France.

It was difficult to determine the precise nature of the capital inflows and to predict how long they were likely to persist, the staff representative remarked. The relevant tables in the staff report showed a gradual decline in those inflows in coming years, but the actual outcome might well be different, as the inflows came from neighboring oil countries and even relatively small transfers from those countries could make a sizable impact on Togo.

The effect of the Nangbeto power project on Togo's balance of payments might well seem alarming at first glance, the staff representative commented. However, it was important to remember that the prices paid by Togo for electricity imported from Ghana were to be renegotiated in coming months, when they were likely to be considerably increased; in the absence of the Nangbeto project, imports of new diesel equipment and oil would certainly increase and the medium-term balance of payments outlook would certainly worsen.

The staff's sensitivity analysis suggested that an appreciation of the U.S. dollar would have a favorable impact on the fiscal and external balances because the share of the total foreign debt denominated in dollars was relatively low--some 25 percent--while most exports, particularly cocoa, coffee, and phosphates, were denominated in dollars, the staff representative explained.

A consulting firm's study of 73 state enterprises was still in draft form; the staff had hesitated to provide any figures from a report that had not yet been finalized, the staff representative commented. However, the staff hoped to be able to obtain the final report during the coming scheduled review.

The staff had estimated the volume of domestic arrears at CFAF 2 billion, the staff representative said. It was conceivable that the consulting firm examining some of the state enterprises would discover additional arrears. Domestic arrears in Togo were difficult to gauge, and the staff planned to look at them again carefully during its coming discussions with the authorities.

Foreign reserves at end-1984 had been equivalent to some SDR 200 million, or eight months' imports, the staff representative from the African Department noted. In 1985, there was likely to be a moderate, unalarming decline in reserves to the equivalent of six months' imports, a level that should be sufficient. In addition, Togo's membership in a regional currency union provided some built-in safeguards.

The staff representative from the Exchange and Trade Relations Department recalled that at the conclusion of the latest review of surveillance, the staff had been encouraged to experiment with abbreviated versions of reports on recent economic developments in member countries. Apparently a number of Executive Directors felt that, in the case of Togo, the usual, longer version of such reports was helpful.

The staff representative from the World Bank commented that the agricultural strategy had been at the core of Togo's two Bank-supported structural adjustment programs. Under the first program, substantial price adjustments had occurred, but most of them--particularly export crop prices--had basically compensated for past inflation. Accordingly, in 1979-84, prices had generally remained unchanged in real terms. The World Bank staff had concluded that a greater effort was needed if the authorities were to reach the GDP growth targets and restore creditworthiness. Under the second structural adjustment program--which was to be submitted for Bank Executive Board approval in the near future--additional price adjustments were to be made. However, it was important to bear in mind that price was not the only factor in the effort to restore positive economic growth and creditworthiness. Farmers were likely to feel an incentive to increase production only if real incomes increased over time. Therefore, the main objective was to sustain increases in real income over the coming five years. In recent years, price increases in real terms had resulted in an increase in real income of approximately 5 percent. The staff hoped that that rate would be accelerated in 1985 and maintained at that higher rate in the medium term. To that end, the staff and the authorities intended to negotiate by mid-1986 medium-term objectives for real producer price adjustments and productivity increases resulting from greater availability of extension services and inputs such as fertilizer and insecticides. The negotiations would probably take some time, and they would be based on the fact that producer prices would be an important element, but not the only one, in encouraging increased production.

A considerable part of the farm population was engaged in food crop production, the staff representative from the World Bank remarked. In some areas, particularly in the southern cotton zones, food crops were produced together with export crops. In other areas, particularly dry farming zones, food crops alone were produced. The Government felt that food crops were a major source of potential economic growth and that the country should be basically self-sufficient in food supply in the medium term. The authorities were reluctant to liberalize food exports because they were worried that, in certain circumstances, a relatively large consumer such as Nigeria or Ghana could quickly consume Togo's food stocks. But the staff had been assured by the authorities that they intended to liberalize progressively food crop exports in line with food crop output increases due to structural improvements, better extension services, and increased availability of fertilizers, insecticides, and feeder roads. The authorities had stated their intention to gradually increase the licensing of foodstuffs. They had already done so in 1985 as a result of the relatively large surpluses, and the staff expected them to continue the liberalization effort in the coming period. As a part of the liberalization effort, the authorities had undertaken not to increase stocks of grain in excess of 10,000 tons. Moreover, the authorities intended to intervene in the grain market only on the market's very low and very high sides. Accordingly, the Government would furnish grain only in a crisis, and it would purchase grain only when prices were very low; even then, the limit on government stocks of 10,000 tons would remain in effect. The goal was to increase the volume of grain held in the private sector.

The food crop sector was a particularly difficult one, and the staff believed that the approach he had described had a reasonable chance of permitting a steady expansion of food crop farmers' real income and of food crop output, the staff representative from the World Bank went on. Recent developments in cotton production underscored the potential positive effect of price increases on output: the rate of increase in cotton prices had exceeded the rate of inflation while cotton output had risen from 15,000 tons in 1980 to 50,000 tons in 1984. The enlarged production had been due partly to the expanded acreage of cotton farms and to productivity increases, but it had not taken place at the expense of food crop output, which had been gradually increasing.

The phosphoric acid project probably could not be launched before 1990, the staff representative from the World Bank said. The feasibility study commissioned by the Government and the World Bank indicated that unless the prices of phosphoric acid and phosphate were to rise above the current level, the project was unlikely to be viable. World market conditions for phosphoric acid and phosphate were not improving, and the authorities had to consider the best strategy for the relative use and production of phosphate and phosphoric acid. In any event, the estimated cost of the project--$550 million--would not substantially increase Togo's public foreign debt; there would be no public guarantees or public financing for the project. The public sector's participation in the project would be restricted to the construction of the plant and the related infrastructure. In addition, the price at which the Government would sell phosphate to the operators of the new plant would have to be negotiated.

Given the number of uncertainties about the phosphoric acid project, the prospects for it were not promising, the staff representative from the World Bank said. The Government was proceeding with its investigation of the project, including possible private participation. Taking the project into account would of course cause a sharp increase in the external current account deficit forecast for the likely construction period, 1990-92. Moreover, the operation of the plant would result in an increase of about 2 percentage points in the GDP growth rate. The present projections were based on the assumption that economic growth would be driven essentially by the agricultural sector in general, and by coffee, cocoa, and cotton in particular. Coffee and cotton would be especially important in the immediate future, since the cocoa sector required substantial rehabilitation.

Mr. Templeman commented that the staff representative from the Exchange and Trade Relations Department had usefully recalled that during the previous discussion on surveillance the Executive Directors had underscored the need for the staff to concentrate its time and resources on priority matters. In that connection, Executive Directors had suggested conducting experiments with a view to saving time on the preparation of reports on recent economic developments in member countries. He was not certain whether Togo was the best country for such an experiment, but the staff certainly should not be discouraged from conducting further experiments.

Mr. de Maulde said that in principle he agreed with Mr. Templeman. During the discussion on surveillance, Executive Directors had said that shorter reports on recent economic developments would not be appropriate for countries that, for reasons of their own, had a special preference for full staff reports on recent economic developments in those countries. Togo seemed to be such a country.

Mr. Doe noted that the contract with Ghana on the supply of electricity was due to expire at end-1987, and the terms on which it would be renegotiated were not known. It was useful to recall that one of the reasons for the increase in expenditure forecast in 1984, at the time of the midterm review under the stand-by arrangement, was the need to buy equipment to generate more electricity after the cut in Ghana's supply to Togo owing to the drought in Ghana. Moreover, the Nangbeto project was designed not only to supply electricity but also to store water for irrigation purposes.

The authorities were greatly concerned about the decline in GDP over the previous four years, Mr. Doe commented. Real GDP had declined by a cumulative 13 percent in those years, when significant adjustments had been made in both the fiscal and external sectors. The improvement in both those sectors would certainly have been stronger and more visible if economic activity had been less depressed. The authorities had that conclusion in mind in organizing the Donors' Conference to be held June 26-28, 1985, when they hoped to secure additional funds to finance investment projects and stimulate growth in coming years.

The Acting Chairman made the following summing up:

Executive Directors agreed with the thrust of the views expressed in the staff appraisal for the 1985 Article IV consultation with Togo. Directors welcomed the continued adjustment efforts and the positive results achieved by the Togolese authorities. They noted that after the important turnaround in 1983, impressive further progress had been made under the 1984 financial program in stabilizing the financial situation while making needed structural adjustments. In particular, Directors commended the authorities for the continued restraint in current expenditure, especially personnel expenditure, which was lower than programmed. This restraint, underpinned by strengthened expenditure controls, had enabled the Government to reduce the fiscal deficit even more than targeted under the revised program while strongly reducing the domestic payments arrears. The reduction in the external current account deficit in 1984 and the improvement in the overall external position were warmly welcomed. Directors expressed concern about the significant and continuing decline of real GDP in recent years, which was, however, due largely to exogenous factors. They noted that the Togolese economy continued in 1984 to be adversely affected by the decline in regional trade, which led to a further reduction in per capita income and to a shortfall in budget revenue.

Directors expressed concern about the expected deterioration in the balance of payments in 1985 and also the unfavorable medium-term prospects for Togo's balance of payments on account of the high debt service obligations and urged the authorities to persevere with their adjustment efforts. Emphasis was placed on strengthening supply-side and structural measures aimed at stimulating growth in exports and broadening the tax base. In this respect, Directors welcomed the structural adjustment policies being implemented by Togo with the support of the World Bank, and they encouraged continued close cooperation between the staff of the Fund and the Bank with regard to Togo. Directors noted, in particular, that further progress had been made in restructuring public enterprises and stressed the urgency of forceful action in this sector so as to reduce the financial burden which it constitutes for the budget. With regard to agricultural policy, Directors welcomed the considerable increases in agricultural producer prices granted in recent years, permitting a real rise in rural incomes. They noted that there was, however, room for further increases in producer prices for certain export crops in order to bring these prices in line with market prices in the region. Directors also called for prompt decisions on other measures to promote agricultural exports, production, and development. Particular importance was attached to reducing restrictions on exports. Directors also emphasized the importance of careful investment programming with appropriate emphasis on agricultural development and infrastructure development, such as hydroelectric power. The need for improvement in the mechanisms for credit allocation to the productive sectors and an interest rate policy was also mentioned by some Directors.

Directors cautioned, however, that even with continued financial and structural adjustment efforts by Togo, the medium-term outlook remained worrisome and that debt rescheduling would be required for several more years. In this respect, they urged creditors to continue their generous support of Togo's adjustment efforts through appropriate debt reschedulings, and they expressed the hope that the forthcoming Donors' Conference would result in increased flows of concessionary assistance to Togo.

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

The Executive Directors then took the following decisions:

Decision Concluding 1985 Article XIV Consultation

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

2. The Fund notes with satisfaction that Togo continues to maintain an exchange system which is free of restrictions on payments and transfers for current international transactions.

Decision No. 7975-(85/74), adopted
May 17, 1985

Stand-By Arrangement

1. The Government of Togo has requested a stand-by arrangement in an amount equivalent to SDR 15.36 million for a period of 12 months from May 17, 1985 through May 16, 1986.

2. The Fund approves the stand-by arrangement set forth in EBS/85/94, Supplement 2.

3. The Fund waives the limitation in Article V, Section 3(b)(iii).

Decision No. 7976-(85/74), adopted
May 17, 1985

2. GREECE - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered 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 report on recent economic developments in Greece (SM/85/122, 5/3/85).

Mr. Coumbis made the following statement:

> My authorities would like to express their appreciation to the staff for the high quality of the consultation reports. My authorities attach great importance to the discussions held with the mission in Athens which have provided an excellent opportunity to exchange views and evaluate the state of the Greek economy. The Greek authorities generally do not disagree with the staff's assessment of the current economic situation and of the key policy priorities. There are however some differences in the relative importance attached by the staff and the authorities to the long-term structural problems compared with the short-term difficulties reflected in the financial imbalances of the Greek economy.
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> In 1984, the Greek economy experienced a moderate recovery in economic activity after a protracted period of stagnation. GDP at factor cost increased by 2.8 percent compared with a growth rate of 0.3 percent in 1983 and minus 0.1 percent in 1982. On the supply side the recovery was broadly based and was manifested in a pickup of activity in all sectors. Specifically, agricultural output increased by 6.4 percent, manufacturing output by 1.9 percent, and the output of the services sector by 2.8 percent. It is noteworthy that manufacturing output in 1984 rose by 1.9 percent compared with an average growth rate of minus 2.2 percent for the previous three years and virtual stagnation in 1980. On the demand side, the recovery was based on increased domestic consumption and a higher rate of export growth. On the other hand, investment activity was weak due primarily to a further decline in private investment. These developments were the combined result of a substantial drop in private investment in housing and transport equipment which could not be offset by the significant increase in agricultural investment and, for the first time after three years of decline, the modest increase in manufacturing investment. In 1984, inflation decelerated to 18.5 percent compared with 20.2 percent in 1983, 21 percent in 1982, and 24.5 percent in 1981. At the same time, the rate of increase in unemployment slowed while the downward trend of employment in the manufacturing sector was reversed.
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> The public sector borrowing requirement in 1984 reached 15.5 percent of GDP, which was higher than the initial forecast. The higher than planned deficit of the Central Government was not a consequence of either a tax revenue shortfall or a current

expenditure overrun relative to the initial budget estimates. Instead, it was mainly the result of the increase in treasury bill rates by 2.75 points in early 1984, the unanticipated higher interest payments due to the appreciation of the dollar, and the deficit of the petroleum account due to the partial adjustment of domestic oil prices. These factors account for Dr 94 billion or 73 percent of the recorded overrun in the government deficit.

Monetary and credit aggregates grew faster in 1984 than in 1983. Broad money (M-3) increased by 29.4 percent in 1984 due to the rise in bank deposit rates in early 1984, the continuing slackness in housing investment, and the higher than initially forecast growth rate of GDP. It must be noted, however, that M-3 in Greece does not exhibit the same degree of liquidity as analogous monetary aggregates in other countries because, in the absence of well-developed monetary and capital markets, bank deposits represent private savings of a more or less stable, and thus less liquid, nature. Finally, bank credit to the private sector increased by 20.7 percent compared with an initial target of 18 percent. The overshooting was due primarily to the specialized credit institutions for housing and agricultural loans while credit expansion by commercial banks was only marginally above target, given the rate of increase of nominal GDP and the liquidity problems faced by many private firms. These developments do not reflect an overly accommodating credit policy.

The current account deficit reached $2,182 million, which was higher than the initial estimate. The deterioration was due to a further reduction of the invisibles surplus, especially a decline in shipping receipts and emigrants' remittances, while the trade balance deficit was in fact slightly lower than in 1983 despite an increase in net oil imports as a proportion of GDP. The current account deficit was 6.5 percent in 1984 compared with 5.4 percent in 1983, 4.9 percent in 1982, 6.6 percent in 1981, and 5.5 percent in 1980.

The observed imbalances of the Greek economy in 1984 should not be seen as the result of a change in the policy stance but rather as the reflection of the long-standing structural weaknesses of the economy.

The structural problems of the Greek economy are primarily manifested in three areas: investment activity, the balance of payments, and the structure of public finances. In all cases the weaknesses are basically the consequence of the pattern of economic growth and of development policies adopted in the early 1950s. In particular, the virtual stagnation in business investment since 1979 largely reflects the low productivity and poor profitability of manufacturing firms during that period. The manufacturing sector was traditionally characterized by excessive protection and subsidization which permitted its growth so long as domestic and foreign demand increased at a fast rate. The relative high rate of industrial growth was not accompanied by the necessary restructuring of the manufacturing sector dictated by changing domestic and international economic conditions. In particular, during the 1970s the necessary adjustments in the manufacturing sector were inadequate, while excessive bank financing at subsidized rates led to unsustainable debt/equity ratios for most industrial firms. Those accumulated structural problems became more acute following Greece's accession to the European Communities (EC) in the early 1980s.

Greece's balance of payments has traditionally registered chronic current account deficits. The structural problems in the country's balance of payments can be attributed to a number of factors: first, the low ratio of merchandise exports to imports, which in the past ten years has on average been less than 50 percent; second, the high dependence on earnings from invisibles, which are very sensitive to external economic conditions. The invisibles' surplus has corresponded to about 68 percent of the trade deficit in the past ten years but has shown a declining trend in the recent past; and third, the reliance on traditionally significant autonomous capital inflows, which has contributed to a relatively low need for external borrowing.

The structural problems in Greece's balance of payments have led to relatively high current account deficits in the past several years which, combined with a declining trend in autonomous capital inflows, have resulted in a considerable increase in the country's external debt. It is important to note, however, that the adverse developments in the current account are largely the result of a deterioration in the invisibles' surplus, which declined by $4.5 billion in 1980 to $3.2 billion in 1984. The slow recovery in Western Europe, the world shipping crisis, temporary exchange restrictions by France and Yugoslavia, and a secular decline in emigrants' remittances are the principal factors behind this deterioration. On the other hand, the non-oil trade deficit during the same period has actually declined in absolute terms from $4.1 billion in 1980 to $3.2 billion in 1984. If it were not for the "entrance shock" and the import penetration of EC products, the improvement in the non-oil trade deficit during the 1980s would have been greater.

Structural problems exist in the area of public finances. On the revenue side, income tax is characterized by a narrow tax base and by considerable tax evasion while indirect taxes comprise a complicated system with cascading effects on prices. Indirect taxes constitute by far the largest part of total tax revenue. On the expenditure side, there is a pervasive and cost-ineffective system of subsidies. Overall, it may be argued that the sizable budget deficits of the past five years are not only the result of expansionary fiscal policies but are also to a considerable extent due to structural factors reflecting built-in rigidities and accumulated inefficiencies in the fiscal system.

Despite the predominant role played by those structural problems, it is clear that the financial imbalances in the Greek economy can also be attributed to the macroeconomic policies pursued since the mid-1970s. In particular, as a rule both fiscal and monetary policies have been expansionary, leading to increased inflationary pressures and rising inflationary expectations. Since 1982, the stance of economic policy has changed in favor of stabilization and efforts to modernize the structure of the economy. This effort has been particularly evident in the area of monetary policy. In the move toward positive real interest rates the authorities consolidated the interest rate structure by abolishing several extremely low lending rates and raising most deposit rates. An equally important step toward a more rational interest rate structure was the significant increase in the treasury bill rate and the interest rate at which public entities can borrow to rates that reflect market conditions. Finally, there has been significant progress toward the simplification and rationalization of credit policy rules with a view to enhancing the role of commercial banks.

In the area of exchange rate policy, the basic objective during the past two years has been to maintain and if possible to improve the competitiveness of Greek exports, without exacerbating the domestic inflationary pressures. Thus, after appreciating by 3.8 percent in 1981 and 3.9 percent in 1982, the trade-weighted real effective exchange rate of the drachma, as measured by relative consumer prices, declined by 7.7 percent in 1983 and 3.0 percent in 1984. The authorities, however, believe that in the long run the competitivess of Greek exports can be maintained only through structural changes in the industrial sector, the containment of inflationary pressures, and the mitigation of factors that feed back into the inflationary process.

Many of the measures taken in the context of structural reform had a short-term cost reflected in the temporary accentuation of financial imbalances. For example, the larger cost of public debt servicing due to the higher interest rates on treasury bills had an undesirable effect on domestic credit expansion. However, the rise in interest rates on treasury bills is viewed by the authorities as a temporary side effect of a positive development which aims at limiting the degree of monetization of the public debt. In general, the authorities believe that increasing interest rates toward real positive levels may be considered an important mechanism of self-discipline within the economic system leading toward an improved allocation of resources and enhancing the role of market forces. Nevertheless, although there has been a moderate recovery of the economy and a modest slowdown on inflation in 1984, the Greek economy exhibited significant financial imbalances, namely a higher public sector borrowing requirement (PSBR) and a higher current account deficit than originally expected. Although these developments can be attributed in part to unexpected circumstances and to reversible factors related to the short-term costs of the necessary structural reforms, the Greek authorities are aware that such imbalances should be corrected.

Recognizing that the current account deficit constitutes a major policy constraint, and considering the overall framework of gradualism in the combination of stabilization and development objectives, my authorities see the need for speeding up the short-term stabilization efforts of economic policy. In accordance with the targets of the five-year development plan, the necessary measures will be taken in order to reduce the rate of inflation, and to reduce the PSBR and the current account deficit as a percent of GDP. As regards monetary policy, the authorities are determined to pursue nonaccommodating credit expansion and to ensure that nominal magnitudes increase at rates compatible with the expansion of domestic supply and the targeted slowdown of inflation. In the area of fiscal policy, the authorities intend to rationalize the structure of public finances. In particular, the introduction of a value-added tax in 1986 will be a major reform of the tax system and is expected to increase the elasticity of revenues, further enlarge the income tax base, and further reduce tax evasion. In addition, 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 general, the Greek authorities appreciate the need for, and are determined to set, more ambitious stabilization targets in the coming years in order to alleviate the external constraint and to pave the way for a sustainable and noninflationary recovery of the economy.

In conclusion, the Greek authorities would like to stress that they have benefited a great deal from the constructive approach to the consultation discussions taken by the staff mission and that they have appreciated the candid way it presented its views and advice.

Mr. Goos remarked that despite the improvements in the economy in 1984, the overall situation remained serious. That did not come as a complete surprise. During the 1983 and 1984 Article IV consultations with Greece, Executive Directors had expressed doubts about the adequacy of the authorities' general policy approach, particularly in light of the size of the domestic and external imbalances. That the authorities had failed to meet even their moderate adjustment targets in 1984 was disappointing. Indeed, there were indications that the major problems facing the economy had worsened. For example, the deficits of the public sector and the external current account had reached historic peaks, the foreign debt had increased dramatically, and private investment had been declining at a worrying rate. Moreover, he doubted whether the recent slowing of price increases reflected an abatement of underlying inflationary pressures; there were indications that the slowdown in inflation was due largely to price controls, which had a dampening effect on imports.

The authorities' gradualist approach had clearly failed, and it was difficult to understand why they were still reluctant to adopt a more appropriate adjustment strategy, Mr. Goos said. After all, the pressure on the Greek economy to adjust was bound to increase in proportion to other EC members' success in further stabilizing their economies. There was an urgent need for decisive changes in virtually all areas of economic policy in Greece. The changes should be implemented without delay and designed to create a sound economic basis for achieving the modernization and restructuring of the Greek economy that was crucial to improving the country's medium-term prospects. In that context, he fully endorsed the policy course recommended by the staff. The staff's views were clear and apparently shared to a large extent by the authorities in the Bank of Greece. The staff's recommendations included numerous corrective actions that might considerably conflict with the authorities' short-term objectives, but the actions were commensurate with the diversity and severity of the underlying distortions in the economy. Highest priority should be given to reducing the public sector deficit, containing wage pressures, and phasing out wage indexation. Those measures, if accompanied by a sufficient degree of monetary restraint, should go a long way toward improving the climate for private investment and reducing the external imbalances.

Exchange rate policy was addressed only vaguely in the staff report, Mr. Goos continued. During the discussions on Greece in 1984, his chair had agreed that Greece's international competitiveness should preferably be maintained by containing domestic cost and price pressures. Moreover, if the rate of inflation in Greece were to continue at a rate considerably higher than the average rate of other EC member countries, exchange rate policy would have to be geared strictly toward reducing the external imbalances. It remained to be seen whether that requirement could be met by the modest real depreciation in 1985 envisaged by the authorities. In any event, should a larger depreciation become necessary, the resulting intensification of inflationary pressures in Greece would have to be contained by appropriate fiscal, monetary, and incomes policies. Finally, he supported the staff's recommendation that the authorities improve the reliability and currentness of their macroeconomic data in order to permit effective monitoring and analysis of the economy.

Mr. Templeman recalled that during the previous discussion on Greece, his chair had noted that the gradualist approach to economic adjustment adopted by the authorities in 1982 had not been having the desired effect. The present staff report confirmed that conclusion.

Moreover, the medium-term strategy in the five-year plan (1983-87) did not seem to be ambitious, and the performance under the plan apparently had already fallen short of expectations in several areas: the desired shift in the composition of expenditure from consumption toward investment and exports; the diversification of exports--especially toward high-technology exports; and the decentralization and rationalization of the public sector.

The performance in 1984 was mixed and in many respects disappointing, Mr. Templeman went on. Real GDP growth had recovered to 2.6 percent, compared with 0.3 percent in 1983, and exports had made a good contribution to growth, but private investment had continued to decline steadily. While the rate of inflation had decelerated somewhat, it had remained well above the rate in most other OECD countries. Moreover, developments in the fiscal, monetary, and balance of payments areas had been disappointing: the net public sector borrowing requirement on a cash basis had risen from 11.7 percent of GNP in 1983 to 15.5 percent in 1984; domestic credit expansion and the growth of M-3 had substantially exceeded the targets; and the external current account deficit had risen to 6.6 percent of GNP. Furthermore, the staff had expressed doubts about the likelihood of Greece's achieving its 1985 targets for both the fiscal and current account deficits.

Over the long run, realistic price signals throughout the economy would be essential, Mr. Templeman said. There was some doubt about the adequacy of the price of foreign exchange. The real effective exchange rate, based on relative consumer prices, had depreciated from the high reached in late 1982, but the picture was less comforting when the real effective rate was calculated on the basis of comparative unit labor costs. The staff could usefully comment further on that matter.

While some progress had been made toward reaching positive real interest rates, the savings and time deposit rates shown in Table 43 of SM/85/122 were still negative, Mr. Templeman observed. Moreover, after dropping sharply in nominal terms in 1983, wage rates had reaccelerated in 1984, and the prospects for wage restraint in the coming period were overshadowed by the continuation of the wage indexation system. In addition, adjustments in prices of publicly produced goods and services had been delayed, and price controls on some privately produced goods remained in effect. In sum, he thought that pricing signals were still significantly impeded in fully playing their role as an efficient means of resource allocation.

The staff doubted whether a shift toward exports and investment could take place in the face of rising real consumption and falling profits, Mr. Templeman noted. While reliable data on profits apparently were lacking, the continuous and rapidly rising labor costs, price controls, and labor market rigidities were bound to have discouraged private investment and job creation. Indeed, real fixed private investment had on average fallen more than 8 1/2 percent over the previous four years and the rate of unemployment had risen steadily to over 8 percent in 1984.

Since the general government sector had been generating negative savings during the previous several years of 5 percent or more of GNP and business profits had been very weak, all the burden of financing investment was falling on the household sector and foreign savings. The continued high nominal interest rates reflected the rapid rate of inflation and acted as a disincentive to investment by highly leveraged private Greek business. At the same time, real rates of interest on savings deposits were still negative.

He shared the staff's concern about the slow pace of price deceleration and the negative effects of the wage indexation system, Mr. Templeman remarked. He wondered whether there were any plans to modify the system. The staff's doubt about the realism of the 16 percent inflation target for 1985 and the indication that real wages of civil servants might rise by 5-6 percent were not encouraging. The planned continuation of price controls would also pose an obstacle to improving business profitability and to decreasing inflationary expectations.

The very large fiscal deficits also had constituted a serious obstacle to both the recovery of real economic growth and the achievement of price stability, as the rapid growth of real public consumption and public investment had been pre-empting resources for exports and private investment, while the deficits had been a cause of large-scale monetary expansion, Mr. Templeman commented. The central government tax burden was expected to be equivalent to 29 percent of GNP in 1985, compared with 21 percent in 1981. Furthermore, the planned reduction in the fiscal deficits was to be achieved mainly through the growth of revenues, an approach that contrasted with the one being employed in many other industrial countries. However, the recent cut in personal income tax rates in Greece and the plan to increase revenues by broadening the tax base--by eliminating some exemptions and improving tax collections--suggested that the authorities were aware of the danger that an excessive tax burden could create disincentives to savings and work. A further comment on the likely heavy reliance on improved tax collections would be helpful.

The ratio of government expenditure to GNP was expected to be nearly 40 percent in 1985, compared with 33 percent in 1981, Mr. Templeman continued. Apparently there was still room to reduce both current expenditures--especially subsidies--and the public enterprises' growing deficits. The rapid growth of public investment probably was not filling the gap created by the inadequate private investment; indeed, it might well be impeding the recovery of private investment. The public sector had been a substantial source of demand for credit; it had accounted for nearly 48 percent of all domestic credit outstanding at end-1984 and about two thirds in recent months.

The pressure generated by the fiscal deficits had clearly contributed to the substantial overshooting in 1984 of the targets for domestic credit expansion, credit to the Government, and M-3, Mr. Templeman commented. However, some useful monetary and financial reforms had been undertaken. For example, real interest rates had been increased, penalty rates on overdrafts with the central bank had been applied more consistently, and global limits had been substituted for the sectoral limits on credit extended by the Agricultural Bank and the National Mortgage Bank. The sale of treasury bills to the nonbank private sector should also be useful, although there was some danger that facilitating the financing of fiscal deficits through that new instrument could undercut the achievement of the more fundamental goal of reducing the deficits.

That the ratio of the external current account deficit to GNP had not declined was disappointing, Mr. Templeman said. It had fluctuated between 5 percent and 6 1/2 percent of GNP since 1981 and was expected to remain within that range in 1985. Financing the deficit had not caused serious problems, but the rapid growth of the foreign debt--which had doubled in 1979-84--would invariably weaken confidence in Greece's creditworthiness. In fact, long-term private capital inflows had been steadily declining, and the errors and omissions item of the balance of payments had been persistently negative. Moreover, official borrowing--including borrowing by the public enterprises and the Bank of Greece--had grown rapidly in recent years. It would be interesting to know the shares in total foreign borrowing of compensatory balance of payments financing and investment project financing. While the foreign debt ratio was modest, the staff's projections suggested that the ratio would be reduced only a little or might even increase over the rest of the 1980s.

The authorities' use of a variety of direct and indirect export subsidies was a cause for concern, Mr. Templeman commented. Such subsidies could not improve the country's competitiveness but did distort trade and burden the budget. He wondered whether the subsidies were to be removed following the introduction of the value-added tax in 1986.

He remained quite concerned about developments in the Greek economy and about the prospects for achieving even the authorities' fairly modest economic targets, Mr. Templeman concluded. Developments over the previous year had not been reassuring. Greece played an important role in the international economy, and the success of its adjustment effort was important not only to Greece but also to the world community. He hoped that the authorities would make a renewed effort to correct the difficult problems facing the economy.

Mr. Schneider remarked that as a result of various political and economic constraints and the long-standing structural problems in the economy the authorities had opted for a gradualist approach to adjustment. However, that approach apparently had been excessively gradual, as the economic situation had barely improved since the previous Article IV consultation with Greece; indeed, the latest data indicated that developments in certain areas in 1984 had been even more adverse than the previous data had suggested.

The economy continued to suffer from slow growth, a relatively high rate of inflation, sizable fiscal and external deficits, and growing domestic and external debt, Mr. Schneider noted. Given the urgent need to speed up the adjustment effort, substantially improve the balance of payments, reduce the public sector deficit, and improve the competitiveness of the economy, developments in 1984 had not been encouraging.

A more active exchange rate policy could reverse the deterioration in the balance of payments by reducing the basic inflation differential between Greece and its main trading partners, thereby improving the economy's competitiveness, Mr. Schneider continued. However, as Mr. Coumbis had noted in his opening statement, the authorities had placed little emphasis on exchange rate policy as a means of improving the competitiveness of Greek exports. They believed that, over the long run, competitiveness could be improved by making structural changes and by containing inflationary pressures. Tight monetary and fiscal policies together with radical structural changes in the economy were of crucial importance if the exchange rate were to be the basic means of maintaining competitiveness. In that context, the wage indexation scheme was a central issue. He agreed with the staff that the present scheme reduced the chances for achieving a rapid decline in inflation and inflationary expectations. The link between inflation and the real depreciation of the currency could be broken only by phasing out the wage indexation system.

There had been a moderate recovery in economic activity in 1984, Mr. Schneider commented. Real GDP at market prices had grown by 2.6 percent, the external balance apparently having contributed 2.1 percentage points. In that connection, the data in Tables 2 and 5 of SM/85/116, Supplement 1, and in Tables 2 and 48 of SM/85/122 were difficult to interpret. The revised export figures in Table 2 of SM/85/116, Supplement 1 were lower, and the import figures higher, than the relevant data in Table 48 of SM/85/122, which implied a smaller contribution of the external balance to GDP growth than the 2.1 percentage points shown in Table 5 of SM/85/116, Supplement 1; in Table 2 of SM/85/122 the relevant figure was 1.3 percentage points. Moreover, the data on net factor income from abroad in 1980-83 had been revised in Supplement 1, a change that would of course affect the GNP growth rates in those years. The staff should comment on those discrepancies.

The increase in domestic consumption--mainly public consumption--had exceeded the increase in total domestic demand since 1981, thereby adversely affecting the savings capacity of the economy, Mr. Schneider remarked. As the staff had noted, to achieve the two main objectives--reducing the external current account deficit by about 3 percent of GDP and increasing investment's share by 2 percent--of the five-year plan by 1987, domestic savings should increase by the equivalent of about 5 percent of GDP over the previous level of about 16 percent. That objective could be achieved only by curtailing consumption--mainly public consumption--and the authorities' intention to emphasize public investment at the expense of public consumption was therefore welcome.

Although the monetary and credit aggregates had grown faster than expected, there had been some tightening of monetary policy in 1984, as interest rates had been increased and the attractiveness of treasury bills had been enhanced, Mr. Schneider commented. Because of the slight decline in inflation, together with the increase in the interest rates on savings accounts, the yield on long-term deposits had become positive in 1984, a development that was certainly welcome. However, if the wholesale price index were used instead of consumer prices in making the relevant calculation, it appeared that all categories of deposit and lending rates had remained negative in real terms in 1984. The staff should comment on whether or not those interest rates reflected market conditions.

The increase in reserve money and in the rate of inflation did not seem to be closely interrelated in Greece, Mr. Schneider remarked. Reserve money had grown by 42.9 percent in 1981, 27.5 percent in 1982, 9.8 percent in 1983, and 29.5 percent in 1984, while the rate of inflation had declined from 24 percent in 1981 to 18.5 percent in 1984.

Foreign exchange deposits held by Greek residents and workers abroad had amounted to about $5.5 billion at end-1984, Mr. Schneider noted. He wondered whether those deposits were subject to a reserve requirement. If so, a further comment on that requirement would be helpful. If they were not subject to a reserve requirement, the staff should comment on the impact of the deposits on the monetary aggregates.

Greece's external debt had been growing since 1979, Mr. Schneider remarked. The maturity structure of the debt was well balanced, but the debt service burden would become increasingly onerous in coming years; substantial efforts to improve the current account position should therefore be given the highest priority.

He agreed with the staff that in light of the revisions of the data for 1984, some of the objectives for 1985 seemed excessively ambitious, Mr. Schneider commented. Elections were to be held in 1985, and he hoped that the imbalances in the economy would not increase in that year. Finally, the proposed deviation from the 12-month Article IV consultation cycle presumably was a one-time-only change in order to permit future consultations to be held in May of each year.

Mr. Polak said that he fully agreed with the staff appraisal, in which the staff had noted that developments in 1984 compared unfavorably with those in 1982 and 1983. The administration that took office after the coming elections would have to make a drastic shift in policies. The present discussion was propitious, as it would give the new administration the Fund's latest views on the Greek economy.

The authorities' gradualist approach to adjustment clearly was not sufficient to achieve the necessary reduction in the internal and external imbalances, Mr. Polak continued. In 1981 and 1982 the external current account deficit had been equivalent on average to 5.7 percent of GNP. In 1983 and 1984 the deficit had increased to 6 percent despite developments that should have helped the current account, namely, the decline in investment, the improvement in the oil trade balance, and the increase in EC transfers. As a result of the growing current account deficit, the external debt had continued to increase strongly, from 22 percent of GNP in 1981 to 38 percent in 1984. Moreover, the public sector borrowing requirement had remained large--13.4 percent of GNP--in 1981-84 and the staff had estimated that if no progress were made in reducing the external current account deficit, the external borrowing requirement would rise to the range of $2.5-3.5 billion a year in coming years. The authorities should heed the staff's warning that foreign commercial banks might well hesitate to increase their exposure in Greece, particularly in light of their recent experience in other countries and of strengthened banking supervision abroad. In the circumstances, achieving the goal of reducing the external current account deficit to 3 1/2 percent of GNP in 1987 was essential.

The large external deficit was a symptom of the authorities' demand management position and the high rate of inflation in Greece, Mr. Polak commented. The excessive wage increases in the late 1970s had not been corrected and, given the consequent reduced profitability, the badly needed upturn in investment was unlikely to occur. The immediate cause of the inflation in Greece was the excessive money creation, which in turn was traceable to the fact that monetary policy had been subordinated to the requirements of the budget, including the Bank of Greece's large financing of the budget deficit in 1984. In line with their overall approach to demand management, the authorities were stressing the importance of reducing current expenditures. In that context, he wondered whether the large structural increase in public sector real wages envisaged by the authorities was appropriate. Broad measures to reduce the rate of inflation were clearly necessary, for example, further development of the financial markets to permit more nonmonetary financing of the budget, an increase in real interest rates, and changes in the wage indexation system. Otherwise, the benefits of the real effective depreciation of the drachma would be short lived.

The authorities were emphasizing the need to address the structural problems facing the economy, Mr. Polak observed. Such changes were clearly needed to raise the level of incomes in Greece. But the need to address structural problems was not an acceptable reason for failing to correct the macroeconomic policies that had caused the existing imbalances, and the fact that that view had been expressed by authoritative persons in Greece was encouraging. The latest annual report of the Bank of Greece contained a blueprint for the kind of stabilization plan that was urgently required. The report mentioned that "a coordinated economic stabilization process dictated by the need to curtail internal and external imbalances, far from being incompatible with medium-term strategy, can ultimately lead to faster self-contained economic growth.... International experience has shown that the sooner the required adjustment, the smaller its short-term cost compared with its long-term economic benefits." He fully agreed with those conclusions.

Mr. Pérez remarked that while there had been some favorable developments in the Greek economy in 1984, the overall performance had been disappointing. The roots of the problems facing the economy were much deeper than had previously been thought, and the authorities' policy framework should be more realistic if excessively optimistic projections were to be avoided. In that connection, the effects of EC membership on Greece--including the potential distortions in the implementation of policies in Greece--were a cause for concern; a further comment by the staff would be helpful.

The increase in the public sector borrowing requirement in 1984 to the equivalent of 15.5 percent of GNP was worrying, Mr. Pérez said. The absence of specific targets for that requirement in the five-year program--the general policy framework for the medium term--was surprising. In any event, there were contradictions between the program targets and the projections for 1985. For example, ordinary budget expenditures were projected to increase more rapidly in 1985 than expenditures under the public investment budget. Moreover, the authorities' statement that there was little scope for reducing the level of government expenditure was worrying, given the already high ratio of such expenditure to GNP.

The authorities' decision to reduce subsidies and to introduce measures designed to cut the borrowing requirement of public enterprises would promote greater transparency and eliminate rigidities in the economy, Mr. Pérez continued. Another major positive development was the plan to introduce a value-added tax in January 1986; he asked the staff to comment on the expected effect of the new tax. He wondered whether the staff believed that fiscal policy management was biased in favor of increasing revenue rather than reducing expenditure.

The recently introduced monetary measures seemed more consistent than the fiscal measures with the authorities' macroeconomic targets, Mr. Pérez commented. Promoting the domestic financial system by developing a market for treasury bills was fully appropriate and was a key part of the effort to rationalize the credit system. The new arrangements for financing the two major credit institutions would alleviate the financial burden on the Bank of Greece and would enable the monetary authorities to increase the effectiveness of monetary control to avoid the overshooting that had occurred in 1984, thereby removing an important obstacle to reducing the rate of inflation.

While the indexation system could conceivably help to reduce inflationary expectations, it might well limit the potential benefits of the counterinflation effort, Mr. Pérez remarked. Real wages had risen by 4 percent in 1984, and there was no need for further increases in real terms in 1985. He wondered whether the advantages of introducing a uniform civil service salary scale would offset the disadvantages of a 5-6 percent increase in real wages of public employees. In other words, was there any way of applying the new scale gradually, in order to moderate wages in 1985?

The staff should comment on the effects of Greece's EC membership on Greece's external sector in general, and on its trade in particular, Mr. Pérez said. Export subsidies had remained constant in 1984, and, given Greece's EC membership, he wondered whether they would continue to do so.

All measures aimed at eliminating structural rigidities in the Greek economy were welcome, Mr. Pérez stated. However, the recently adopted legislation in that area apparently had not significantly improved the economic situation in Greece, and it was not clear to him why the staff expected a 1 percent increase in private investment in 1985 after several years of highly negative rates of growth. The estimated decline of 12.1 percent in gross fixed investment in 1984 was discouraging.

Recently adopted legislation had not encouraged private investment as the authorities had hoped, and the planned government intervention to help less profitable firms was at the least dangerous, since, once such a process was initiated, it would be difficult to eliminate, Mr. Pérez commented. Moreover, the adverse effect on the public sector deficit of an increase in transfers to ailing enterprises could be substantial. Finally, he agreed with the staff appraisal and accepted the proposed decision.

Mr. de Maulde recalled that during the previous discussion on Greece he had expressed some sympathy for the approach of the Greek authorities, who had wished to proceed in a gradual manner toward solving the deep-rooted structural problems facing the economy. At the same time, however, given the two main constraints on the economy, namely, the high rate of inflation and the growing external debt, he had urged the authorities to adopt a more decisive policy course in at least two areas--the fiscal deficit and the cost of labor. He shared the staff's disappointment in the lack of progress in those two areas. The deficit of the ordinary and investment budgets had risen from Dr 289 billion in 1983 to Dr 389 billion in 1984. The deficit of the public sector enterprises had also increased. As a result, the net public sector borrowing requirement had risen, on a cash basis, from 11.3 percent of GDP in 1983 to 15.4 percent in 1984. The adjustment effort in Greece had clearly retrogressed.

The evolution of salaries was another cause for serious concern, Mr. de Maulde went on. The ratio of the wage bill to nonagricultural GDP had increased again in 1984, to about 57 percent. Moreover, unit labor costs in the manufacturing sector had increased 23.3 percent in 1984 in nominal terms and 5 percent in real terms. Those basic deficiencies in fiscal discipline and incomes restraint had caused a marked deterioration in the overall economic situation.

The external current account deficit had reached 6.5 percent of GNP in 1984, compared with 5.6 percent in 1983, Mr. de Maulde noted. He agreed with Mr. Coumbis that the deterioration might have been due partly to the decline in the invisibles' surplus, but he strongly doubted that what Mr. Coumbis had called the "temporary exchange restrictions by France" had had any damaging effects on Greece in 1984. A restriction on the availability of foreign exchange for tourist travel abroad introduced in France in the spring of 1983 had been removed at the end of 1983. His authorities and the staff agreed that that restriction, imposed for internal psychological reasons, had not been particularly useful. In any event, it could not explain the deterioration in Greece's external accounts in 1984. Indeed, as demand in France for Greek tourist services was traditionally strong and had apparently been pent up in 1983, it must have been particularly buoyant in 1984.

The increase in the external debt burden and the continuing high rate of inflation were worrying, Mr. de Maulde remarked. The rate had decelerated somewhat in 1984, to 18.4 percent, but much less rapidly than in the other EC countries.

Another major problem facing the economy was the weakness of private investment, which had fallen by 5 percent in 1984, 4.5 percent in 1983, and 6.3 percent in 1982, Mr. de Maulde continued. The problem was due partly to structural factors and reflected the low productivity and poor profitability of manufacturing firms in recent years, but a sounder macroeconomic environment, and particularly a smaller public sector deficit and a more appropriate pattern of behavior of incomes, would have avoided the decline in private investment. Such investment was essential to the future growth of the economy.

The authorities' policies in 1984 had resulted in a moderate rate of increase--2.8 percent--in real GNP, Mr. de Maulde noted. However, in the light of the growing disequilibria in the economy, it was clear that even that moderate improvement could not be repeated in 1985. The medium-term scenarios underscored the need to bring the Greek economy back on track. They clearly showed the need for a substantial decrease in the external current account deficit, given the rapid rise in amortization payments on existing external debt. A rapid deceleration in the rate of inflation was also urgently required, partly to reinforce external competitiveness. Priority should be given to narrowing the differential between the inflation rate in Greece and the average rate of inflation in the other EC countries. In that connection, the 16 percent rate of inflation expected in 1985 was entirely inappropriate.

Experience showed that if balance were to be restored to the external accounts and the rate of inflation were to be reduced, the authorities would have to implement coordinated and effective measures to affect the budget, income, and the exchange rate, Mr. de Maulde considered. He agreed with Mr. Coumbis that exceptional factors, such as the rise in interest rates and the appreciation of the U.S. dollar, might well explain part of the deterioration in the fiscal position, but there was still an urgent need to adopt measures to significantly reduce the fiscal deficit. Efforts should be made not only to cut expenditures, particularly current outlays and subsidies, but also to broaden the tax base, which was the narrowest of all the EC countries. In that connection, the plan to introduce a value-added tax in 1986 was very welcome. As to incomes policy, the authorities had explained that the resilience of inflation in 1985 had been due to the carryover effect from the inflation rate of the preceding years through the wage indexation system. The time was certainly ripe to move toward eliminating that backward-looking wage indexation; a first step might be to resort instead to a forward-looking system. In the exchange rate area, the present policy was on the right track. The slight depreciation of the drachma in 1984 had had positive effects on the economy. The authorities should maintain a flexible exchange rate policy, at least in the first stage of the adjustment process. Of course, the inflationary effects of any further depreciation of the exchange rate should be carefully offset.

The other EC members fully understood the problems facing the Greek economy, Mr. de Maulde remarked, as most of those countries had faced similar problems to various degrees and at different times. In tackling those problems, they had benefited from the help of and support from the other members of the European Communities, which would also be available to the Greek authorities once they had undertaken the urgently needed adjustment effort.

Mr. Ainley said that he agreed with the main points in the staff appraisal. In summing up the previous discussion on Greece (EBM/84/26, 2/17/84), the Chairman had noted that "most Directors considered that the seriousness of the present problems was such that more rapid and decisive adjustment action was required. The targets set for 1984 by the Government seemed inadequate and were not likely to be fulfilled by the present policies." The recent trends in inflation, unemployment, private investment, the fiscal and external accounts, and the debt service ratio showed that those concerns were fully warranted. Indeed, the adjustment effort had retrogressed, and the prospects for economic growth were uncertain.

That outcome had occurred mainly for two reasons, Mr. Ainley went on. First, as Mr. Coumbis had noted, the current problems were a reflection of long-standing structural weaknesses in the economy. Those weaknesses were well known, and the authorities had drawn up a commendable plan for correcting them. However, little progress apparently had been made in implementing the plan. That development was disappointing, as structural adjustment was crucial if Greece were to benefit fully from its EC membership. The authorities should be encouraged to accelerate the introduction of measures to modernize the industrial base and to strengthen the agricultural sector. Moreover, renewed efforts should be made to promote domestic private investment and to encourage private capital inflows, for example, by eliminating unnecessary controls and restrictions. Reviving investment would depend ultimately on restoring confidence which, in turn, required financial stability and sound policies to show that the economy was moving in the right direction.

The second reason for the problems facing the economy was the excessively gradual approach to adjustment, which had produced few tangible gains and, equally worrying, was undermining the authorities' medium-term strategy, Mr. Ainley commented. Mr. Coumbis's assurance that the authorities recognized the need to reverse recent policy slippages and to step up the stabilization effort was therefore welcome. Indeed, the introduction of a comprehensive set of anti-inflation policies was essential, given the magnitude of the imbalances in the economy. Incomes policy could have an important role to play in controlling inflation.

In practice, however, as experience in 1984 had shown, the present system of backward-looking indexation had limited the scope for reducing the rate of inflation. He recognized the political constraints on the authorities, but he hoped that they would adjust the indexation system along the lines suggested by the staff. Other European countries had made similar adjustments with encouraging results.

Priority also must be given to strengthening the public finances, Mr. Ainley considered. The authorities should act quickly to improve tax administration and broaden the tax base. On the expenditure side, the steps being taken to strengthen the financial position of the public enterprises were welcome. The adoption of more realistic pricing policies by those enterprises could help considerably to reduce the overall budget deficit. In addition, a tight fiscal policy was needed to permit the implementation of monetary policy to be effective, something that was difficult at present because of the large financing needs of the public sector. However, the recent efforts to diversify monetary policy instruments and to strengthen credit control were encouraging and should be continued.

The medium-term scenarios showed that a sharp reduction in the external current account deficit and a sustained increase in foreign exchange earnings were vital if the growing debt service burden were to remain manageable, Mr. Ainley concluded. He fully supported the authorities' efforts to promote and diversify exports, particularly the exports of small and medium-sized firms. A flexible exchange rate policy could contribute to the efforts to improve competitiveness, provided that it was supported by firm financial policies.

Mr. Leonard said that he agreed with the staff appraisal. He was pleased that the authorities concurred with the staff's assessment of the economic situation in Greece.

The Greek economy obviously was going through a difficult stage of adaptation to recent developments, Mr. Leonard commented. The problems facing the economy were due partly to past policies that had made the structure and operations of the economy and the attitudes of the main economic agents poorly suited to meet the current needs of the economy. Moreover, adaptations had had to be made to the conditions of EC membership, new world trading conditions, and changes in policy emphasis in the main industrial countries. For some time, the Greek authorities had been well aware of the need for such adaptations and had shown commendable readiness to define and accept the form they should take. Their attitude had been clearly reflected in their declarations of the objectives of demand management over the previous few years and in the structural goals under the Five-Year Plan for Economic and Social Development. The authorities' aims were also fully reflected in Mr. Coumbis's opening statement. Nevertheless, the progress toward meeting the stated policy objectives had been limited, and the concerns Executive Directors had expressed during the previous discussion on Greece about the strength and pace of adjustment had unfortunately proved well founded.

Instead of declining as a proportion of GNP, as forecast, the public sector borrowing requirement in 1984 had exceeded the 1983 level by more than 4 percent, Mr. Leonard went on. Such a slippage was disquieting, and the fact that it had taken place in the public sector suggested that the information base for policymaking was faulty, or that basic policies had been inadequate or their implementation insufficiently vigorous. In that connection, he had been surprised to read on page 10 of the staff report that the authorities considered that the recent fiscal developments were satisfactory since the central government deficit, excluding the petroleum account, had been virtually identical to the budget forecast. The latest information showed that the actual situation was much less favorable, and a further comment on the authorities' present view of the fiscal position would be helpful.

The increased fiscal financing need had had a broad, adverse effect on the economy, Mr. Leonard commented. According to the staff, the weakening of the balance of payments in 1984 had been due largely to the increased expenses for oil imports, owing partly to the appreciation of the U.S. dollar. However, he suspected that the increased fiscal imbalance had encouraged import consumption. In addition, the monetary and credit targets had been substantially exceeded in 1984; indeed, even the Government's legal limits had been exceeded. Those developments might not be merely temporary, and their inflationary consequences could be significant. The increase in liquidity resulting from recent monetary developments would add to the difficulty in breaking the cycle of rising prices that had been perpetuated by the wage indexation system.

The continued decline in private investment--which seemed much greater than the staff had originally thought--was also a cause for concern, Mr. Leonard said. The large volume increases in public sector investment since 1982 had failed to offset the downward trend in total investment. In the absence of appropriate policy action, there was unlikely to be scope for public capital expenditure to reverse the downward trend in total investment.

The authorities' wish to lean toward a gradual approach to adjustment was understandable, Mr. Leonard remarked. None of the desired objectives--restoring business profitability, promoting productive private investment, increasing efficiency, lowering income expectations, changing the attitudes of the economic agents, and containing the role of the state--could be achieved quickly. Attempts by the Government to accelerate unduly the process of restructuring the economy, or an insensitive approach to pursuing that objective, could easily undermine public support for the Government's policies. It was difficult for policymakers to ignore some factors that were important in an academician's analysis of an appropriate policy stance; government officials could not be indifferent to the possible alienation of the electorate.

He was particularly worried about two dangers inherent in the authorities' gradualist approach to adjustment, Mr. Leonard said. First, that approach lacked the shock effect that might be necessary to jolt economic agents into recognizing the urgent need for policy actions. Second, the greater the degree of gradualism, the greater its cost in terms of public sector deficits, external imbalances, increased borrowing, and a larger tax burden. Both dangers were discernible in Greece. Little had been gained by the gradualist approach since its introduction in 1983, and there was some danger that it was becoming even more protracted than envisaged. At the same time, the external debt and the debt service ratio had increased significantly and, if their growth were not curbed, they could impose uncomfortable constraints on the authorities' future room for maneuver.

In pointing out the need for corrective measures the staff had rightly emphasized fiscal policy, Mr. Leonard commented. In that connection, some aspects of the 1985 budget could have been improved upon. A reduction in the public sector borrowing requirement was envisaged, but given the latest information, that goal might have to be revised. In any event, the proposed 7 1/2 percent real growth in the government pay bill and the 9 percent real growth in total central government expenditure were inappropriate responses to the present needs of the economy; they did not send the right signals to the various economic agents. Instead, a vigorous attack on public expenditure was called for as part of the overall effort to turn the economy around. The possibility for cutting all categories of expenditure, including subsidies and transfers, should be explored. Even subsidies that were meant to meet the desirable objective of strengthening the supply side of the economy could be wasteful and foster undesirable business practices if they were merely offsetting poor financial performance and were not aimed at remedying weaknesses that undermined profitability. Similarly, instead of receiving transfers, parastatals should be required to improve their management and should be subject to a tight statutory limit on borrowing.

The projection for revenues in 1985 seemed somewhat optimistic, Mr. Leonard continued. Further tax measures should be considered both as a way to avoid a revenue shortfall and as a step toward longer-term structural reform. There seemed to be room for such measures, and the authorities should take advantage of it.

Reform of the wage indexation system was desirable both to contain public spending and to foster economic competitiveness, Mr. Leonard said. The present system made it difficult to achieve a faster reduction in the rate of inflation and had probably contributed to the shift in income shares in favor of labor that had tended to depress profits and discourage private investment. The authorities recognized the problem but had yet to propose any concrete steps to reduce the rigidities in the wage indexation system. They should give more serious thought to doing so; such action would be a natural counterpart to the price liberalization that was already being undertaken.

The authorities had implemented a number of positive measures, particularly the exchange rate adjustment, Mr. Leonard concluded. Efforts had also been made to integrate the Greek productive base into the European Communities and to make the significant structural changes that those efforts entailed. Such changes, if buttressed by strong, consistent, macroeconomic policies, were likely to prove enduring and effective.

Mr. Clark remarked that the strong message from the previous discussion on Greece was that more rapid and determined adjustment was needed. In that context, actual developments in 1984 were disappointing: while GDP and exports had increased, the underlying rate of inflation had remained at about 20 percent, and the fiscal and external current account deficits had exceeded the levels recorded in 1981, the year before the authorities' present policy of gradual adjustment had been initiated. At the same time, gross investment had fallen to a new low as a percentage of GDP, a particularly worrying development in view of Greece's structural problems and growth potential.

Those developments clearly confirmed the Executive Board's conclusion in 1984 that the present policy stance was unsustainable, Mr. Clark continued. It seemed likely that policies would have to be strengthened if the authorities were to meet even their own very modest targets--especially on the fiscal side--in 1985, let alone the medium-term targets for 1987. In that connection, Mr. Coumbis's assurance that his authorities recognized the need for speeding up the short-term stabilization effort was encouraging; he wondered whether there was likely to be a tightening of the policies already announced for 1985 and, if so, what measures, especially on the fiscal side, were envisaged.

Developments in the external economy, particularly the rapid increase since 1979 in the ratio of debt to GDP and in the debt service ratio, were a cause for concern, Mr. Clark said. While the external position was manageable and Greece's standing in financial markets remained good, international banking confidence would be eroded unless appropriate policies were introduced. Experience suggested that such erosion could occur quickly; given the substantial amount of gross foreign borrowing that was likely to be needed over the coming few years, a loss of confidence could have serious adverse consequences.

The substantial slippage in 1984 that had increased the net public sector borrowing requirement to a record 15.5 percent of GDP increased the urgency of, and difficulty in, reducing the fiscal deficit in the coming period, Mr. Clark remarked. It was true that the slippage had been due partly to special factors. But, given the large size of the underlying fiscal deficit and the high level of public sector debt, the capacity to absorb the effects of such special factors was very limited.

A major cause of the problems in the fiscal sector was the continuing growth of current expenditures, which had nearly doubled as a percentage of GDP over the previous decade, Mr. Clark continued. Reversing that trend should be a major policy objective, although given the rapidly rising interest payments on the increasing stock of debt, achieving the objective would not be easy. The authorities apparently had reached the same conclusion; but that made the further substantial increase in current expenditures under the 1985 budget all the more puzzling. Much more vigorous action, particularly to reduce the substantial transfers to parastatals and to cut the civil service wage bill, seemed required. On the revenue side, the authorities' efforts to improve tax collection and their intention to introduce a value-added tax in 1986 were welcome. However, he agreed with the staff that the authorities' revenue projections for 1985 seemed optimistic, and he hoped that the authorities were prepared to introduce additional measures if slippages on the revenue side were to occur.

There had been a slight pickup in manufacturing investment in 1984, but total private investment had again fallen sharply despite the existence of a range of incentive schemes, Mr. Clark noted. That outcome suggested more fundamental measures were needed if the downward trend in private investment was to be reversed and if the authorities were ever to come close to meeting the targets in the five-year plan. In that connection, there was a clear need to restrain wages, which significantly affected profitability, and the authorities should be urged to establish a timetable for phasing out the wage indexation system. As a minimum first step, indexation adjustments should be made at longer intervals, perhaps annually, rather than every four months.

He agreed with the staff that the so-called problem enterprises in the public sector should if possible be returned to the private sector, where they could be placed on a commercial footing, Mr. Clark went on. He wondered whether there was any further information on the amount of interest rate subsidies and other expenditures in support of those enterprises.

Monetary policy was greatly constrained by the fiscal position. In any event, little progress was likely to be made on inflation without changes in the wage indexation system, Mr. Clark said. The authorities had taken some steps to rationalize the interest rate structure, particularly the strengthening of the link between the rates on government borrowing and on other loans extended by the banking system. The establishment of a market in convertible drachma deposits was welcome, and the authorities should be urged to develop the market further.

He agreed with the staff that the authorities' projection for the external current account in 1985 seemed optimistic, Mr. Clark remarked. If the staff's projection of a deficit of 6 percent of GNP were to prove correct, the task of meeting the 1987 target for that account would be considerably more difficult.

The authorities' intention to pursue a more realistic exchange rate policy in order to promote adjustment and improve cost competitiveness vis-à-vis other EC member countries was encouraging, Mr. Clark said. However, in his opening statement Mr. Coumbis had stated 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." He wondered what the practical implications of that approach would be and the extent to which exchange rate policy would be used as an instrument for correcting the structural problems facing the economy.

The staff's medium-term scenarios underscored the importance of immediate action to reduce the external current account deficit and at the same time the potential burden of debt servicing even if substantial progress in reducing the deficit were made, Mr. Clark commented. Sustaining and, if possible, increasing the level of nondebt financing would clearly be helpful. He would have been interested in the staff's comments on the prospects for such flows if current policies were maintained.

The authorities faced a number of serious problems that were likely to intensify if the current policy stance was maintained, Mr. Clark considered. He broadly endorsed the staff's rather critical appraisal of that policy stance and hoped that the authorities would take prompt and vigorous action.

Mr. Lundstrom remarked that the staff report would have benefited from the inclusion of additional comparisons between Greece and other countries. Some such comparisons were made in SM/85/122 and could have usefully been included in the staff report. At the same time, the staff report need not have contained as many as six medium-term scenarios; three would have been sufficient.

Recent economic developments in Greece--particularly the failure to strengthen most of the structural and demand management policies--were disappointing, Mr. Lundstrom said. The staff's recommendation of an approximately simultaneous policy attack in all areas might have been more constructive if the staff had expressed a view on the policy areas that should be given the highest priority. In that connection, Mr. Coumbis's opening statement provided a sharper perspective on the many problems facing the economy. However, that statement left some doubt as to the authorities' commitment to adopting required policies as quickly as necessary. He hoped that the Government would act vigorously after the coming elections; if steps were taken soon to reduce the budget and external deficits, Greece might still be able to avoid the interest rate-expenditure trap in which so many other countries had been caught.

Some of the problems described by Mr. Coumbis as being structural in nature probably could be appropriately dealt with through ordinary macroeconomic policy measures that need not take long to implement and bear fruit, Mr. Lundstrom continued. At the same time, there were a number of genuine structural problems that would have to be tackled over a somewhat longer period; the sooner they were addressed the better. Structural rigidities must be reduced and eliminated as soon as possible if the tightening of financial policies were to be fully effective. He understood the authorities' domestic political and social priorities, but the experience of other European countries showed that such goals could be achieved through the implementation of general fiscal and social policies while many microeconomic decisions were left to individual enterprises, banks, and households.

The authorities could not hope to make substantial progress on the external front without first significantly reducing the rate of inflation, Mr. Lundstrom considered. While a nonaccommodating credit expansion policy was obviously required, wage containment was the best way to reduce the rate of inflation. The prospect of a 7.5 percent real increase in salaries and pensions in the public sector in 1985 was alarming. It was unrealistic to expect any prompt action affecting the wage indexation system, but the system should be modified or abolished as soon as possible. Serious consideration should be given to phasing it out over the coming two or three years.

A policy stance designed to reduce both the rate of inflation and nominal interest rates would significantly improve profitability, thereby contributing to the much-needed strengthening of business fixed investment, Mr. Lundstrom continued. Such a policy stance would also be an integral part of any efficient industrial policy.

He doubted whether the law concerning so-called problem enterprises was helpful, Mr. Lundstrom said. The question of whether or not a particular enterprise was viable could best be answered by individual economic agents rather than the Government. Once a decision on viability was made, the Government should alleviate any resulting social burdens through its general social policies.

Commercial banks should be given more leeway in allocating credit, Mr. Lundstrom stated. The experience of other countries suggested that the earmarking of credit lines and other detailed regulations on the provision of credit by banks were not effective and in fact could cripple the functioning of the financial and productive enterprise sectors. The authorities should also be encouraged to liberalize and streamline the present complex structure of interest rates.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/85/73 (5/15/85) and EBM/85/74 (5/17/85).

3. INDONESIA - RELEASE OF INFORMATION

The Executive Board approves the proposal to release the staff report on recent economic developments in Indonesia to the Inter-Governmental Group on Indonesia, as set forth in SM/85/134 (5/13/85).

Adopted May 16, 1985

4. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/85/129 (5/15/85) is approved.

APPROVED: February 26, 1986

LEO VAN HOUTVEN
Secretary