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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/135

10:10 a.m., September 10, 1985

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
A. Alfidja	
	M. K. Bush
	M. Lundsager, Temporary
J. de Groote	
B. de Maulde	S. de Forges
	T. Alhaimus
	K. Murakami, Temporary
	B. Goos
	T. Sirivedhin, Temporary
R. K. Joyce	L. Leonard
	G. W. K. Pickering, Temporary
	G. D. Hodgson, Temporary
	H. A. Arias
	T. A. Clark
H. Lundstrom	
E. I. M. Mtei	
F. L. Nebbia	B. Jensen
	J. Suraisry
	E. M. Ainley, Temporary
P. Pérez	G. Ortiz
	J. de Beaufort Wijnholds
C. R. Rye	A. V. Romuáldez
	B. Tamami, Temporary
	A. S. Jayawardena
S. Zecchini	N. Coumbis
	Jiang H.

L. Van Houtven, Secretary
V. Wall, Assistant

Also Present

IBRD: G. T. Park, Latin America and the Caribbean Regional Office; R. M. Westebbe, Western Africa Regional Office. African Department: E. A. Calamitsis, R. O. Carstens, S. E. Cronquist, I. Kapur, J. W. Kratz, M. Sidibe, U. Wilson. European Department: L. A. Whittome, Counsellor and Director; U. Dell'Anno, M. T. Hadjimichael, H. Vittas, P. M. Young. Exchange and Trade Relations Department: M. Guitián, Deputy Director; J. T. Boorman, S. Kanesa-Thasan, M. R. Kelly, K. Yoshinari. Fiscal Affairs Department: V. Tanzi, Director. IMF Institute: G. E. Kpodar, A. D. Tignokpa, Participants. Legal Department: S. A. Silard, J. V. Surr. Western Hemisphere Department: R. A. Elson, M. R. Figuerola, T. F. Lehwing. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: D. Hammann, S. M. Hassan, J. Hospedales, G. Nguyen, A. Steinberg, A. Vasudevan, M. A. Weitz. Assistants to Executive Directors: I. Angeloni, J. de la Herrán, A. K. Diaby, G. Ercel, C. Flamant, S. Geadah, N. Haque, O. Isleifsson, Z. b. Ismail, H. Kobayashi, J. A. K. Munthali, M. Rasyid, J. Reddy, D. J. Robinson, M. Sarenac, A. A. Scholten, B. D. White, Yang W.

1. TOGO - REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff report on the midterm review under the stand-by arrangement for Togo (EBS/85/191, 8/14/85), which had been approved on May 17, 1985 (EBM/85/74).

Mr. Alfidja said that in May 1985 the Executive Board had approved the stand-by arrangement for Togo in order to consolidate the gains already made in stabilizing the economy. In spite of the adverse effects of exogenous factors, the Togolese authorities had implemented the agreed policies. In contrast to the decline projected previously, the agricultural output was expected to increase markedly owing to the favorable impact of the adjustment measures taken and the improved weather conditions. In fact, the overall economic performance in 1985 was expected to be better than originally anticipated, Mr. Alfidja continued. Rather than stagnating, real output for 1985 was expected to increase by 3 percent. The fiscal deficit had also been revised downward, and the external sector's position was expected to strengthen on account of higher export earnings from cotton and coffee.

The midterm review discussions with the authorities had focused on the Government's financial position, domestic arrears, measures taken in the public enterprise sector, and external debt rescheduling negotiations with the Paris Club, Mr. Alfidja pointed out. The outcome of those negotiations had been relatively favorable. The improvement in general economic conditions, together with the fiscal measures taken previously, was expected to bring in additional revenue. In addition, the authorities had maintained strict control of government outlays, which explained the downward revision in the projected fiscal deficit.

In sum, the adjustment program was evolving satisfactorily, and commendable progress was being made, Mr. Alfidja noted. The Togolese authorities were determined to re-establish sustainable economic growth and price stability, and they were looking forward to the continued support of the Fund to help achieve those goals.

Mr. de Maulde remarked that the situation in Togo was similar to that in Senegal, which had been reviewed the previous day (EBM/85/133, 9/9/85). Both countries were engaged in long-term adjustment efforts and were successfully completing their third consecutive stand-by arrangement. Therefore, the authorities of both countries deserved the same high degree of commendation.

The performance of demand management had been remarkable, Mr. de Maulde commented. Fiscal revenues should be higher than originally expected, and if budgetary expenditures remained on track, the overall deficit would be lower than estimated at the beginning of the program period. Those results reflected the authorities' implementation of a number of far-reaching measures, such as the enforcement of a new tax code and the reduction in the number of civil servants--policies popular neither in Africa nor the rest of the world--that should yield long-term benefits.

Much had been done in the area of structural reform, Mr. de Maulde continued. A major effort was under way to restructure public enterprises. Several had been closed, and some were in the process of being privatized, indicating the Government's encouragement of the development of the private sector--not an easy task in Africa, where an abundant supply of local and or foreign investors was lacking.

With the assistance of the World Bank, the authorities were reorganizing the agricultural sector, Mr. de Maulde noted; for example, producer prices had been significantly increased. The World Bank was playing a main role in supporting the Togolese structural adjustment program by providing a second structural adjustment credit that would be supplemented further by financing under the special facility for Africa. Those measures were beginning to pay off: except for cocoa, the production of major crops was on the rise, sustaining economic activity.

Despite efforts already made at great social cost, real growth in the coming period was expected to be no more than 3 percent a year, which was insufficient to allow for any increase in per capita GDP, Mr. de Maulde went on. However, he wondered whether the forecast did not underestimate the strength and duration of the supply response which was now under way. Nevertheless, the huge amount of debt service that Togo would have to face in 1986 would have a depressing effect on the economy. Furthermore, the amount of debt relief from rescheduling would gradually decline in coming years, requiring that a large part of the country's savings be allocated to debt servicing at the expense of growth-generating investment. Those figures indicated that Togo's external constraint was excessive and that some new mechanism should be put in place to scale it back.

He congratulated the Togolese authorities for the result already achieved, Mr. de Maulde said, and he had no doubt that the Government would continue to adhere to appropriate policies. He fully supported the proposed decision.

Mr. Suraisry indicated that he was in broad agreement with the staff appraisal. Togo had continued to make satisfactory progress under the program. By and large, the performance of the economy and the immediate outlook seemed better than initially envisioned. For example, real GDP growth, which had been negative in previous years, had been estimated to rise by 3 percent in 1985 because of the increased agricultural output. Improved supply conditions in agriculture, together with the authorities' cautious fiscal policy, had led to a significant fall in the rate of inflation.

To assess the Government's financial position was a primary focus of the midterm review, Mr. Suraisry noted. It was clear that the fiscal performance under the program had improved. Budget revenues had been higher than expected, and continued strict control over expenditures had resulted in a reduction of the fiscal deficit target to 6.7 percent of GDP instead of the 7 percent initially programmed. In addition, domestic arrears, owed mostly by the public enterprises, were an important subject of the review. The authorities had identified those arrears, and they intended to settle most of them by the end of the year.

In close cooperation with the World Bank, the authorities had made commendable progress in restructuring the public enterprises, Mr. Suraisry said. A number of them had been closed, and a few had been leased to the private sector. About a dozen more were being offered for sale to the private sector, but buyers had not yet been found. Could the staff comment on the prospects for the sale of those enterprises to the private sector? What were the contingent plans if they were not successful? It was important to privatize public enterprises as soon as possible in order to relieve uncertainty surrounding them, reduce the fiscal deficit further, and release additional public savings.

Although Togo's balance of payments outlook for 1985 had improved, it remained critical, Mr. Suraisry commented. The current account deficit of nearly 15 percent of GDP was high by any standard. Moreover, it was clear from the medium-term scenario that the external position would remain under pressure for some time to come, and because Togo had a heavy debt service burden, debt relief would be necessary over the next few years. In order to facilitate the much-needed financial support from the Fund and the World Bank, it would be necessary for Togo to sustain a strong adjustment effort.

Ms. Lundsager remarked that Togo's adjustment program was on a firm footing, with debt rescheduling and donor assistance secured and policy implementation on track. Therefore, she supported the proposed decision. The most favorable developments were the real growth rate of over 3 percent of GDP, following several years of negative or low growth, and the lower projection for the external current account deficit. Those developments could be attributed to better weather and producer price increases. She recalled from the May 1985 discussion on Togo that the World Bank representative, responding to a question from Mr. de Maulde concerning the adequacy of producer prices, had pointed out that the most important incentive for farmers was higher real incomes. With the rate of inflation expected to be 3-4 percent lower in 1985 than in 1984, producer price increases of 10-17 percent would raise farmers' real incomes and provide incentive for higher output. However, considering the other producer price increases, why was cocoa production not expected to increase in 1985?

She supported the reforms of the public enterprises, including the liquidation of enterprises found to lack viability and the sale of some entities to the private sector, Ms. Lundsager continued. Divestiture took time, and the authorities should maintain their effort.

Fiscal adjustment was progressing better than expected, Ms. Lundsager said, with the deficit currently projected to be much smaller--1.5 percent of GDP--than initially projected due to higher tax revenues and grants.

She welcomed that development and the authorities' plan to keep expenditures at originally programmed levels. Also, selectivity in recruitment was appropriate for the ongoing, long-term reform of the civil service.

Finally, she welcomed the generally broad cooperation between Togo's external creditors and donors and the World Bank's extensive involvement in the country's adjustment and development efforts, Ms. Lundsager commented. With the difficult debt service obligations that had been projected, a continued strong adjustment effort would be required in the medium term.

Mr. Goos said that he was impressed with the authorities' efforts, which had been evidenced by the continued reduction of public employment. He was particularly pleased that developments in the public and external sectors were more favorable than originally envisaged. Also, the continued close cooperation between the World Bank and the Fund was welcome.

The authorities' intention not to increase public expenditures beyond the original program target despite higher than expected revenue was highly commendable, Mr. Goos continued. That intention testified to the seriousness of the authorities' adjustment efforts, and it was commensurate with their successful implementation of the program. Whereas the authorities had benefited considerably from better weather conditions and financial assistance, developments in those areas could become less favorable in the years ahead.

There were other important uncertainties affecting the Togolese economy--for example, the growth performance of neighboring countries, Mr. Goos remarked. Taken together, those uncertainties warranted a cautious approach, which seemed all the more advisable since the medium-term projections, notwithstanding the improved balance of payments outlook, continued to be a cause for concern. Those projections clearly demonstrated that a return to a viable overall economic position was contingent upon not only determined stabilization efforts by the authorities but also upon the continued support of the external creditors. A satisfactory track record would no doubt considerably facilitate the negotiations with those creditors, as indicated by Togo's ample access to resources on highly concessional terms. Given that favorable financial environment, a possible future program with the Fund should provide for only a rather modest amount of financing, thereby appropriately reducing the Fund's exposure.

In concluding, the staff should be commended for its concise and clearly arranged paper, Mr. Goos noted. He had found the appendix on state enterprises particularly helpful in assessing the progress in an area that continued to be of paramount importance to the task of improving overall efficiency and reducing the fiscal deficit. He supported the proposed decision.

Mr. Mtei said that Togo's adjustment effort had been impressive in 1984, and the Fund's continued support of that effort was appropriate. He accepted the proposed decision.

Mr. Pickering remarked that he commended the authorities' efforts to restore balance in the economy; they had already resulted in some notable success. The outlook for Togo in 1985 had improved significantly since the adoption of the stand-by arrangement in May 1985. He was encouraged to see that the authorities had remained committed to their policy of fiscal restraint. The original expenditure targets should be adhered to; it would be regrettable if the current progress was diminished.

The authorities had made progress in itemizing the domestic arrears of the Government, Mr. Pickering stated. A preliminary government survey showed that the arrears were about CFAF 2.5 billion. However, the program targets for the arrears had been revised, and the authorities should view the new figure as a minimum and strive to regularize their payments as soon as possible. The process of identifying arrears was still under way, and the authorities should eliminate them as they were discovered.

The authorities had correctly attached priority to the much-needed restructuring of the state enterprise sector, Mr. Pickering noted. In the interim, the authorities should improve the accountability and efficiency of the state enterprises until a private sector participant could be found. In cases in which there was neither the possibility for efficient functioning nor privatization, the authorities should liquidate the enterprises.

While still difficult, the medium-term outlook for the external sector had improved in the previous few months, Mr. Pickering commented. The Paris Club rescheduling, approved in June 1985, had provided some breathing room for the authorities to reduce fiscal imbalances and to restructure their economy. The authorities' goal of eliminating external arrears by the end of 1985 was important. He supported the proposed decision.

The staff representative from the African Department said that the growth rate indicated in the staff report was slightly different from the one in the previous report (EBS/85/94, 4/15/85; and Cor. 1, 4/22/85). The projections in the staff report were in line with those made by the World Bank, and, in fact, there had been a positive growth rate rather than decline and stagnation. Consequently, the staff had felt that after two excellent agricultural years, a third exceptional year could not be anticipated. Therefore, they had forecast a normal agricultural year in 1986, which explained the assumption of a modest growth rate for 1986. In the event of another excellent year, the growth pattern would once again look much better.

The authorities' main concern was the high debt service ratio, because they realized that rescheduling had not reduced the debt but had merely postponed repayment and had actually led to some increase in the debt, the staff representative continued. In fact, the authorities had recently remarked publicly that both debt rescheduling and the use of Fund resources were very expensive ways of financing. Therefore, they were striving to move away from relying on those two modes of financing, using only relatively modest amounts in 1985 and even smaller amounts in 1986.

There had been a spectacular increase in cotton production, but cocoa production had not risen as much, the staff representative stated. However, it was important to note that not all of the cocoa exported from Togo was grown there and that land tenure problems complicated the use of incentive pricing. Consequently, increases in prices of cocoa in neighboring countries had had some effect on its transfer from other countries via Togo. Therefore, the output and export of cocoa had to be viewed differently from products that were actually grown in Togo.

It had proved more difficult than originally expected to find private interests to take over public enterprises, the staff representative from the African Department commented in closing.

The staff representative from the World Bank said that privatization of public enterprises was a complicated and delicate matter; it would be premature to report on individual negotiations and thus on the rate of progress being made. However, the Government had been deciding which firms should be closed, which should be privatized, and which should be restructured. Although that operation would not be completed until the end of 1988, by the end of 1985 all the public enterprises would have been classified in one of those categories.

Negotiations were presently being conducted with a number of the enterprises, the staff representative from the World Bank continued, and an advisor from the International Finance Corporation (IFC) was being sent to assist them. In addition, the Togolese authorities had been in contact with private investment authorities and experts in Europe and the United States, and substantial progress was expected. So far, they had maintained their commitments in the area of structural adjustment--notably, the leasing of the refinery and the steel mill.

The Chairman remarked that Executive Directors clearly believed that the authorities had shown great determination to keep the program on track. The evidence of improvement in Togo's situation was heartening.

The Executive Board then took the following decision:

1. Togo has consulted with the Fund in accordance with paragraph 4(c) of the stand-by arrangement for Togo (EBS/85/94, Sup. 2, 5/20/85) and paragraph 33 of the letter dated February 26, 1985, in order to review financial policies and to reach understandings on any necessary changes in performance criteria, subject to which purchases may be made by Togo during the remaining period of the arrangement.

2. The letter dated July 5, 1985 from the Minister of Economy and Finance setting forth the policies and measures that the authorities will pursue shall be attached to the stand-by arrangement for Togo, and the letter dated February 26, 1985 shall be read as supplemented and modified by the letter of July 5, 1985.

3. Accordingly, as shown in paragraph 7 of the letter dated July 5, 1985 and in Table 1 attached thereto, government domestic payment arrears shall be reduced through cash payments of no less than CFAF 1.0 billion by September 30, 1985, contributing toward the reduction of those arrears as stated in paragraph 15 of the letter dated February 26, 1985.

4. The Fund review contemplated in paragraph 33 of the letter dated February 26, 1985 is completed.

Decision No. 8071-(85/135), adopted
September 10, 1985

2. IRELAND - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with Ireland (SM/85/230, 8/14/85). They also had before them a report on recent economic developments in Ireland (SM/85/240, 8/23/85).

Mr. Leonard made the following statement:

The Government's economic and social plan introduced in September 1984 provides a medium-term framework for the continued adjustment of the economy through 1987. Within this framework, public finance, employment, taxation, and social objectives that are mutually consistent and that will assist in the restoration of fiscal balance are being sought. In settling these objectives, as in the actual management of the economy in the period up to the publication of the plan, the Government has set a course, on the one hand, to avoid a deflationary effect that would severely damage the vitality of the economy and conflict with the major priority of halting and reversing the upward spiral of unemployment and, on the other, to avoid failure to narrow the current budget deficit so that the Exchequer and total public sector borrowing requirements could be reduced. The Government's policies, therefore, are not alone addressed to greater equilibrium in the management of demand, the importance of which is fully recognized, but also to the structural adaptation of the economy.

The progress of the economy in 1984 and so far in 1985 has, in many areas, been extremely good. Inflation, already lower in 1984 than in the previous year, has fallen further by 3 percentage points; the latest figures put it below the average for the European Economic Community (EEC) and for 1985 as a whole it is likely to be less than 5 1/2 percent. Manufacturing output is growing rapidly and is receiving some support from domestic demand which although still extremely weak has steadied. Exports, which expanded by over 19 percent in volume in 1984, are continuing to grow although not as strongly as last year and the external trade account is in surplus. Overall, the external deficit on current account is expected, on the basis of official estimates of August 1985, to improve further on the 1984 figure of 5 1/4 percent of GDP to less than 4 percent in 1985.

These and other data suggest a successful conjunction of adjustment with recovery. Nevertheless, the employment response to the growth in output has been weak. The disappointing response, together with a rate of growth in the labor force twice that of the European average, has brought the unemployment rate to 17 1/2 percent, a figure higher than that of any other EEC country and well above the EEC average of 10.7 percent. Altogether, there has been a massive rise in unemployment since 1980, which imposes a severe burden on the Exchequer. Expenditure on income maintenance for the unemployed in 1985 is estimated at well over £Ir 600 million (about 4 percent of GNP) and is almost four times the 1980 figure. In addition, considerably over £Ir 200 million will be spent this year on special employment and training schemes to cater for persons without jobs. These two categories of expenditure alone together account for over four fifths of the current budget deficit.

The 1985 budget is generally in line with the projections that underlie the economic and social plan. Fractionally higher expenditure than planned is expected to be offset by higher revenue, and the current budget deficit should be almost identical with that originally envisaged in September 1984. The prospective deficit is about 1/2 percent of GNP more than the actual outturn for 1984. So, too, is the exchequer borrowing requirement. These results derive from factors summarized on page 8 of the staff report and were foreseen in the plan. They do not constitute any departure from the Government's stated intention to reduce the deficit to 5 percent of GNP and the exchequer borrowing requirement to less than 10 percent of GNP by 1987.

Within the tight confines of the fiscal stance, the Government has succeeded in making progress toward tax reform and the restoration of incentives by simplifying the tax system, widening tax bands, and reducing marginal tax rates. Hundreds of thousands of taxpayers have experienced relief as a result. In addition, as part of the process of widening the tax base, the required legislation for the introduction of the farm tax mentioned in the staff report has been enacted, related administrative arrangements have been initiated, and it is envisaged that the tax will come into operation in 1986. At the same time, while current public expenditure on the supply services as a proportion of GNP is being reduced, it has also been possible to ensure that allocations which directly promote private sector investment and employment are either maintained intact or expanded. A similar reorientation of capital expenditure affecting the productive sectors has been achieved.

Requirements of competitiveness and export increases over the medium term necessitate that pay increases in Ireland should fall to the average levels obtaining in competitor countries. Higher nominal levels in Ireland have in the past been offset by higher productivity and exchange rate movements. The future scope for the operation of such factors could be less than before, however, and provision needs to be made against such a contingency. Although the extent of Irish pay increases did moderate in 1984 under the twenty-fourth pay round, the necessary narrowing of differentials was not achieved. Developments in 1985 are not yet clear. Information on some 200 settlements already concluded, but covering only 3 percent of total private sector employment, suggests that the annualized rate of increase for the sector as a whole will again be less than in the preceding year.

Government guidelines issued in August state that in order to prevent pay increases in Ireland from being in excess of those in trading partner countries in 1985, the extent to which they add to pay levels in the year should not exceed 1 or 2 percent and in many cases should be nil. In the public sector, the guidelines envisage no pay increases for at least 12 months from the expiry of present agreements, generally around the end of 1985. The Government's response to critical trade union reaction to the guidelines has been firm and underlines its commitment to bring about the convergence in pay increases sought in the plan.

Continued reduction of the current deficit on external account to about 3 percent of GNP is envisaged under the economic and social plans. As mentioned earlier, the latest indications are that a reduction to less than 4 percent is in prospect for this year. With the easing of industrial export growth, import growth is expected to be less than in 1984 in spite of stronger domestic activity and the consequent improvement in the trade balance should be sufficient to offset an expected increase in net factor outflows.

> The authorities' objectives in the field of monetary policy are being met. The Irish pound's position has been maintained within the upper half of the European Monetary System band since about mid-1984; reserves now being about equivalent to four months' imports. There have also been increased spontaneous inflows of funds from abroad that have contributed to the strengthening of the capital account of the balance of payments and an easing of domestic liquidity. The supply of credit available to meet private sector needs is expected to be adequate within the indicative guidelines set out in this year's monetary policy.

Mr. Goos considered that the staff had given an accurate description of the difficult economic situation currently facing the Irish authorities and that the report and its policy recommendations deserved the Executive Board's full support, especially the high priority given to redressing the fiscal imbalance, a view also shared by the Irish Central Bank. The fiscal imbalance and the large public sector debt were at the root of the unsatisfactory performance of the domestic economy and the external current account deficit, which had persisted despite booming exports for several years.

The underlying reason for those problems was apparently that the authorities wavered between adjustment and borrowing, with a considerable bias in favor of borrowing in the face of the difficult labor market conditions, Mr. Goos continued. Although that policy approach had generated some impressive results, especially in reducing the inflation rate and the external current account deficit, it had shortcomings; indeed, its potential risks for the country's economic stability were evident and called for a decisive adjustment focused primarily on current expenditures, especially welfare payments, subsidies, and the public sector wage bill. In that regard, the information provided in Mr. Leonard's helpful buff concerning the Government's wage guidelines was quite encouraging. He appreciated the enormous difficulties involved in reducing expenditures in view of the extremely high unemployment ratio and the structural weaknesses in the economy. Nevertheless, he could not but repeat from the summing up of the 1984 Article IV consultation with Ireland (EBM/84/143, 9/14/84) "that delays in taking decisive action would increase the eventual costs of adjustment." In that context, he shared the staff's serious concern about the current budget deficit and the Exchequer borrowing requirement envisaged for 1985, as well as the revised medium-term budgetary objectives.

The staff had made a convincing case in recommending bolder initiatives to restructure the tax system, Mr. Goos remarked, although he was less convinced about taxing unemployment and other social welfare benefits because of the high administrative cost involved and the fact that it was taxation of previously distributed tax revenue. A direct reduction of welfare benefits, although politically less attractive, appeared to be more effective.

The weak link between output and employment growth was one of the most puzzling and disquieting features of the Irish economy, especially given the strong decline in relative unit labor costs coupled with high real interest rates, both of which were normally conducive to expanding employment, Mr. Goos went on. That fact, together with the limited effectiveness of the various public employment schemes, seemed to reflect the existence of considerable labor market rigidities, including insufficient wage differentiation between export-oriented and domestically oriented industries, as well as excessive replacement ratios. Much could be done in the area of structural rigidities to reduce the unemployment problem.

The authorities' effort to tackle the difficult external problems mainly through domestic adjustment measures, while maintaining rather stable exchange rate relationships was commendable, Mr. Goos stated. The remarkable firmness of the Irish pound within the European Monetary System seemed attributable primarily to high domestic interest rates and the favorable performance of the trade balance. Nevertheless, if uncontained, the recent pace of public borrowing could raise doubts about the sustainability of the exchange rate. Thus, the exchange rate needed to be kept under close review also, because the United Kingdom--Ireland's most important trading partner--did not participate in the European Monetary System. He agreed with the authorities that maintaining the pound as stable as possible was at present the most appropriate course of action.

A peculiar remark in the staff report that he had noted, Mr. Goos said, was that membership in the European Monetary System and the large financing needs of the Exchequer constrained the authorities' ability to influence the monetary aggregates and the rate of inflation. While he had no difficulties with attributing a constraining effect to the large financing needs of the Exchequer, he failed to see why that should also be true of the European Monetary System, which, interestingly enough, had been mentioned in the same breath as the Exchequer's financing needs. Those two factors should be kept separate because the constraining effects of the Exchequer borrowing requirement and the European Monetary System appeared to work in quite opposite directions.

Mr. Lundstrom remarked that in the previous few years the Irish economy had been considerably successful in some important areas. The boom in exports in some industries since the early 1980s--which had resulted primarily from a rapid expansion of export capacity in some industries--had been a major factor in the significant improvement of the current account of the balance of payments. The marked deceleration in the rate of inflation from 10.5 percent in 1983 to 5.5 percent in 1985 was also a positive development.

However, as stated in the staff report "the economic situation remains unsatisfactory and in some respects it has continued to deteriorate," Mr. Lundstrom continued. Indeed, the staff's medium-term projections, which were sensitive to developments in exports and foreign interest rates, were not encouraging. However, he was in broad agreement with the staff appraisal.

Since the 1985 budget envisaged a current account deficit of nearly 8 percent of GNP--more than 19 percent of current revenue--the targets set out in the 1985-87 National Plan could hardly be termed ambitious, Mr. Lundstrom stated. In fact, the authorities had abandoned their objective of eliminating the budget deficit by 1987 and were currently forecasting a deficit of 5 percent of GNP by that time. Given the composition of expenditures, with debt service charges accounting for some 25-30 percent of current outlays, the authorities might not have easy options; however, in time those would become even less attractive. Therefore, he urged the authorities to eliminate the deficit by adopting the policies suggested in the staff report. Because the public sector wage bill accounted for one third of current outlays, restraint in public sector pay was called for. In that context, the wage arbitrator had acknowledged for the first time "that the Government's ability to pay was not unlimited," a welcome, although overdue, statement. Expenditure also could be cut by trimming subsidies to state-sponsored entities and private industry. He welcomed the measures to increase charges for some health and educational services and to eliminate or rationalize those that were unproductive. Borrowing from foreign sources to finance current expenditures could jeopardize Ireland's good credit rating in international capital markets.

The Government had made a commitment not to increase the overall tax burden further because it already impinged on incentives to work and save, Mr. Lundstrom continued. Thus, with little room to maneuver, the authorities had taken bold steps to decrease personal and payroll taxes and increase indirect taxation.

The employment problem had turned out to be extremely worrisome, with unemployment rising from just over 8 percent at the beginning of the 1980s to about 17 percent by mid-1985, Mr. Lundstrom said. It was particularly disappointing that the export boom had not prevented that outcome. Not much comfort could be taken from the fact that the cumulative increase in the unemployment rate from 1979 to 1985, almost 120 percent, had been lower than in the Netherlands, the United Kingdom, or the Federal Republic of Germany. However, there were reasons for the weakness of the link between output and employment growth. Could the staff comment on the possibility that foreign ownership of firms impaired interindustry linkages?

Measures to address unemployment should be directed at dismantling frictions in the labor market and removing incentives to be unemployed, Mr. Lundstrom maintained. The decentralization of wage and salary determination was welcome and should increase wage flexibility. However, there was a sizable wedge between the employer's labor costs and the employee's real net wages, as dramatically depicted in Chart 11 of the staff report. It was estimated that from 1979 to 1984 real labor costs had increased by 10 percent, while real after-tax earnings had declined by 15 percent. Did the staff have any information on how Irish labor costs--wage as well as nonwage--compared internationally? Although it would involve difficult political decisions, the existing legislation on recruitment, dismissals, employment conditions, minimum wage, and nonwage labor costs should be adjusted in order to reduce friction and strengthen the demand for labor. The high replacement ratios reduced incentives for seeking work. The staff's useful appendix on replacement ratios indicated that short-term unemployment benefits should be taxed as income. Indeed, the authorities had indicated that that approach would be taken during the next few years provided the associated administrative difficulties could be overcome.

Mr. Wijnholds commented that notwithstanding the reductions in the rate of inflation and the external current account deficit, the Irish economy faced substantial problems--the high and still rising unemployment; the serious fiscal imbalances; the Exchequer borrowing requirement of more than 13 percent of GNP; and the alarming increase in public debt, the external part of which had limited the improvement in the trade balance on the external current account. Since 1981, policies to deal with those imbalances had not brought about the necessary improvement. In addition, the seriousness of the situation continued to be underestimated by the Irish authorities. For example, the authorities had not offset the 1 percent rise in debt service charges to 13 percent of GNP in 1985 by cuts in other expenditures. That failure to act implied an acceptance of the current high level of the Exchequer borrowing requirement. Moreover, despite the disappointing revenue outturn of the first half of 1985 and the commitment to refrain from increasing taxes, it appeared uncertain that the authorities would respond with further expenditure reductions.

It was regrettable that the target to eliminate the current budget deficit by 1987 had been abandoned for a much less ambitious goal, Mr. Wijnholds noted. The problems inherent in further delays of fiscal correction should not be underestimated. For example, if international interest rates did not come down as expected, then notwithstanding further cuts in noninterest expenditures, a sufficient reduction in the Exchequer borrowing requirement would not be possible, especially because higher taxes had been ruled out.

A rapid reduction in the Exchequer borrowing requirement was necessary in order to avoid continuously high real interest rates, more external debt, and even further cuts in noninterest expenditures, Mr. Wijnholds continued. In other words, fiscal correction was necessary to avoid becoming trapped in low growth and rising unemployment. Indeed, without reduction of the budget deficit, the necessary decline in external borrowing was unlikely. The increase in the public sector external debt would keep the external current account deficit relatively high. Furthermore, the external debt had been contracted with variable interest rates and it had amounted to 40 percent of GNP. Therefore, Ireland would become even more vulnerable to fluctuations in international interest rates.

Nonmonetary financing of the budget deficit should be increased even if it led to higher domestic interest rates, Mr. Wijnholds commented. If that fiscal policy were adopted, a devaluation might allow for some relief in the short term, particularly in light of the depreciation of the dollar, in which currency 40 percent of the external debt was denominated. However, with present policies, such an approach would only weaken the authorities' position. In fact, easy access to foreign capital markets made it difficult to sustain support for persevering with the adjustment effort. To resort to devaluation as another escape route would not make the authorities' task any easier, and it might lead to a cycle of lower exchange rates and higher prices and wages. Therefore, the authorities had correctly disregarded that option.

Limiting domestic cost increases was necessary to improve competitiveness in the more traditional sectors of the Irish economy, Mr. Wijnholds said. Ireland could not rely on the modern sector alone to increase opportunities for employment and to improve the external current account position. To accomplish that would require a difficult structural adjustment. Even though traditional manufacturing industries provided about one half of total employment, preserving those industries in their present state was questionable when output per man was only one third of what it was in the modern sector that nevertheless accounted for half of the manufacturing output. Could the staff elaborate further on the role of the more traditional sectors?

Wage moderation was important, Mr. Wijnholds commented. Ireland's modern export industry, with its impressive profitability and above-average productivity, created an upward pressure on wages. While a general incomes policy would be one way of addressing that problem, he preferred the approach chosen by the authorities, which was to encourage decentralized wage bargaining, a way that allowed wages to increase in the sectors that could afford it, giving some support to domestic demand. Moreover, he was encouraged that the Government intended to maintain the guidelines on public sector wages.

The problems facing the Irish authorities were difficult, and policies had improved a number of them, Mr. Wijnholds continued. His concern had been based on the experience that it was difficult to reverse deep-seated imbalances that were allowed to linger on. Furthermore, easy access to international financial markets would not be available indefinitely if the external debt kept growing.

Mr. de Forges said that he agreed with the thrust of the staff appraisal and that he was pleased to see that except for some minor points, the Irish authorities also had broadly endorsed it. Since 1981 the Irish authorities had shown courage and determination in the implementation of a medium-term adjustment program. Indications of the good results of that program had been welcomed during the 1984 Article IV consultation. At present, the authorities were to be commended for improvements in inflation, economic growth, and external accounts.

Despite those achievements, the fiscal and external imbalances were still significant, and unemployment figures, at 17 1/2 percent of the labor force, were discouraging by any standards, Mr. de Forges commented. For those reasons, there was no other alternative than to pursue adjustment.

In addition, progress in the public finances had been insufficient, Mr. de Forges continued. Nonetheless, although regrettable, the abandonment of the objective of a balanced budget by 1987 should be viewed from a realistic point of view: rather than aiming at an unattainable target, the authorities had wisely adopted reachable goals. Thus, the reduction of the deficit from 13 percent to 10 percent would cut recourse to foreign borrowing and ease pressures on the domestic financial markets. That decrease of almost 3 percent in the current expenditure by 1987 would not be easy to attain, but it was necessarily a minimum. The authorities and the staff agreed that the best approach to tackle the budget deficit was through cuts in expenditures, since the overall tax burden had already become excessive. Thus, curtailments in the wage bill were particularly appropriate, but other areas of restraint, such as social transfers, should be identified. In addition, the tax system would gain much from rationalization and simplification. The reduction in the number of value-added tax rates and of rate bands was a step in the right direction. However, more needed to be done to address the weaknesses of the system and to discourage tax evasion and recourse to the underground economy.

A courageous incomes policy was necessary in order to preserve external competitiveness, Mr. de Forges said. The return to free collective bargaining had constituted an improvement that had led to a decrease in average pay increases and to more flexibility in the methods of determining them. However, further labor cost restraint should remain the principal aim because Ireland depended so much on external trade, which was closely linked to the question of unemployment. Of course, the unemployment problem was not restricted to Ireland, but its size there raised questions as to the appropriateness of recent industrial policies. The policy of attracting large-scale foreign investment through different fiscal incentives had not succeeded entirely in producing the desired effects on employment or revenues. The staff report noted that "real GNP, however, rose by only 2 1/4 percent as net factor payments abroad, including profit repatriation and royalty payments by Irish subsidiaries of multinational firms, increased sharply for the fourth year in a row to the equivalent of 10 percent of GDP."

Therefore, it was comforting that some changes had occurred in industrial policy in order to enhance interindustry ties between foreign-owned and indigenous firms, Mr. de Forges remarked. He hoped the staff would discuss the importance of the multinational industries in the economy and their share of total exports. Also, the elimination of labor market rigidities would help resolve the problem. Although labor market rigidities were always more obvious in a country with high unemployment, they might be beyond the control of the authorities in Ireland.

Despite some falloff, the short-term prospects were encouraging, Mr. de Forges noted. However, internal and external deficits were at an unsustainable level. They had to be reduced in the medium term through continuous domestic restraint and further gains in exports, which, in turn, would allow the authorities to control external indebtedness and diminish debt service charges. The success registered since 1981 boded well for the future, and he remained confident of the authorities' commitment to pursue adjustment. He hoped that the more realistic objectives would be met and, if possible, surpassed.

Ms. Bush remarked that since the 1984 Article IV consultation with Ireland, progress had been made in restoring economic growth, lowering the rate of inflation, and reducing the current account deficit of the balance of payments. However, problems remained, especially in the fiscal and labor areas; for example, the public sector borrowing requirement was more than 16 percent of GNP, and the unemployment rate was 17 percent. Until there were more reductions in the burden of taxation and the large fiscal deficit and until more fundamental reforms had been effected in some parts of the labor market, it was difficult to see how sustainable economic growth with financial stability could be achieved.

Double digit fiscal deficit ratios to GDP had prevailed for both the Exchequer and public sector during the previous four years and were expected to continue in 1985, Ms. Bush went on. The accumulation of those deficits had led to a ratio of public debt to GNP of 128 percent in 1984 and a ratio of foreign public debt to GNP of nearly 70 percent. Interest payments on the public debt currently amounted to more than one fourth of the Central Government's expenditures and more than one third of revenues. In addition, negative public savings of the Central Government had fluctuated between 7 percent and 10 percent of GNP. The 1985 budget outlook was for an increase in the deficit on current account operations, a minor decline in the Exchequer borrowing requirement, and almost no change in the ratio of the external sector borrowing requirements to GNP. Therefore, the budget outcome could be worse than anticipated, and monetary financing of the deficit remained a threat.

The fiscal target for 1987, which originally had called for balancing the current budget deficit, had been revised to allow for a deficit of 5 percent of GNP, Ms. Bush continued. That revision was disappointing, as were the GNP ratios of 9 3/4 percent and 11 1/4 percent, respectively, envisaged for the Exchequer borrowing requirement and the public sector borrowing requirement. It was not clear why a scaling down of original estimates had been necessary. In addition, the negative public savings ratio was particularly disturbing. Fortunately, the growth of private savings in the previous few years had offset any adverse effects on investment, and real positive interest rates had been established on deposits. She did not underestimate the difficulties in strengthening Ireland's fiscal position. However, even if the current fiscal targets were achieved, growth and financial stability would still be questionable.

The commitment of the authorities to avoid further increase in the overall tax burden and to concentrate on easing the deficit by reducing expenditures was welcome, Ms. Bush noted. She hoped that the reduction of subsidies would be a major component of the authorities' efforts. She also welcomed the recent simplification of personal income tax and value-added tax--a reduction not only in the number of rates but also in the maximum personal income tax rate, from 65 percent to 60 percent, and in the value-added tax rate, from 35 percent to 23 percent. Also, the indexation of personal income tax and allowances should deter further increases.

With an overall ratio of total revenues of more than 48 percent of GNP and a tax ratio of 37 percent--not to mention the social welfare benefits--it was easy to believe that there was an adverse effect on incentives to save and work, as well as on the labor market in general, Ms. Bush said. The staff had cited the wedge between labor cost and take-home pay, and replacement ratios were in excess of 75 percent. Such a situation must discourage hiring, on the one hand, and diminish work incentives, on the other, resulting in the slow or negative growth of employment in the economy demonstrated by the 3 1/2 percent a year average decline in employment and manufacturing during the previous four years. However, progress had been made in real wage flexibility and in educating workers about the link between productivity and the capability of the employer to pay. In fact, in the previous two years there had been a remarkable rise in productivity in the manufacturing sector and significant declines in unit labor cost, and another drop was expected in 1985. Those interlocking developments should, in turn, help business profits and improve economic growth. However, large-scale labor shedding in traditional manufacturing firms had influenced the statistics. Apart from increased flexibility in real wages, labor market rigidities remained serious.

Real export growth had averaged more than 12 percent in the previous three years and promised to be nearly that high in 1985, Ms. Bush continued. In fact, external demand had been the major drop behind recent economic recovery, while the growth of domestic demand in the previous three years had been either negative or imperceptible, with the same prospect for 1985. Good export growth, at least in the high tech sector, had also alleviated some of the debt burden, as shown in the moderate level of the debt service ratio. However, the medium-term debt scenario was not altogether comforting, as the ratio of foreign public debt to GNP would remain about 70 percent through 1990, although the debt service ratio would fall considerably. Nevertheless, if export growth and interest rate assumptions proved to be too optimistic, the debt ratio could actually rise to about 82 percent by 1990.

Therefore, the authorities must keep exchange rate policy under close review, Ms. Bush indicated. The evidence of Ireland's competitiveness was not clear: actual export performance to date had been good, and movements in relative unit labor costs in manufacturing suggested improved competitiveness, but other measures of competitiveness were less convincing. In order to retain ready access to foreign credit, it was important that Ireland be viewed by international capital markets as maintaining its competitive position. Nevertheless, too easy access to foreign credit might cause the authorities to weaken their resolve to reduce the still high current account deficit and to avoid a further buildup of foreign debt.

Mr. Clark remarked that the staff and several speakers had noted the improvements in Ireland's economic position, perhaps the most noticeable of which in the previous four years had been the narrowing of the current account deficit and the deceleration in the rate of inflation. Even so, major imbalances remained. Although the authorities had expressed their continued commitment to adjustment, there was some doubt whether present policies were adequate to bring the imbalances under control.

The Exchequer borrowing requirement had declined for three consecutive years, and it was disappointing that in 1985 there would be an increase, however modest, Mr. Clark continued. It would hardly improve credibility for the 1987 target for the current budget deficit, which called for a decline of 3 percentage points of GNP in only two years. Furthermore, the original objective of balancing the budget by 1987 had been substantially weakened. In addition, the original 1985 projection for public sector pay was somewhat higher than envisaged in the authorities' current plan. However, the mid-August announcement of a public sector pay freeze was welcome and, if effective, should by the end of 1986 return the pay bill to the amount in the original plan. Nevertheless, the authorities were encouraged to reduce civil service numbers.

Fiscal revenue might turn out lower in 1985 than envisaged, Mr. Clark commented. Although the reasons were not entirely clear, the high level of real interest rates had encouraged some delay in pay-as-you-earn payments. If the shortfall persisted through the third quarter, the authorities should take action. He welcomed the reduction in the operating losses of state-sponsored enterprises and the improvement in the overall performance of the parastatals that was expected to continue for the next few years. However, he would like to know a little more about the policies that would underpin those improvements.

The ratio of public debt to GNP had risen sharply and presently was about 130 percent, Mr. Clark indicated. He wondered how high the rise in debt had driven the increase in long-term interest rates. Those two effects--rise in debt and rise in real interest rates--appeared to be reinforcing one another.

He endorsed the staff's comments on the need to reduce labor market rigidities, as well as the suggestions for increasing work incentives by reviewing the tax and welfare systems, Mr. Clark continued. Reform was particularly important because the 17 percent unemployment rate was among the highest of industrial countries. The statistics on labor productivity could apparently be interpreted favorably, but much of the improvement stemmed not from better performance in industries but from a decline in the labor force in low productivity sectors, coupled with a rise in the sectors where productivity was higher. He noted the staff's comment on the difference between employment cost and employment take-home pay, a discrepancy primarily due to indirect taxation rather than payroll taxes.

He welcomed the redirection of industrial policy to give priority to indigenous firms, Mr. Clark went on. In view of the rather modest effects of that effort mentioned in SM/85/240, the authorities might consider whether larger subsidies should be given to locally owned companies. Furthermore, the efforts made by the authorities to restructure the maturity profile of external debt did not have much bearing on the real resource cost of external debt service, whose impact was demonstrated by the growing disparity between GNP and GDP growth. An external debt of three fourths of GNP was a matter to be concerned with, and as the medium-term scenario made clear, there was little prospect that the ratio would decline. If international interest rates remained high, the Irish economy would have to maintain a rapid rate of growth simply to hold debt ratios where they were presently.

Whereas the authorities were clearly making adjustments to tackle the imbalances, the legacy of high external and public sector debt raised questions, Mr. Clark pointed out. If the external balance turned out to be more unfavorable than the authorities or the staff had projected, the difficulties would be greatly increased.

Mr. Rye said that by some indications the Irish economy had performed reasonably well in 1984: the moderate rise in real GNP, the considerable reduction in the rate of inflation, and the small but welcome decline in the deficit on the current account of the balance of payments. Moreover, those favorable trends had carried through into 1985.

The question, of course, was how long such gains could be maintained, Mr. Rye continued. They were overshadowed by the disturbing levels of internal and external debt. Total central government debt in 1984 was equivalent to nearly 130 percent of GNP, the external component amounting to 54 percent of GNP. Total external debt, including that of state-sponsored entities and financial institutions, amounted to 86 percent of GNP--high ratios by any standard. These ratios reflected the large public sector deficits of recent years, which had reached 20.9 percent of GNP in 1981. That figure had been brought down to 16.6 percent in 1984, but it seemed possible from the budget deterioration that, in contrast to the minimal decline projected, that ratio might move back up in 1985. He would appreciate knowing whether there was any real difference of view between the Irish authorities and the staff regarding the budget outlook.

Even taking the projections at face value, the overall deficit would remain disturbingly high, at 11 1/4 percent of GNP by 1987, Mr. Rye went on. That would imply a further increase in the ratio of central government debt to GNP and, presumably, a further increase in the proportion of tax revenues required to service that debt--a share already more than one third. The slower the fiscal deficit was brought down the more difficult the task would be. Accordingly, it was regrettable that the Irish authorities had abandoned their earlier target of eliminating the current budget deficit by 1987.

He shared the staff's concern about the budgeted increase in the current deficit for 1985 as well as the prospect that the 1985 budget target would not be achieved, Mr. Rye commented. Indeed, would even the revised 1987 target be attainable? Those developments raised more fundamental questions about the commitment to maintain real welfare benefits. Could Ireland afford to rule out significant cuts in welfare when debt service was taking an increasing claim on the budget?

An increase in taxation relative to GNP had been ruled out, Mr. Rye indicated, and there were good reasons for that. However, if expenditure could not be sufficiently restrained, the authorities might be left with no alternative but to increase taxes, a second-best solution to adequate restraint on expenditures, difficult as that would be in the short term. Ireland's external debt should be scaled down progressively and quickly. Higher domestic interest rates might be necessary in order to reduce the external borrowing requirement. However, the overriding need was for an early and substantial cut in the total government borrowing requirement.

No discussion of the Irish economy could avoid reference to the extraordinarily high rate of unemployment, Mr. Rye stated. Without implying that the causes of unemployment could be looked at exclusively in economic terms, there was compelling evidence that the price of labor played an important role. It surely was no coincidence that employment had fallen during a period when real wage costs and wage replacement ratios were both rising. The authorities were planning to address some aspects of that issue, and he would urge them to implement corrective measures as soon as possible. He had read with great interest the appendix to SM/85/240 regarding replacement ratios. While the relationship was not altogether conclusive, it appeared that reducing unemployment benefits would help to balance the budget and enhance incentives to work. The time had come to break the links between those benefits and wages.

Ireland's support for a new round of GATT talks was welcome, although the reservations to protect traditional labor-intensive industries were less welcome, Mr. Rye continued. In the interest of establishing a more robust indigenous industrial base, Ireland should expose its traditional industries to a little more external competition. Also, Ireland's subsidized agricultural sector had increased output by 8 1/2 percent, and real incomes of farmers had increased by nearly 8 percent in 1984, the third successive year of real output and income growth. Of course, the remedy for irrational policies in that sector lay with the European Community as a whole. Nevertheless, curtailment of agricultural subsidies in Ireland was warranted.

Mr. Ainley remarked that the position of the Irish economy had improved since 1981, particularly with respect to inflation, productivity, growth, and exports, and the authorities deserved credit for those achievements. Against that, however, was the problem of high and rising unemployment--perhaps the major concern of the authorities. The problem was extremely difficult to tackle successfully when major imbalances persisted in the fiscal and external accounts. Given those imbalances, especially the large debt servicing requirements, the authorities did not have a firm base for a steady recovery with growing employment opportunities.

The three-year plan aimed in the right direction, and the 1985 budget contained several useful measures, Mr. Ainley continued. However, the question was whether the authorities were moving far enough and fast enough to restore the necessary balance to the public finances. There was persuasive evidence that they were not. Even if the targets of the three-year plan were met--and that was by no means certain--the budget deficit and the public sector borrowing requirement would remain high relative to GNP, which, in turn, implied a continuing rise in the debt burden and a pre-empting of resources badly needed for more productive uses.

More urgent and broad-based efforts were needed to sort out the fiscal imbalances, Mr. Ainley went on. The recent plans to broaden the tax base should be pursued with determination. In addition, the successful steps taken to restrain public sector pay and restructure state enterprises should be supported by a re-examination of public services and welfare benefits. Such moves were not easy, but delays could only add to the underlying fiscal problems.

If the fiscal situation could be strengthened and more resources made available to the private sector, the authorities could deal better with the unemployment problem, Mr. Ainley said. A reform of the tax and welfare systems would help in that regard by reinforcing work incentives and improving the climate for wage restraint. He fully supported the Government's recent wage guidelines and the firm response to what Mr. Leonard had described as "critical trade union reaction." Continued wage moderation was essential over the medium term to free resources for investment that would create new jobs. Much should be done to deal with other structural rigidities that stood in the way of higher employment and efficient economic growth. The authorities were on the right track, but there was a strong case for moving faster along it.

Mr. de Groote said that despite recent significant improvement, the overall economic situation of Ireland remained uncertain because the authorities had been indecisive in adopting adjustment policies. Whereas the reduction in the rate of inflation had been a positive result of the medium-term adjustment program that had begun in 1981, the pickup in economic activity had been due mainly to external impulses. Therefore, because of its excessive gradualism, the 1981 program had done little to improve fiscal imbalances and reduce the high level of unemployment. As a result, the ratios of Exchequer borrowing requirement and public sector borrowing requirement to GNP had been maintained at an excessive level and had led to a sizable increase in the external debt, a medium-term reduction of growth prospects, and a worsening of the employment situation.

High unemployment, together with easy access to foreign capital, had led the Irish authorities to reject more radical measures for correcting the existing imbalances, Mr. de Groote continued. The issue was whether a gradual strategy could achieve sustainable medium-term adjustments. The National Plan for 1985-87, announced in the autumn of 1985, contained few welcome adjustment measures. However, it had been highlighted with useful changes--placing cash limits on the total public sector pay bill in order to keep the level of taxation in relationship to GNP at its 1984 level and setting targets for Exchequer borrowing requirements and public sector borrowing requirements. Nevertheless, the reduction in the budget deficit forecast in the Plan for 1987 was modest. The targeted decline in the current budget deficit and in the overall 1985 budget in relation to GNP indicated that a sizable amount of borrowing would be needed to finance current spending. Thus, the debt service would continue to limit growth. Accordingly, the authorities should substantially reduce the Exchequer borrowing requirement and the public sector borrowing requirement.

Despite a remarkable improvement in the external current account--the deficit had been reduced from 15 percent in 1981 to 6 percent in 1984--it remained high in proportion to GNP, Mr. de Groote commented. The target deficit envisaged in the National Plan--reducing the deficit to 3 percent of GNP by 1987--would mostly depend on positive developments in the world economy. Even under those circumstances, the objectives of the Plan were the essential minimum conditions for a viable external position over the medium term. Therefore, the competitiveness of the Irish economy would have to be improved significantly, and the authorities' medium-term policies on competitiveness appeared capable of accomplishing that. In particular, structural changes, additional modernization of industry, and wage restraints would increase the profitability in the export sector. However, the authorities had not relied on exchange rate policy for enhancing competitiveness and employment opportunities, mainly because of the effect that depreciation would have had on prices. The experience in other European countries, however, indicated that the authorities should be open to employing exchange rate measures as a way to improve competitiveness rather than relying exclusively on wage restraints. Although an arduous course from the political viewpoint, Ireland appeared ready for an incomes policy, a necessary precondition of a successful adjustment of the exchange rate. Understandably, Ireland was hesitant to add an exchange rate measure to an incomes policy, even though that would be more palatable politically and would bring out the advantages of wage restraint.

The level of the external public debt and net external liabilities of financial institutions was beyond an acceptable ceiling, Mr. de Groote remarked. A reduction in the outstanding external debt was an urgent priority. However, only if the budget and current account deficits were reduced by vigorous economic policy restraints could the debt situation and the unemployment situation be eased. Continuation of a gradual approach would require continuous and painful adjustment measures for a number of years--too long to maintain sympathetic public opinion and easy access to international capital markets.

Mr. Pérez said that in 1984 the Irish economy had produced a very good performance regarding growth and inflation. Improvements in the export sector had resulted in economic growth, and the reduction in the rate of inflation was due to increased productivity and reduced indirect taxes. Nevertheless, prospects for adjustment of imbalances in the fiscal sector were not satisfactory, and the external debt and the high level of unemployment continued to be matters of serious concern.

In spite of the positive measures taken to date, the recent slowing down of the pace of adjustment made the prospect for fiscal balance uncertain in the short and medium term and could jeopardize the progress already achieved, Mr. Pérez continued. Therefore, he urged the authorities to adopt policies that would rapidly restore strong fiscal balance.

The size of the national debt was also a matter of concern because of the negative impact that repayments had on economic growth, Mr. Pérez went on. In addition, the debt included external obligations that would cause large capital outflows, which, in turn, would require improvement in the current account of the balance of payments. Notwithstanding improvements in the current account, the projection for the medium term indicated that the burden of debt was so heavy that Ireland would have to adopt additional measures in balancing the external sector. A program should be implemented to strengthen and promote foreign investment through a more reasonable taxation system. In addition, the authorities should avoid the cycle of offsetting the external deficit by increasing external debt. Was the Government contemplating measures to reduce its external debt in absolute terms?

To increase labor earnings while unemployment was rising was incompatible, Mr. Pérez said. The authorities should design policies to moderate salary increases and promote additional opportunities for employment--a challenge that the Irish economy could meet if industrial productivity continued to be high, taxation decreased, industrial production modernized, and the fiscal deficit lowered. Those developments would strengthen the internal and external sectors because of reasonable public expenditure and reduction of the external debt.

The authorities were correct in viewing the adjustment of the economy as a medium-term process, Mr. Pérez concluded, and they should adopt measures to that end in 1985. However, immediate fiscal action and reduction of the external debt was called for.

Mr. Zecchini remarked that positive results had been achieved by the Irish authorities in 1984, but the adjustment had been slow in improving existing imbalances. The reduction of inflation was particularly noteworthy, as consumer price increases had progressively decelerated from 24.4 percent in 1981 to an estimated 5.5 percent in 1985. A partial adjustment had been obtained on the external front where, by virtue of a strong export performance, current account deficits had been reduced to 5.8 percent of GNP in 1984.

Although progress had been made in reducing fiscal imbalances, achievements had fallen short of what was required, Mr. Zecchini continued. In particular, the current account deficit and the overall fiscal deficit must be evaluated in light of the existing high level of public debt, particularly the external side. Both had been growing continuously, with the total reaching 128 percent of GNP in 1984, and the external component, 69 percent. Therefore, medium-term financial policies should aim at a progressive reduction of public debt. In addition, the authorities had to face the increasingly high rate of unemployment.

The authorities had abandoned their previous plan to eliminate the current fiscal deficit by 1987, Mr. Zecchini commented. A much milder, and perhaps not sufficiently ambitious, fiscal adjustment had been substituted for the medium term, and, consequently, total public debt and its external component would increase further in the next few years. In fact, there were indications that the fiscal deficit in 1985 might exceed its target because, despite a cyclical pickup in economic activity, efforts to contain fiscal deficits in 1985 were faltering. Even if the 1985 budget were met, current deficits as a ratio to GNP would increase over 1984 and would be only partly compensated for by a decrease in the capital deficit. Not to exceed the 1985 budget should, therefore, be considered a minimum target, and he hoped that the expectations of success would materialize. The brunt of adjustment should focus on reducing current expenditures, which had increased markedly. However, it would be difficult to obtain the necessary degree of restraint by acting mainly on the Government's pay bill: the authorities might consider the possibility of making expenditure cuts in other areas, such as in social welfare payments.

Budget financing needs had constrained the authorities' room for maneuvering, Mr. Zecchini said. Relatively high interest rates were needed to continue to attract capital from abroad and to place government paper in the portfolios of the private sector. In 1984, it had been necessary to ease monetary policy because of increased financial needs of the Government and temporary difficulties in placing government securities in the market. As a result, domestic credit to the public sector had risen sharply. Thus, domestic credit, narrow money, and broad money had increased in 1984 at a higher pace than in 1983, after declining in the previous two years. Those developments caused concern because of their implications for price dynamics. Therefore, a tightening of financial policies was warranted.

The most effective way of dealing with the unemployment situation was in the medium term, Mr. Zecchini noted. Increased flexibility in labor market practices and greater wage moderation were necessary. Fiscal measures should be designed to avoid further increases in the gap between overall labor costs to the employer and net wages received by the employee, because that situation promoted labor substitution from employers as well as high wage demands from employees, both of which tended to depress employment levels. A durable improvement in the employment situation would derive from a strong attack on the fiscal imbalances, notwithstanding the short-term implications for economic growth. In turn, fiscal improvement would ease some of the constraints on monetary policy, leading in the long run to lower interest rates, higher private fixed investment, and more job opportunities.

The staff representative from the European Department said that while the obligation to maintain narrow margins under the European Monetary System arrangements implied a limitation on the authorities' ability to influence the money supply, at present the main constraint on monetary policy was the large size of the public sector borrowing requirement. In the conduct of interest rate policy, the authorities had aimed at striking a balance between two conflicting objectives--namely, minimizing the interest payments on the public debt and avoiding excessive recourse to foreign borrowing. While it was possible to finance a larger part of the public sector borrowing requirement in the domestic market this would require increases in domestic interest rates, which would tend to discourage private spending and could also attract capital inflows from abroad. Such inflows were not viewed as a preferred alternative to direct borrowing abroad by the Government as they tended to be more volatile. The authorities and the staff shared the view that a reduction in the size of the public sector borrowing requirement was needed to stop the growth in interest payments on the public debt.

The authorities had indicated that they were contemplating taxing unemployment benefits in the period covered by the National Plan, the staff representative noted. The taxation of unemployment benefits was favored because it was likely to have a greater effect in restoring work incentives than an equivalent reduction in the nominal amount of benefits.

The question had been raised as to whether foreign ownership of firms impaired interindustry linkages, the staff representative remarked. There was some evidence to suggest that modern industries, whether foreign owned or indigenous, were less integrated into the economy than the so-called traditional industries because they were more capital intensive and less dependent on raw materials produced in Ireland. For example, the import content of materials used in the production of food products for export had been estimated at about 30 percent in a recent period, while for exports of chemicals, the corresponding percentage was 45-50 percent. In addition, however, there was some evidence that foreign-owned firms were less dependent on indigenous inputs than the Irish-owned companies. Estimates by the Industrial Development Authority indicated that imported intermediate inputs by foreign firms accounted for as much as 40 percent of the total value of their sales. This represented a huge potential market for domestic suppliers of intermediate inputs and the new industrial policy aimed at assisting domestic firms to exploit that potential market as fully as possible.

It was difficult to obtain data on nonwage labor costs that were comparable across countries, the staff representative said. However, the data that were available suggested that nonwage labor costs were much lower in Ireland than in its main competitor countries. In particular, social security contributions by employers were comparatively low because, in contrast to most other countries, a large part of the cost of the social system was borne directly by the Exchequer. Other nonwage costs, such as paid vacations, also seemed to be rather low in Ireland. According to some unofficial estimates, total nonwage costs in 1981 were about one third of hourly wage earnings in Ireland, while they were close to 50 percent or more in many other countries, especially those in Europe. There were also some estimates by the European Commission which suggested that, in common currency terms, Ireland's total hourly labor costs were significantly lower than in any other European Community country, except Greece. However, that comparison was not in itself meaningful as it did not take into account intercountry differences in productivity. Estimates that allowed for different levels of productivity among countries indicated that unit labor costs were still on the low side in Ireland, but the relative position differed markedly from industry to industry.

A number of Directors had referred to exchange rate policy, the staff representative continued. Despite their limitations, the various indicators of competitiveness suggested that Ireland's position was still relatively favorable. Nevertheless, given the very high level of unemployment, and the prospect of little improvement in the foreseeable future, many commentators had argued that exchange rate policy should play an active role in promoting adjustment. The staff's view was that the causes of the high unemployment in Ireland were complex and included many structural weaknesses--for example, in the tax and welfare systems and in the labor market. For that reason the staff doubted whether a change in the exchange rate would be useful unless it was part of a broad policy package that addressed all the structural weaknesses in the economy at the same time. Without that overall approach, there would be a serious risk of a change in the exchange rate rekindling inflation, without much benefit to the balance of payments or the employment situation.

The high level of real interest rates had probably contributed to the revenue shortfall in the first half of 1985, the staff representative remarked, to the extent that it may have encouraged companies to delay the transfer of revenue collections to the Exchequer. It should be noted, however, that because of the significant changes in the structure of the tax system, both direct and indirect, it had been particularly difficult to estimate the likely growth in revenue. In the budget, the authorities had assumed that the changes in the value-added tax rate would boost revenue by reducing diversion of spending to Northern Ireland, but it remained to be seen whether that assumption would be fully borne out in practice. On the basis of the trends that were apparent in the first half of 1985, the staff had suggested that there would be a revenue shortfall for the year as a whole as well as some overrun on the expenditure side. However, in the light of more recent data that had not yet been published, the authorities expected that the gap in revenue collections would be reduced during the third quarter of the year.

The adjustment policies that had underpinned the improved financial performance of the semistate enterprises had involved a significant reduction in the size of the work force and some rationalization of their pricing policies, the staff representative noted. A further significant factor had been the introduction of strict criteria for the assessment of investment projects, which had led to a cut in capital spending that was now eventually paying for itself. However, there had also been some injection of Exchequer funds to improve the capital structure of some of the enterprises. As in many other countries, some serious problems remained, but the authorities' efforts to strengthen the sector were continuing.

Mr. Leonard remarked that interindustry linkages between the traditional and the foreign-owned industries had not developed as far as the authorities would have hoped. However, a recent study indicated that the number of linkages in the food industry was growing at a rate of 1/2 percent a year in terms of indigenous raw material. In the nonfood areas, the ratio was also increasing; consequently, there were prospects of greater integration of domestic and incoming industry, and the authorities were fostering that. Indeed, incoming firms were kept fully aware of what could be supplied to them from domestic sources; likewise, domestic firms were informed of the needs of incoming firms. Technical assistance on product quality was available both from incoming firms and domestic sources. Quality standards were not a major problem, although high standards were a factor for some incoming firms.

The easing of the pace of balancing the budget had been foreseen in the National Plan and did not signal a weakening of intention, Mr. Leonard continued. It was true that the authorities thought there might be an overshooting in the deficit in 1985, but there was room for minor variations in forecasting; for example, in 1984 there had been a greater reduction of the deficit than had been envisaged in the budget. The intention was not to tolerate a major discrepancy. In fact, the possibility of reducing external borrowing should not be entirely precluded.

The difficult questions of the debt burden and the adjustment of the economy were interrelated, Mr. Leonard went on. The debt burden was heavy. The fact that so much current revenue had to be devoted to the servicing of external debt restricted the authorities' room for maneuver; they were acutely aware of that but were also deeply conscious of high and rising unemployment. Some borrowing would have to continue for the next few years. The debt problem was discussed explicitly in the National Plan, and the authorities' concern had been stated on numerous occasions. The pace of economic adjustment was more a political than an economic issue.

When the Government had drawn up the National Plan, they had tried to look at a number of options, Mr. Leonard said. Although a tighter fiscal scenario would have reduced the current budget deficit and overall borrowing at a faster rate, it was not compatible with the Government's employment, taxation, and social objectives. They had also investigated a plan that would have been less severe than the one they adopted. However, that would have been incompatible with the main theme of the National Plan--to take the minimum steps necessary to restore balance. Consequently, they had taken an intermediate course, and the realism of the decision was indicated by the difficulties they were encountering in meeting the public finance targets. Those very real difficulties were being addressed, although the cost in political terms was high.

The Government, Mr. Leonard went on, was in a predicament: if it moved too fast in the adjustment efforts, it might damage the vitality of the economy; if it moved too slowly, it would not meet its schedule. The burden of the debt, which was increasing, was heavy but could not be reduced immediately and would have to be borne while the authorities developed the economy and shaped a modern export sector through numerous supply-side measures. Those measures were helping to mitigate, though they could not entirely overcome at the present stage the waste of a major resource--16 percent of a well-educated labor force. If the external environment did not deteriorate markedly, the economy would be strengthened by the change through which it was going--the first stage of which would be completed by 1987.

He had noted the remarks concerning the importance of the interest rate and the growth of the debt, Mr. Leonard stated. Although assumptions other than those in the Plan could be defended, those adopted were realistic and could prove to be close to the mark.

A number of tough but fair proposals for the reduction of government expenditure had been made by the Executive Directors, Mr. Leonard continued. The issues involved in those proposals had already been discussed by the authorities, whose decisions had found the right balance. Nevertheless, he would convey the suggestions to his authorities so that they could note the weight that people who appreciated the Government's problems had placed on various measures.

The authorities had stated in a note from the Central Bank in Dublin that the exchange rate was always under review and that their position was well known to the Fund and to Directors, Mr. Leonard noted.

The Chairman made the following summing up:

Executive Directors commended the Irish authorities for the progress made since the 1984 Article IV consultation in lowering the rate of inflation to about the average rate of Ireland's main trading partners. They also referred positively to Ireland's sustained strong export performance, which had contributed to a further reduction in the current account deficit of the balance of payments.

Directors stressed, however, that despite the substantial adjustment that had been achieved since mid-1981, the economic situation in Ireland was far from satisfactory and that policies had, all in all, been, in their view, not adequate to bring about the needed improvements.

The unemployment rate had continued to rise to some 17 percent of the labor force, which was very high by international standards. The external position remained vulnerable. Underlying cost pressures were still strong, and, perhaps most importantly, the disequilibria in the public sector accounts remained daunting.

Directors noted also that the aggregate of the domestic and external indebtedness of the public sector had risen to a level that, at nearly 130 percent of GNP in 1984, was among the highest in the industrial world and that the cost of servicing this indebtedness was making it all the more crucial to bring the current budget deficit under control.

In view of the precarious condition of the public sector finances, Directors expressed their serious concern that the momentum of fiscal retrenchment had been lost in 1985 as the current budget deficit and the Exchequer borrowing requirements were budgeted to rise in relation to GNP compared with the outturn for 1984.

Directors also viewed with great concern the decision of the Irish authorities to scale down markedly their medium-term fiscal objectives in the context of the National Plan. The revised fiscal objectives were generally seen to be inadequate to deal with Ireland's problems.

Directors urged the authorities to take early action to avoid any slippage in the implementation of the 1985 budget and to give the highest priority to rapid fiscal adjustment in 1986 and beyond because a further buildup of the public debt as a ratio to GDP could become unsustainable and would have severe adverse consequences for growth and employment in Ireland.

Directors generally shared the view that the overall tax burden was very onerous and had weakened incentives to work. Noting the commitment of the authorities to avoid any further increase in the tax burden, Directors emphasized that a corollary of this commitment was the progressive reduction in the ratio of public expenditures to GNP. While endorsing the authorities' intention to severely restrain the growth in the public sector pay bill, Directors stressed the importance of also limiting the growth of social welfare spending and trimming the government support to state-sponsored bodies as well as state assistance to industry.

Directors welcomed the direct tax reliefs provided in the 1985 budget, together with the steps taken to simplify the personal income tax and the value-added tax systems, and encouraged the authorities to intensify their efforts to restructure the tax system so as to make it possible to lower the high burden of taxation borne by wage earners. In this regard they advocated early action to broaden the tax base and to improve tax collection.

Directors welcomed the increased nonmonetary financing of the Exchequer during the first half of 1985 but pointed to the need for a further slowdown in the rate of domestic credit expansion. While noting Ireland's good standing in international capital markets, Directors stressed that Ireland's external public debt was uncomfortably high at some 69 percent of GNP and urged the authorities to scale down official borrowing abroad so as to contain the heavy drain on national resources represented by interest payments abroad and to reduce Ireland's potential vulnerability to changes in sentiment and conditions in international capital markets.

Directors underscored the importance of improvements in competitiveness as a means of strengthening further the external account position and creating employment opportunities for the rapidly growing labor force. Directors noted that average increases in earnings had decelerated in recent years and that pay increases in individual firms had tended to be more closely related to their ability to pay. Nevertheless, average earnings had continued to rise more rapidly in Ireland than in its main trading partners. Directors stressed, therefore, that tighter pay restraint was necessary to improve competitiveness and noted that it was doubtful whether pay developments in the 1985 wage round would be consistent with the attainment of this objective.

Directors also pointed out that reforms of the tax and welfare systems were needed to improve the functioning of the labor market and moderate the growth in total labor cost, thus enhancing employment prospects.

A number of Directors observed that the relatively strong position of the Irish pound within the European Monetary System was a reflection of the continued heavy recourse to foreign borrowing by the public sector, perhaps more than of the underlying external position, which remained weak.

Continued heavy borrowing abroad could raise doubts about the sustainability of the present exchange rate. While agreeing with the paramount need for restraining labor costs and with the merits of maintaining a high degree of exchange rate stability, Directors encouraged the Irish authorities to keep the adequacy of the exchange rate under close scrutiny.

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

3. COSTA RICA - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with Costa Rica (SM/85/223, 8/7/85; and Cor. 1, 9/9/85). They also had before them a report on recent economic developments in Costa Rica (SM/85/247, 8/28/85).

Mr. Pérez made the following statement:

At the end of the 1970s and early 1980s, the Costa Rican economy suffered a series of external shocks that precipitated a severe economic crisis. The sharp deterioration in the terms of trade, the decline in world economic activity, the shrinkage of the Central American Common Market, and the difficulties in maintaining a system of trade payments within the region led to a sharp decline in economic activity and a surge of inflationary pressures, as well as growing fiscal and current account deficits. In turn, the external and internal imbalances produced an enormous increase in the external public debt, which jumped from 66 percent of GDP in 1980 to 119.4 percent in 1983.

Since 1982 the new administration has implemented a series of policy actions aimed at correcting the country's economic imbalances. A part of this package of economic measures, specifically those implemented in 1983, was supported by a one-year stand-by arrangement with the Fund. This was accomplished with a satisfactory degree of success. Actually, in 1983 GDP grew by 2.3 percent, the rate of inflation went down from 90.1 percent to 32.6 percent on average, the overall deficit of the public sector was reduced from 9 percentage points of GDP to 3.1 (one point further than targeted), the balance of payments registered a surplus, and payments arrears were eliminated.

Although a new arrangement with the Fund was not formalized in 1984, the process of adjustment was maintained, and the authorities continued consulting closely with this institution. For the year as a whole, significant progress was made in reducing both inflation and the public sector imbalances. Through the combination of tight fiscal and monetary policies, the inflation rate decreased from 37.6 percent in 1983 to 11.9 percent in 1984, on average. Another factor contributing to this positive outcome was the excellent agricultural year that 1984 turned out to be.

In 1984 the overall deficit of the nonfinancial public sector was reduced from 3.1 percentage points of GDP to 1.9 percent. As the staff points out, a significant increase in indirect taxes, a deceleration in expenditure growth, and the achievement of a balanced position in the accounts of public enterprises contributed to this development.

On the external front, the combined effect of a higher level of world economic activity and the active exchange rate policy followed by the authorities allowed the country to register an increase in exports substantially above that attained in previous years. In 1984 exports increased by 11 percent, compared with a virtual stagnation in 1983 and a substantial decline in 1982. However, as a result of the recovery experienced by the country, imports grew at the same rate as exports, resulting in a trade deficit roughly the same in relation to GDP as the one registered in 1983. As net capital inflows were substantially lower than expected, the overall deficit of the balance of payments led to the accumulation of external arrears, partly because Costa Rica failed to obtain debt relief from bilateral creditors, which was contingent upon reaching an agreement with the Fund.

On March 13 the Board approved a one-year stand-by arrangement with Costa Rica. The program's main objectives were to maintain the trend toward a balanced public sector in the medium term and a strengthening of the balance of payments. To this end, as a primary objective of fiscal policy the authorities would limit the overall government deficit to 1.7 percentage points of GDP. In the external sector, the Government would pursue a flexible exchange rate policy permitting the colón to be adjusted from time to time to reflect price changes in the domestic market and among its trading partners abroad.

In spite of the more adverse economic circumstances than previously envisaged, as the staff points out, Costa Rica was in compliance with all the quantitative performance criteria at the end of June, with the exception of the limit on external debt arrears. This failure was due partly to the delay by the

Costa Rican Legislative Assembly in passing the necessary modifications for the approval of the structural adjustment loan. Additionally, a requirement for the second disbursement of the banks' new money facility was not met. The law was approved by the Legislative Assembly last August, and it is hoped that the World Bank will disburse the first tranche in the next few days. The problem related to the banks' disbursement awaits the Fund's notification that Costa Rica is qualified to make the third purchase under the current stand-by arrangement.

The Costa Rican authorities expect to fulfill all quantitative performance criteria at the end of September. However, a problem with the limit on external arrears could arise if the disbursement from the banks' new money facility is not made. Regarding the structural adjustment loan tranche, the Government is confident that the tariff reform will be approved. In this connection, negotiations with the other Central American partners have practically been concluded, and it is expected that the Costa Rican Legislative Assembly will pass the law within the next 30 days.

The sharp deterioration of Costa Rica's economic growth prospects during the first part of this year--a decrease of 1.1 percent is now estimated compared with an increase of 3 percent envisaged in the program--has posed additional difficulties in the attainment of the fiscal targets. It should be stressed that in spite of those adverse circumstances, the Costa Rican authorities promptly adopted a series of measures geared to maintaining the program on track.

In the fiscal area, the Government reviewed both the expenditure and revenue sides of the budget. On the expenditure side, ₡ 1.9 billion, corresponding to various expenditure programs, were either cut or postponed. On the revenue side, the authorities took steps to improve collection procedures by regarding some taxes--sales and selective consumption taxes--and declaring a tax amnesty in order to facilitate the collection of arrears. Regarding the fiscal yield of the amnesty, the authorities estimate that this would be close to ₡ 1 billion, whereas the staff estimates only a yield of ₡ 300 million. Preliminary information indicates that the Government's estimates may prove to be more accurate, since 10 days before the closing of the amnesty periods, collection of sales tax arrears alone had reached ₡ 400 million, while collections of arrears on income and property taxes have not been accounted for. Furthermore, the authorities have prepared a new package of expenditure cuts and postponement of payments worth an additional ₡ 700 million for the rest of the year. These actions show the commitment of the Costa Rican Government to comply with the program's targets and objectives. The authorities estimate that, given the measures taken throughout the year, the overall government deficit will reach 1.7 percent of GDP at the end of 1985 as contemplated in the program.

In the rest of the nonfinancial public sector, the authorities expect to record an overall surplus similar to that projected in the program. Preliminary information on the results expected by the State Electricity Corporation indicate a profit level of about ₡ 300 million, compared with a deficit of ₡ 100 million recorded in 1984. The results of the Electricity Corporation alone would suffice to comply with the surplus of 0.2 percentage points of GDP contemplated in the program for all state enterprises.

Given the expected behavior of the finances of both the Central Government and state enterprises, the outcome of the Central Bank's operating losses will be the determining factor in the consolidated public sector deficit, which, under the program, is scheduled to decline to 5.7 percent of GDP in 1985. The authorities aim at maintaining the Central Bank's losses as a percentage of GDP under 4.2 percent in 1985 through (a) a reduction in interest rates on central bank deposits representing the counterpart of U.S. Agency for International Development (AID) grants; and (b) the savings resulting from substituting open market operations for reserve requirements for purposes of monetary control.

On wage policy, as commented on by the staff, it is expected that minimum wage increases both in the public and private sectors will, on average, be negative or zero in real terms in 1985. Although the increase approved by decree as of December 22, 1984 (three months before the Executive Board's stand-by approval) was higher than that observed in the basic basket, the second adjustment was delayed until July and was granted by an amount lower than the recorded increase in the basic basket at that time. Furthermore, during the next revision in January, the Government plans to grant wage increases by a smaller amount than the rise of the basic basket.

In sum, Costa Rica has experienced a remarkable adjustment process since 1982. A reduction in the public sector deficit from 14.1 percent of GDP in 1981 to 1.9 percent in 1984 as well as a decline in the rate of inflation from 90.1 percent in 1982 to 12 percent in 1984, on average, are attainments that speak for themselves. In 1985, despite the overwhelming difficulties that arose in the first part of the year as a consequence of a less favorable external and internal environment than previously envisaged, the Costa Rican authorities reacted promptly by adopting complementary measures in order to maintain the program on track. They expect these efforts to be recognized by the Board during our discussion on the 1985 Article IV consultation with Costa Rica.

Mr. Pérez stated that a delegation from Costa Rica would be coming to Washington to meet with Fund management and staff on September 12 and 13 in order to finalize negotiations for the review of the current stand-by arrangement.

Mr. Arias said that the Costa Rican authorities should be congratulated on having complied with most of the quantitative performance criteria as of June on the current stand-by arrangement. The noncompliance with the criterion of external payment arrears was related to a temporary delay in arrangements for external financing, and it should not be seen as a structural deviation from the program. Nonetheless, he encouraged the authorities to continue their adjustment efforts.

Economic activity in Costa Rica had been sluggish, Mr. Arias continued. While a positive growth of 3 percent had been encouraged under the program, real growth of GDP had been negative so far in 1985. That development was explained by the weak performance of government revenues. Nevertheless, the authorities had made every effort to keep the program on track. They had shown a firm intention to maintain revenue collections at a level that would make the program operational. The mechanism of a tax amnesty in order to collect arrears, which could be called extraordinary revenue, was a welcome development. He agreed with the staff regarding the issue of wage increases that could undermine the economic program. He congratulated the authorities' adjustment measures and their willingness to tackle or offset any deviation that might occur before the program started.

Net operational losses of the Central Bank had worried the authorities for some time, Mr. Arias commented. Adjustment measures, such as changes in the level and structure of the Central Bank's lending rates were made late last year, aimed at alleviating such financial problems, and they proved to be worth it. He added that although further strengthening of public finances would be needed, the authorities were confident that there would be an improvement in the savings performance in the main sectors, and in the external sector they continued to be firmly committed to a flexible exchange rate policy.

Mr. Arias welcomed the approval of the structural adjustment loan program of the World Bank by the Costa Rican Legislature last August. The loan would involve a number of structural reforms that would provide the Costa Rican economy with sustained growth for the medium term.

Mr. Hodgson remarked that when the stand-by program for Costa Rica had been approved by the Executive Board six months earlier, it had been recognized that Costa Rica would have to maintain its adjustment effort for some time if a sustainable position was to be achieved. In that light, the present circumstances were disappointing. Admittedly, part of the explanation lay beyond the authorities' control. For example, the failure to meet the arrears target for the second quarter of 1985 was related to delays in disbursements by the banks, and it was regrettable that that had led to delays in Fund disbursement. However, the Costa Rican authorities had not helped their own cause by only partially implementing the adjustment program.

Nevertheless, the program targets had been met with comfortable margins other than the one pertaining to external arrears and some weaknesses in fiscal policy and wage policy, Mr. Hodgson continued. Therefore, it was unfortunate that the authorities did not have a more fully developed report to present to the staff because that might have allowed the Board to complete its review.

Overheating of the economy in the first half of 1985 was a disappointment, but revenues had fallen below projections, Mr. Hodgson commented. However, the authorities had remained committed to expenditure guidelines and had taken some measures to increase revenues. Nonetheless, because those measures had been inadequate for the program targets to be met, additional measures would be required. Could the staff comment on what other measures might be taken?

He was encouraged that the authorities still expected to achieve their projected surplus for the rest of the public sector, Mr. Hodgson went on. However, in view of the central government shortfalls, even more might be done to improve the parastatals. For example, an increase in fuel prices had been agreed upon but had as yet to be implemented. Whereas an increase might be politically unpopular, further delay was unlikely to make it any more palatable.

The continuing large central bank losses were the principal issue regarding monetary policy, Mr. Hodgson stated. Those losses could only partially be reduced through adjustments in interest rates. The authorities' suggestion that losses should be more directly incorporated into the fiscal position had considerable merit. Therefore, he supported a measure that would increase the transparency of foreign reserves and would place the burden for adjustment in the fiscal area.

The authorities' failure to achieve the program's target on wage policy was a major weakness that had affected fiscal and external competitiveness, Mr. Hodgson remarked. In fact, over the medium term, an exchange rate based on something other than a basket of basic goods and services would be a wise step. In the short term, however, adjustment would likely focus on fiscal expenditures and the exchange rate.

The complex trading arrangements within Central America had not helped to strengthen or diversify exports, Mr. Hodgson went on. In addition, the fact that exports outside Central America had not increased during the first half of 1985 suggested that more rapid exchange rate adjustments combined with structural trade reforms were required to achieve the program's targets--something the current policy mix did not seem adequate to accomplish. He was pleased that the World Bank had provided a structural adjustment loan to begin the process of tariff and trade reform.

Despite the recent setbacks, Costa Rica could reach a sustainable balance of payments position over the medium term, Mr. Hodgson said. However, further delays and deviations from the program would only hurt its efforts.

Ms. Bush said that when the Board had approved Costa Rica's stand-by arrangement, she had noted that because of its weak medium-term outlook and high debt service, the country would have to strengthen its adjustment effort. Indeed, substantial progress had been made in reducing the fiscal deficit in 1983 and 1984. Therefore, it was disappointing that the adjustment effort, including the reduction of the central bank losses, had fallen short the first half of 1985. That development was jeopardizing the attainment of the program targets despite the fact that almost all quantitative performance criteria had been met. Discussions on the program review would continue, and the Costa Rican authorities should take the measures needed to offset earlier excessive expenditures, including lasting controls as opposed to simple postponements that would only add to the fiscal burden in 1986.

She welcomed the emphasis placed on wage restraint in the staff report, Ms. Bush continued. However, by spring 1985, wage increases, which were to be determined by price increases for a basic basket of consumer goods, had more than doubled program targets.

Currently, the authorities expected to enhance revenue performance by improving tax collection with an amnesty, Ms. Bush went on. If maintained, administrative measures could permanently increase revenues, but a one-time tax amnesty would only generate a one-time revenue bonus. Furthermore, reductions in expenditures and taxes would be required to revitalize the economy, given the high proportion of taxes to GDP.

The legislative actions to reduce expenditures were welcome, Ms. Bush commented. However, the other proposed solution--a postponement of spending--would only be temporary. She would be interested in hearing details of the authorities' plans for additional expenditure reductions, and she welcomed the planned fiscal reform--in particular, the elimination of revenue earmarking and extrabudgetary operations.

Performance in public enterprises appeared to be on target, Ms. Bush said. For example, the price increases by the National Grain Marketing Agency should lead to a 50 percent reduction in the deficit of that agency. One industry that caused concern was the National Petroleum Refinery (RECOPE), which had not raised domestic fuel prices in two years, although an increase had been expected under the stand-by arrangement. Were there any details on how price increases or cost savings could offset past increases in oil import costs? There was progress in the reforms of the National Development Corporation (CODESA), which should generate long-lasting savings for the Government while leading to more efficient production in the private sector.

Reduction of the overattractive interest rate on dollar-denominated deposits clearly was necessary, Ms. Bush continued. The spread over the London Interbank Offered Rate (LIBOR) had been reduced to about 1 percent, but that reduction still had left the Central Bank saddled with losses because only a small portion of the deposits were invested abroad and earned foreign exchange. On the condition that the stand-by arrangement was operative, U.S. AID had agreed to a four-month moratorium on the requirement that the Central Bank pay interest on AID's local currency deposit. However, even that would not substantially reduce the Central Bank's losses. Despite increases in interest rates--for example, on interest payments by public utilities--expected losses of the Central Bank in 1985 would not meet the program target and would be virtually unchanged from 1984. Progress in that area must be accelerated, and the losses should be directly incorporated into the fiscal program. She was interested in any further measures that Mr. Pérez might envisage that could contain the fiscal deficit and reduce the losses of the Central Bank.

Assuming that the Fund program and the structural adjustment loan were disbursed as planned, external financing would be tentatively secured, and even with a weak export performance, balance of payments difficulties should not emerge in 1985, Ms. Bush noted. Even without a financing shortfall, the Costa Rican authorities should not relax, given the medium-term outlook with its large financing gaps. Attainment of almost balanced trade accounts by 1987 would require "prudent financial management and an aggressive export-oriented strategy," a reduced fiscal deficit, a larger depreciation of the colón, and substantial wage restraint in order to improve competitiveness. Wage restraint was especially important given the increases in real wages in Costa Rica in the previous few years. Even if balanced trade accounts could be attained, exceptional external assistance would most likely be required. Creditors and donors would be disposed to provide assistance only if an adequate adjustment effort continued. She urged that the World Bank, the Fund, and the Costa Rican authorities continued to work closely together. Such cooperation would reassure commercial banks that the adjustment effort was on track and would generate their continued financial support.

The tariff reform of the Central American Common Market remained an important development, and the Costa Rican authorities were to be commended for taking the lead in implementing reforms, Ms. Bush said in closing.

Mr. Nebbia said that only a few months earlier he had supported a program for Costa Rica based on several facts. The pace of adjustment in the past few years had been achieved despite a hostile local environment. The authorities' strong commitment and political strength had been proved by restoring balanced economic growth with the aim of strengthening the country's external position over the medium term. More important, Costa Rica was a test case for the interlocking of rescheduling arrangements and support of the Fund, in order to bring together for the remainder of the decade the necessary amounts of external financing. He would like to quote the following paragraph from Mr. Pérez's buff:

> In sum, Costa Rica has experienced a remarkable adjustment process since 1982. A reduction in the public sector deficit from 14.1 percent of GDP in 1981 to 1.9 percent in 1984 as well as a decline in the rate of inflation from 90.1 percent in 1982 to 12 percent in 1984, on average are attainments that speak for themselves. In 1985, despite the overwhelming difficulties that arose in the first part of the year as a consequence of a less favorable external and internal environment than previously envisaged, the Costa Rican authorities reacted promptly by adopting complementary measures in order to maintain the program on track. They expect these efforts to be recognized by the Board during our discussion on the 1985 Article IV consultation with Costa Rica.

It was therefore unfortunate that the agenda did not read "1985 Article IV consultation and review under stand-by arrangement."

He would like to elaborate on a related issue because it was important for future discussions not only of the program with Costa Rica but of the more general aspect of the role of the Fund in assisting members with commercial banks and official creditors, Mr. Nebbia continued. Based on quantitative performance criteria to June 30, 1985, Costa Rica was to have made its third purchase under the current stand-by arrangement. With the sole exception of the target for external payments arrears, Costa Rica had met all the performance criteria by substantial margins--for example, net domestic assets, net credit to the public sector from the bank system, net international reserve position, foreign indebtedness of the public sector, and cumulative central government expenditure commitments. Furthermore, failure to meet the arrears was partially related to delays in the commercial banks disbursing their committed $75 million in new loans. Why had that occurred? He had tried to disentangle the maze of cross-conditionality among Costa Rica's agreement with the commercial banks, the structural adjustment loan of the World Bank, and the Fund's stand-by arrangement--all of which were in clear legal language that was irrelevant economically. The stand-by arrangements with the Fund maintained Costa Rica's eligibility to make purchases if it complied with each quarter's performance test. However, it would suspend eligibility for purchases if the midterm review had not been concluded by August 31, 1985. If that occurred, the eligibility to make purchases under the stand-by arrangement would not be reinstated even if the September targets were met.

The following financing had been expected already to be in place by June 30, 1985: the first tranche of the structural adjustment loan from the World Bank, which had been made on August 27, and the third drawing under the stand-by arrangement with the Fund, Mr. Nebbia noted. However, on August 31, eligibility for a purchase under the stand-by arrangement had been suspended until the completion of the midterm review. Disbursement of the remaining $56 million from the commercial banks had depended on the first two items. Therefore, it had not taken place because the contractual commitment had expired on August 31. No one had a clear explanation for the date of August 31. One possibility was that it was related to the date of the midterm review by the Fund, and he would appreciate comments on that. He apologized for the digression, but he felt that that background was important for upcoming discussions. Furthermore, he doubted that rigid calendar dates provided an appropriate environment to conduct sensitive economic policy.

Considering the Fund-supported adjustment program and the Fund's catalytic role with commercial banks, Mr. Nebbia asked why Costa Rica was not eligible for a waiver, or, more appropriately, why the Board did not address the possibility. Were not the excessive noneconomic cross-conditionalities in the commercial bank agreements implicitly pressing for too much forecasting on the part of the Fund? That pressure could be affecting the role of the Fund in evaluating the progress of adjustment programs.

The main components of the program had been detailed a few months earlier, Mr. Nebbia went on, and it had been labeled as a strong one. A few slippages had emerged, which would be too short lived to be indicative of anything serious, but they should be resolved as soon as possible. For example, revenues were currently less than expected because of foreign trade flows lower than projected in the program. Exports were lower by 10 percent, imports were lower by 9 percent, and there was recession in some key sectors of the economy, such as agriculture. It was commendable that the authorities had undertaken additional revenue measures in spite of the steady growth of government revenues as a proportion to GDP in recent years.

In addition, some expenditure overruns had clouded the original program, Mr. Nebbia stated. Wages had been the main problem. However, realities had to be faced in that area. Moreover, the authorities had expressed their commitment to stay within the original targets and had prepared a new package of expenditure cuts and postponements that would guarantee the desirable overall fiscal target for 1985.

The mechanism of the exchange rate was a concern, Mr. Nebbia noted. The combination of devaluations and recent movements in the U.S. dollar had provided the program with a real depreciation of the colón. In addition, the authorities were changing the mechanism of their exchange rate avoiding appreciation in their currency due to movements in the U.S. dollar.

He praised the boldness with which monetary and interest rate policies had been implemented when domestic pressures for relaxation existed, Mr. Nebbia continued. Monetary stance had been tighter than called for under the program, and the authorities had confirmed their commitment to that stance. Therefore, a reasonable plan of adjustment for the coming months would be established shortly.

One quote from the staff report bothered him, Mr. Nebbia said--"notwithstanding the temporary problem of Costa Rica's financing arrangements under the program, it appears that for 1985 as a whole, Costa Rica's financing requirements will be satisfied." How could that be achieved? The rescheduling arrangement with the commercial banks had been imperiled, and a waiver from all the participants was required in order to reinstate the remaining commitments of $56 million. The Fund should ensure that the commercial banks' responsibility was carried out as originally envisaged. It would be unfortunate if the program failed because of lack of coordination among the parties.

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

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/85/134 (9/9/85) and EBM/85/135 (9/10/85).

4. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 84/178 and 84/179 are approved. (EBD/85/229, 9/3/85)

Adopted September 9, 1985

APPROVED: May 21, 1986

LEO VAN HOUTVEN
Secretary