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Minutes of Executive Board Meeting 85/133

10:00 a.m., September 9, 1985

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
A. Alfidja	Mawakani Samba
	M. K. Bush
	D. C. Templeman, Temporary
	H. G. Schneider
B. de Maulde	
M. Finaish	T. Alhaimus
	M. Sugita
G. Grosche	B. Goos
	M. Rasyid, Temporary
	L. Leonard
	J. R. N. Almeida, Temporary
T. P. Lankester	T. A. Clark
	H. Fugmann
E. I. M. Mtei	A. Abdallah
	M. A. Weitz, Temporary
	J. E. Suraisry
	J. de la Herrán, Temporary
J. J. Polak	
	A. V. Romuáldez
G. Salehkhou	
	A. S. Jayawardena
S. Zecchini	N. Coumbis
	Jiang H.

L. Van Houtven, Secretary
R. S. Laurent, Assistant
J. Bungay, Assistant

Also Present

IBRD: N. M. Gojestani, Western Africa Regional Office; P. Nouvel, Europe, Middle East and North Africa Regional Office. African Department: A. D. Ouattara, Director; E. L. Bornemann, J. P. Briffaux, E. A. Calamitsis, A. B. Diao, M. G. Fiator, C. A. François, I. C. Lienert, S. M. Nsouli, E. Sacerdoti, L. Schmitz, M. Sidibé, P. C. Ugolini. European Department: L. A. Whittome, Counsellor and Director; P. Alonso-Gamo, L. M. Beleza. A. Leipold, A. López-Claros, T. M. Ter-Minassian. Exchange and Trade Relations Department: S. J. Anjaria, G. Begashaw, J. T. Boorman, E. R. S. Kalter, S. Kanesa-Thasan. IMF Institute: B. A. Sow, M. A. Sow, Participants. Legal Department: J. M. Ogoola, S. A. Silard. Treasurer's Department: J. V. Soromenho-Ramos. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: G. W. K. Pickering, T. Sirivedhin, A. Vasudevan. Assistants to Executive Directors: W.-R. Bengs, M. B. Chatah, A. K. Diaby, C. Flamant, S. Geadah, V. Govindarajan, N. Haque, G. D. Hodgson, L. Hubloue, Z. b. Ismail, S. King, H. Kobayashi, M. Lundsager, R. Msadek, J. A. K. Munthali, E. Olsen, J. K. Orleans-Lindsay, D. J. Robinson, M. Sarenac, A. A. Scholten, L. Tornetta, Yang W.

1. EXECUTIVE DIRECTOR

The Chairman welcomed Mr. Lankester as Executive Director for the United Kingdom.

2. PORTUGAL - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with Portugal (SM/85/237, 8/19/85; and Cor. 1, 9/4/85). They also had before them a report on recent economic developments in Portugal (SM/85/242, 8/26/85; and Cor. 1, 9/4/85).

Mr. Zecchini made the following statement:

My Portuguese authorities are grateful to the staff for the detailed and comprehensive analysis carried out on the occasion of the previous Article IV consultation. The documents prepared for this discussion accurately reflect the current situation of the Portuguese economy, and the major economic policy priorities, summarized in the staff appraisal, are broadly supported by the authorities. We will therefore concentrate on a few key policy issues that are of special importance, particularly in the light of the recent economic developments. We will also outline the approach on which the authorities intend to base the future course of their policies.

The recent experience

At the beginning of 1983, Portugal found itself in a seriously unbalanced economic and financial position. The external current account had worsened considerably, from near-balance in 1979 to a deficit higher than 13 percent of GDP in 1982. This was due partly to a deteriorated competitive position and expansionary fiscal and monetary policies, and also to a number of exogenous factors, including the second oil shock, the recession of the world economy, relatively high foreign interest rates, and larger imports of agricultural products and energy resulting from adverse weather conditions. Faced with a clearly unsustainable external position, the authorities decided in mid-1983 to embark on a major adjustment program supported by the Fund with the primary purpose of bringing the foreign current account to a level compatible with realistic financing prospects in the short run and of allowing a reduction of debt service burden in the longer run.

The program was very successful in attaining its main objectives. The current account deficit as a ratio to GDP fell dramatically, from the peak of 13.2 percent of 1982 to 7.2 percent in 1983 and 2.3 percent in 1984, with substantial margins compared to the program objectives in both years. As a consequence, the growth of total foreign debt, expressed in dollars, declined from an average rate around 23 percent per year in 1979-82 down to about 6 percent in 1983 and 3.1 percent in 1984. The improved confidence of international capital markets in Portugal's creditworthiness during the program period allowed for progressively more favorable borrowing conditions, and was reflected in a decline in the share of short-term over total outstanding debt. The overachievement of the external current target significantly contributed, as observed by the staff, to facilitate the authorities' management of external debt and to shorten the time necessary to achieve the longer-run objectives of the adjustment program.

Just as the strength of the favorable turnaround in the external accounts turned out to be underestimated, so were the effects of the program on the main components of domestic demand. Specifically, the effects of tight financial policies were strongly felt on gross fixed capital formation, which declined by about 8 percent in 1983 and by an estimated 20 percent in the last year, against program projections of 3.5 and 13 percent, respectively. Given the presence of considerable margins in the expansion of domestic credit to the private sector with respect to the program targets, the fall in investment appears to be attributable mainly to the high level of lending interest rates in real terms, particularly at the end of the program period, and to the negative effects on business expectations of the unfavorable prospects for consumption and household expenditures in general. Private consumer expenditures declined, at constant prices, by a cumulative 4 percent over the years 1983-84, as a result of a sharp compression of households' real disposable incomes and despite a fall in the personal saving ratio. Overall, it seems that both the favorable and the unfavorable overshootings that have occurred under the program have been due to some underestimation of the speed and magnitude of reaction in some crucial variables in the economy. These variables are the response of trade flows to improvements in competitiveness and to the relative cyclical position of the economy compared to its trading partners, the reaction of domestic prices to exchange rate developments, and the behavior of domestic demand in general in the face of changing monetary conditions and expectations about future economic trends.

The current key policy issues

While viewing the experience of the adjustment program as a success, the authorities consider that the time is ripe to proceed beyond the recent experience, and to steer the economy on a more balanced growth path. The future course of policies will have to be geared in such a way to complete the process of ajustment in those areas in which full success has so far been lacking, yet at the same time to promote a sound recovery of domestic demand. The concern of the authorities in the present juncture appears to be concentrated on four main issues--namely, (i) the effects of a prolonged recession on economic development and the productive structure; (ii) the response of the economy during the transition to full European Economic Community (EEC) membership; (iii) the outlook for public finance; (iv) the situation of the banking system.

The repercussions of the long recession on the productive structure of the economy and its development are the major concern of the authorities today. As mentioned above, gross fixed capital formation declined in both 1983 and 1984, and in the latter year it fell by a very substantial amount--about 20 percent. Moreover, preliminary information relating to the first quarter of 1985 indicates that in the most recent months the decline is continuing roughly at the same pace. In the view of the authorities, such a reduction in the rate of capital formation is not compatible with the urgently needed modernization of the structure of Portuguese industry and prevents an increase in overall level of productivity. In the absence of a revitalization of investment, the industrial sector would not be in a position to sustain the increased foreign competition that Portugal's gradual entry into the European Communities (EC) entails, and would then be more exposed to the dangers of such entry. The recovery in investment is to be supported, according to the authorities, both by gradually lower bank lending rates, and by an expansion of the program of public investment. Moreover, since investment activity is believed to be particularly sensitive to the developments of overall domestic demand, a revival in all components of domestic demand is an important prerequisite.

The Portuguese authorities regard entry into the EEC as an important occasion to realize an improvement in the productivity and competitiveness of all sectors of the economy that are open to foreign competition. Given the substantial differences between the levels of domestic costs and prices in Portugal and in its main European competitors, a transition period was negotiated with the EEC so as to allow for a gradual reconciliation of these differences. During the transition period, those sectors with the highest export potential but with comparatively low levels of productivity should be encouraged to introduce more efficient production processes by a more favorable environment for investment. Consistently with this aim, the authorities have recently specified a series of guidelines for industrial policy. According to such guidelines, no sectoral priorities are to be established, but all sectors should be provided with equal oppportunity to develop their export potential. It should be noted, in this connection, that the Portuguese authorities are trying to encourage the inflow of foreign direct investment. In the field of agriculture, entry in the EEC is regarded as particularly critical, in view of the fact that many producers' prices are considerably higher than the ones prevailing in the European markets. The authorities believe that, to realize the needed increase of agricultural productivity, a substantial share of resources will have to be devoted, in the coming years, to investment projects in the sector.

The third area of concern is the prospects for the public sector's accounts. After the substantial reduction in the public sector's deficit in 1983--15.1 percent of GDP against 22.2 percent in the previous year--the fiscal outcome for 1984 has been rather disappointing as a consequence of lower than expected tax collection--in turn connected with the unexpected depth of the recession--of some delays in increasing administered prices, and of higher than projected interest payments on the public debt. The less than fully satisfactory outcome in these areas contrasts with the continued effort in the "discretionary" part of public expenditures--noninterest outlays, which declined, as a ratio to GDP, from 36.2 to 34.7 percent. At any rate, the authorities view the current level of the public deficit as excessively high, and continued effort will be made to reduce it.

Finally, the fourth area that has caused considerable concern in recent times is the financial situation of the banking system. Bank profitability has declined sharply, particularly in the last two years, generating doubts about the prospective stability of the financial sector and prompting the authorities to introduce a package of policy measures affecting the deposit and lending rates. In fact, the problem of bank profitability is closely connected with the administrative approach to monetary policy, since on the one hand, the spread between the loan and deposit interest rates has been compressed by administrative regulation, while on the other hand, the credit ceiling has induced the banks to hold large amounts of treasury paper carrying relatively low interest rates. In view of the connection between the two problems just mentioned, the authorities believe that an improvement of bank profitability should be made consistent with a gradual removal of the rigidities that now impair the fuctioning of the financial markets. Moreover, for the reasons already mentioned, these two objectives have to be achieved together with a significant reduction of the cost of credit to enterprises.

<u>The prospects for policy</u>

In light of the above considerations, the authorities are of the view that a balanced policy approach, geared at promoting both continued adjustment and controlled recovery, is now the most appropriate one. Continued adjustment will have to concentrate on those areas, like public sector's revenues, in which the progress achieved up to 1984 is considered insufficient.

At the same time, policies aimed at promoting economic recovery should primarily address those segments of expenditures, like gross fixed capital formation, that are of primary importance for the future of the economy. Unfortunately, the precise definition of the prospective course of economic policy is now complicated by the political uncertainties connected with the forthcoming parliamentary elections, scheduled to take place in the fall. Consequently, although the broad orientation of policy expressed during the consultation discussions is expected to be maintained over the medium term, a more detailed definition of the specific measures will not be possible until late this year.

(a) Fiscal policy

Official projections for the public sector's accounts in 1985 envisage a further, small decline in the enlarged public sector's deficit as a ratio to GDP, resulting from a small increase in tax revenues and a moderate decline in noninterest expenditures, partly compensated by a further increase in the interest component of expenditures. The fiscal outcome through the end of the year is, however, subject to a number of uncertainties, partly outside the authorities' control, whose net effect on the public sector's accounts is, at present, difficult to determine. No evidence available at the moment, however, seems to suggest that the fiscal objectives should be significantly exceeded. In the month of July, for example, the growth of credit to the public sector was still running at a rate below 28 percent, against a target of 29.8 percent. Moreover, the considerable progress against inflation--12-month CPI growth fell to 17.3 percent in July from 20.1 percent in June and 23.8 percent in May--will favorably affect the dynamics of budget expenditure for nominal interest payments over the coming months.

In relation to the fiscal prospects beyond 1985, the authorities wish to reiterate their objective of attaining further reductions in the public sector's deficit, while safeguarding some areas that are regarded as of key importance. Among these, particular emphasis is put on a selective expansion of investment in public works.

On the revenue side, concern over the budget balance in 1986 induced the authorities to limit the reduction in the tax rates on time deposits from the 10 percentage points originally envisaged for all deposits to 5.7 points for residents' deposits and 6.9 points for emigrants' deposits. Nonetheless, the reduced taxation on deposit interest will require, as the authorities recognize, some compensatory measures to avoid excessive burden on the 1986 budget. The nature of these measures is not likely to be specified before the presentation of the budget, expected to take place near the end of the year.

(b) Monetary policy

The conduct of monetary policy is directed toward the attainment of the three objectives already mentioned, namely, the creation of the conditions for a recovery in private investment, the allowance for an improvement in bank profitability, and the increase in the role of market forces in the monetary area. The latter, in particular, is viewed as a longer-term objective, to be achieved gradually along with the necessary development in the financial markets. In parallel, it is expected that the role of the Bank of Portugal in the financing of the public sector deficit be reduced over time, in conjunction with the creation of a more active market for treasury paper, accessible to both financial and nonfinancial investors.

The recent reductions in interest rates were conceived to achieve both targets of stimulating the recovery of investment through a cut in lending rates, and to strengthen the financial conditions of the banking system through an improvement of their interest-related cash flow, while at the same time limiting the impact of the lower after-tax yield rates on the demand for time deposits. The improvement in bank profitability will result from the parallel reductions on loan and deposit interest rates, coupled with an increase in the average return of the banks' bond portfolio. The latter is to be achieved gradually substituting low-interest claims vis-à-vis the public sector, held by the banks, with newly issued, more remunerative ones. Moreover, in an attempt to stimulate the development of a money market, the authorities have begun issuing short-term treasury paper that should provide both an alternative to bonds for the banks, and a substitute for deposits in the portfolios of the nonfinancial private sector.

(c) External policies

Since the large devaluation of mid-1983, the Portuguese authorities have followed a policy of gradual but steady adjustment of the exchange rate, aimed at preserving the improved competitiveness level attained during the first year of the adjustment program. This policy has been a major factor behind the considerable success achieved in 1983-84 on the external front. In view of the size of Portugal's external debt and debt service, the authorities are of the view that a strong competitiveness is a necessary condition for the future financial viability of the economy, and that the current exchange rate policy should therefore be continued.

In connection with the entry into the EEC, measures are being proposed to increase the role of market forces in foreign exchange operations. In contrast with the present system, in which the commercial banks address their requests for foreign exchange only to the central bank, in the new system under consideration the banks would be free to trade foreign exchange among themselves at a market-determined exchange rate. The Bank of Portugal would stand ready to buy and sell foreign currency at the official rate of exchange during a limited period of time each day, while at any time transactions would be effected on the interbank market at freely determined exchange rates.

(d) Labor market policies

Labor market practices in Portugal have traditionally expressed a preference for a relative security of employment manifesting itself in a number of regulations affecting layoffs, labor mobility, etc. More recently, however, and partly in connection with the desire to make Portugal a more attractive destination for foreign direct investment, the authorities have become gradually more concerned about the risks implicit in an overly rigid labor market, and have introduced measures to ease some of the rigidities. These include a more active use of the Unemployment Fund to provide temporary compensation to laid-off workers, and are considering ways of promoting a wider use of part-time contracts and fixed-term arrangements.

The staff representative from the European Department explained that because of an oversight, no reference had been made in the staff report to the presence of the Executive Director at some of the consultation discussions for Portugal.

Mr. Goos expressed full agreement with the staff appraisal, which identified a number of serious risks that could easily reverse the impressive improvements in the external sector achieved during the past two years, thereby depriving Portugal of the chance to return to balanced, sustainable economic growth. Under the circumstances, the authorities would be well advised to follow the staff's recommendations with respect to both financial and structural policies. Specifically, he was dissappointed to note the lack of any major progress in addressing the serious fiscal imbalances, as reflected in the overshooting of the program targets for 1984 and also in the recent acceleration in the growth of credit to the public sector. Of course, a number of factors limited the Government's room for maneuver in correcting the public sector deficit, most notably the country's external debt obligations, the unfavorable impact of the depressed state of the domestic economy on both public revenue and public expenditure, and the need for financial reform measures. Nevertheless, the serious risks of an unduly expansionary stance of fiscal policy had to be faced: there would occur either a crowding out of private sector demand for credit, or an oversupply of liquidity through the central bank. Each would have adverse repercussions on Portugal's economic stability and international competitiveness.

Like the staff, Mr. Goos continued, he had considerable difficulty in reconciling the official target for economic growth in 1986 with the expected further deceleration of inflation, if present policies continued. Inflation had shown a strong acceleration during the past two years, even with weak domestic demand and a pronounced cyclical downswing, suggesting the existence of considerable structural weaknesses. Those weaknesses were probably the most disquieting feature in the economy, mainly for two reasons: first, the fact that Portugal's structural weaknesses had been the subject of repeated discussions with the staff and in the Executive Board in previous years had apparently failed to produce major results.

Accordingly, Mr. Goos commented, the improvement in the external sector since 1983 seemed to have depended largely on the impact of restrictive demand management policies and much less on structural measures that would have strengthened underlying productive capacity. Thus, investment activity had had to shoulder an extremely heavy burden of the recent adjustment effort, and gross fixed capital formation was continuing to decline at an alarming pace. Notwithstanding the recent pronounced improvement, the external position appeared rather fragile. Second, the existing structural weaknesses would become even more cumbersome with the accession of Portugal to the EC, which would open up trade opportunities, but would also entail serious challenges to domestic producers by increasing international competition. At the same time, existing import restrictions pointed to a lack of competitiveness in several industries owing to insufficient modernization and widespread structural difficulties. There could be no doubt about the urgency of addressing the weaknesses in those areas, and he considered it unfortunate that the necessary reform measures were being postponed further in the wake of present political uncertainties.

In conclusion, he supported the proposed decision, Mr. Goos said. It would be interesting to learn whether the authorities had considered adopting Article VIII status in the context of Portugal's entry into the EC.

Mr. Templeman noted that although there had been an impressive improvement in Portugal's external accounts under the 1983-85 stand-by arrangement with the Fund, Portugal had fallen out of compliance with the program at the end of September 1984. At present, no arrangement was in effect. The advent of parliamentary elections in October 1985 and of presidential elections early in 1986 complicated economic policy planning and implementation. At present a caretaker government was focusing primarily on fostering economic recovery, having obtained some breathing space by an impressive improvement in the external accounts. Some economic recovery might indeed occur, along with a slight slowing of inflation and a continued small deficit on current account. However, problems loomed in 1986 unless adjustment policies were strengthened and structural reforms begun in industry, agriculture, the tax system, and financial and labor markets.

As Portugal had made good progress in balance of payments adjustment, he understood the authorities' decision to assign a high priority to fostering economic recovery, Mr. Templeman remarked. However, growth must be sustainable over the long term and the present pattern of savings and investment raised serious doubts on that score. In 1984, public sector savings had continued to be negative, to the extent of almost 10 percent of GDP; from 1981 to 1984, the household savings rate had fallen steadily; gross fixed investment had declined by nearly 8 percent in 1983 and about 20 percent in 1984, having apparently been substantially negative so far in 1985. Clearly, improvements were needed in those areas both to provide a basis for long-term sustainable growth and to allow Portugal to compete and prosper following its accession to the European Communities.

Strengthening the fiscal accounts, in part to eliminate large negative savings, must occupy an important place in the authorities' continuing efforts at adjustment and reform, Mr. Templeman noted. The public sector borrowing requirement had averaged over 19 percent of GDP each year from 1981 to 1984, and the 17.4 percent of GDP forecast for 1985 was only marginally lower. Furthermore, there was a danger of slippage and of a wider deficit from new public works expenditures aimed at reviving investment. Although major fiscal reforms could not realistically be expected until a new government assumed office, it was important that, in the interim, the authorities should control public spending, promptly make administered price adjustments, maximize tax enforcement, and closely monitor the borrowing of public enterprises. For 1986 and beyond, the staff report expressed concern about the effect on the bugetary balance of no change in policy and cited an expected deterioration in the financial position of public enterprises. The authorities would need to consider fundamental reforms designed to improve the tax system and tax administration, reduce the burden of subsidies on the budget--which had represented nearly 12 percent of public sector current expenditures--and reform public enterprises. Such reforms should encompass financial restructuring, physical restructuring to reduce capacity and overmanning, more rapid price adjustments, and careful assessments of investment priorities and efficiency. Could the staff explain the reason for the regrettable delay in negotiating a restructuring loan from the World Bank?

Until more fundamental fiscal and monetary reforms could be effected, the authorities should avoid too accommodative a stance toward credit demand and any crowding out of the private sector as in 1984, Mr. Templeman suggested. Although plans for 1985 called for a shift to more credit for the private sector, possible fiscal overruns could present the monetary authorities with the dilemma of either permitting total credit expansion to exceed the targets or reducing credit availability to the private sector. More generally, the rate of expansion during the past four years of both net domestic credit and M-2, at an average of 24 percent and 25 percent, respectively, had surely facilitated an unacceptably high rate of inflation. He would encourage the authorities to continue to move away from direct credit controls toward more market-oriented monetary instruments and also to proceed promptly with other reforms. What did they have in mind in the "comprehensive financial reform" referred to on page 7 of the staff report? Furthermore, he welcomed the opening up of the banking system to domestic and foreign private initiative.

Price and wage developments in recent years had not been satisfactory, Mr. Templeman considered. During 1980-84, the average yearly price increase of nearly 23 percent in Portugal had been higher than other major western and southern European countries, with the exception of Greece. Furthermore, the expected fall in the inflation rate during 1985, from 21 percent to 20 percent, would hardly represent a substantial improvement in price performance, which was apt to become more important after Portugal's accession to the EC. In contrast, changes in real wages had been increasingly negative over the past four years, reaching negative 9 percent in 1984, despite nominal wage increases averaging 19 percent over that period. The relative movement of prices and unit labor costs suggested a rise in profitability, yet private investment had remained weak and apparently required further incentives to recover.

Labor market reforms would be helpful, and the authorities had already taken a few steps in that direction, Mr. Templeman noted. For example, the increase in unemployment insurance should help to promote labor mobility, although the authorities must take care to insure that the replacement ratio did not become so high as to impose a disincentive to work. He welcomed the authorities' intention to encourage part-time work, contractual work, and geographic mobility and, especially, their creation in 1984 of the Social Coordination Council to promote dialogue among the social partners. However, he wondered why collective dismissals had not occurred more often during recent periods of slow growth.

The ratio of Portugal's foreign debt to GDP had risen from 46 percent in 1981 to over 77 percent in 1984, and the debt service ratio had risen from 23 percent to 35 percent, Mr. Templeman remarked. True, improvements in the balance of payments had helped Portugal's creditworthiness; the staff's medium-term debt projections, under fairly favorable assumptions, did not foreshadow any worsening in the debt situation. However, even the fairly optimistic scenario would leave Portugal with debt at 76 percent of GDP and a debt service ratio of 28 percent in 1995. That scenario suggested the need for considerable caution in debt management.

In conclusion, the authorities had made good progress in making external adjustments and should continue to try to hold the line on serious domestic imbalances until a new government was in place, Mr. Templeman said. It would be a great pity if the external adjustment already achieved came to be eroded during the present interim period.

Mr. Polak observed that the forthcoming entry of Portugal into the EC made the country's economic and financial situation deserving of even more careful consideration than previously. Portugal should indeed find a way to move toward quick, effective integration into the EC.

When the Executive Board had approved the previous stand-by arrangement for Portugal in October 1983, Mr. Polak recalled, Mr. Feito had perceptively observed that Portuguese policies in recent years had had a cyclical pattern, while the fundamental characteristics of the economy had shown little improvement. That observation seemed valid still; although Portugal's current account deficit in 1984 and early 1985 had been quite small, it was poised to increase sharply. The cyclical pattern had occurred previously. In 1973, Portugal had had a current account surplus; in 1974, a current account deficit had emerged equal to 6 percent of GDP, which expansionary policies had pushed to 9 percent of GDP by 1977. In the following year, Portugal had agreed on an adjustment program with the Fund under which the current account had swung into near-balance by 1979, with the greater part of the adjustment burden borne by the private sector. However, in the early 1980s, after being reduced less than planned, public sector deficits had begun to expand even further, while the effects of the second oil price increase had propelled Portugal into double-digit current account deficits in both 1981 and 1982. At that point, the authorities had again adopted a severe adjustment program involving fiscal, monetary, and exchange rate policies--all having proved inadequate before--with the result that between 1979 and 1985 the Portuguese economy had come full circle. In fact, between 1973 and mid-1985, the economy had come full circle twice. At present, there was much evidence that the downward swing was to begin again.

Thus, the hope expressed by the staff that Portugal had found "an approach that succeeded in reconciling economic growth with external equilibrium" remained unfulfilled, Mr. Polak observed. The 1983-84 adjustment had been brought about by a sharp decline in investment and by steeper than expected declines in real wages, real disposable income, and consumption. At present, the authorities were prepared to steer the economy onto a more balanced growth path by adopting a more stimulative policy stance involving both interest rate deductions, which would ultimately be borne by the budget, and increased expenditure on public works. An increase in Portugal's current account deficit to some 5 percent of GDP was projected, but, even supposing a relaxation of foreign constraints, the staff had warned of the need for a significant decline in the public sector deficit, precisely as the Board had recommended in the 1984 Article IV consultation with Portugal. Yet the authorities were forecasting a decline of only 0.2 percent of GDP in the public sector deficit from the astronomical level of over 17 percent, almost all of it financed by monetary means. Indeed, if present policies were continued, the staff foresaw an increase in the public sector deficit. Moreover, the upcoming elections might not prove helpful to efforts to reduce that deficit.

Despite the long-term benefits for Portugal deriving from membership in the EC, membership was unlikely to make policymaking easier in the short run, Mr. Polak considered. Among the rigidities in the economy, Portugal continues to rely excessively on imports for both food and energy, neither of which would respond well to exchange rate changes. Ultimately, those rigidities should wither away, but the provisions for a long transition in the accession agreement meant that Portugal might have to pass through another adjustment cycle before most benefits of EC membership materialized.

The rise in Portugal's debt ratio to near 80 percent of GNP imposed severe limits on the admissible current account deficit, lest the country fall victim to a real debt crisis, Mr. Polak commented. In 1984, because of a rapid increase in short-term debt, Portugal had had to pay an amount equal to over 50 percent of its export earnings for interest on and repayment of such debt, compared with less than 15 percent in 1980. Ominously, the 1984 figure for Portugal had been comparable to that for Brazil.

The rate of inflation remained about 20 percent, so that adherence to the crawling-peg mechanism remained essential to maintain the country's competitiveness, Mr. Polak said; in the past, the effects of lapses in such adherence had quickly become evident. Portugal's forthcoming accession to EC membership would also involve an expectation that competitiveness should be preserved by the convergence of member countries' policies to a compatible rate of inflation. Such convergence would require urgent increases in efficiency in the Portuguese economy, particularly in agriculture, more flexible policies on prices and interest rates, and much less reliance on subsidies. He hoped that the authorities would make all those policy changes during the opening up of the economy under the aegis of EC membership.

Mr. Leonard observed that Portugal had made important strides in economic stabilization during the past two years: adjustment in the trade balance and current account balance had been impressive, and overachievement of the external targets for 1983 and 1984 had helped to restore the confidence of the international banking community. Thus, Portugal was in far better shape than two years previously to service its growing stock of external debt, although the debt service ratio had risen beyond 35 percent. He agreed with the staff that the current account deficit must be contained below 6 percent of GDP if the external debt situation were to stabilize. Happily, recently released data showing a trade deficit of only $170 million in the first half of 1985--as against $270 million in the first half of 1984--suggested that the current account outturn for the whole year should be close to or even slightly better than the official forecast of $415 million or about 2.3 percent of GDP.

On the negative side, Mr. Leonard said, continuing difficulties in implementing a coherent monetary policy, problems with public sector financing, and labor market inflexibility remained major obstacles to long-term stability. Portugal's prospective entry into the European Communities made it all the more important for the authorities to address those structural weaknesses. However, he hoped that the forthcoming elections would help to resolve present political uncertainties and allow a renewal of consensus-building on economic policy. For 1986, the outlook on the whole did not appear favorable. Any improvements could come about only through tackling the economy's structural imbalances.

Despite a Fund-supported adjustment program during 1983-84, Mr. Leonard continued, the public sector deficit was too high to be sustained for long. Indeed, the overall public sector borrowing requirement for 1984--at 14.5 percent of GDP--had been some 3 percent higher than programmed. If the authorities were to improve the overall fiscal balance, they should deal head on with management weaknesses in the public sector. He agreed with the staff that adjustments were needed in both revenue and expenditure, especially the dismantling of subsidies. Another area requiring urgent attention was the management of public sector enterprises; not only should administered prices be raised and adjusted more regularly to cover costs, but steps were needed to eliminate arrears and restructure many parastatals financially and physically. He was disappointed that discussions between the authorities and the World Bank on a restructural adjustment loan had not yet been successfully concluded, and urged the authorities to complete them as soon as possible.

Portugal's present tax system was greatly in need of reform, Mr. Leonard noted. The exclusion of civil service salaries and agricultural revenue from income tax, and the bias against labor-intensive production, ran contrary to Portugal's need to diversify production, expand employment, and trim the civil service. A broadly based value-added tax, the elimination of special exemptions, and improved tax administration were all necessary to make the revenue base more elastic and tax collection more fair.

Relatively inflexible interest rates and the lack of well-developed capital markets led the monetary authorities to rely upon credit ceilings for the private sector in implementing monetary policy, an approach both inefficient and inadequate, Mr. Leonard considered. The recent opening of the nationalized banking system to domestic private and foreign initiatives had been a welcome step in promoting competition and flexibility in financial markets. A great deal remained to be done, however, in broadening the range of available financial instruments at appropriate interest rates to promote more efficient mobilization and allocation of domestic savings as well as more adaptable, market-oriented management of monetary policy.

Recent improvements in the legislation governing unemployment benefits should make it easier for enterprises to adjust their staffs to more sustainable levels, Mr. Leonard remarked. Benefits from the unemployment fund should accrue to unemployed workers rather than to inefficient enterprises, as had happened on occasion in the past. Understandably, enterprises had not wished to shed surplus workers when no effective safety net had existed, so that real wages rather than unemployment had tended to bear the brunt of labor market adjustments. Nevertheless, labor market inflexibility militated against productivity increases and even more against structural realignment within the economy as a whole. The establishment of a forum for consultations among the social partners should help the new Government to build a consensus on future labor market policies.

Membership in the European Communities could provide substantial advantages for Portugal, but there were also challenges in adapting the economy that the authorities had to meet resolutely, Mr. Leonard concluded. For example, producer prices in Portuguese agriculture currently exceeded those in the EC; agricultural productivity in Portugal must therefore increase significantly over the medium term if farm incomes were not to fall. Those challenges might serve as exactly the stimulus that Portugal needed. He hoped that the authorities would address such serious issues once the political situation became clearer.

Mr. Schneider expressed agreement with the staff appraisal. The authorities' efforts at stabilization under the 1983-84 stand-by arrangement with the Fund had created the conditions for a sustainable recovery. During the 1984 Article IV consultation with Portugal, his chair had been impressed with the progress already achieved: owing to a realistic exchange rate policy supported by tight fiscal and financial policies and moderation in real wages, the current account deficit had narrowed, and the confidence of international capital markets had been restored. However, since that time, the authorities had made little progress in solving the structural problems of the economy; severe rigidities persisted in the financial and labor markets, in the structure of industry, and in fiscal policy. It was regrettable that the lengthy negotiations on a World Bank loan for restructuring public enterprises could not have been concluded earlier, as domestic political developments made further progress unlikely for some time. As the required structural adjustment policies had not been put in place well before the end of the adjustment program and as demand policies had recently begun to show some weakening, the country's structural rigidities could again predominate unless the authorities took corrective actions soon.

In sum, the present condition of the Portuguese economy illustrated how important it was to start tackling structural and supply-side problems at an early stage of adjustment, Mr. Schneider observed. Because it took time to implement such policies, negotiations on cooperation with the World Bank on those problems should probably begin well before the approval of any Fund program.

Although the authorities had limited room for maneuver at present, Mr. Schneider said, he was pleased that they continued to be preoccupied with Portugal's structural shortcomings. The recent measures announced for improving the financial system should be regarded as useful steps toward a more comprehensive reform. However, the staff was correct in suggesting that, pending more fundamental measures, immediate action was needed to halt and possibly reverse some of the recent weakening in demand policies. The growth rates of monetary and credit aggregates, public spending, borrowing by public enterprises, and arrears of banks and the public sector would have to be monitored carefully in the months ahead. Could the authorities take other measures to consolidate the stabilization efforts of 1983/84, given the repercussions of present political uncertainties on the short-term policy stance?

At least initially, Portugal's accession to the EC would have a considerable adverse impact on its economic situation, Mr. Schneider concluded. Perhaps during the 1986 Article IV consultation, it would be helpful to the Portuguese authorities to complement the staff analysis with initial efforts of their own, together with a comprehensive study of measures designed to reverse those adverse effects over the medium term and make the country's accession an economic success. Finally, as Portugal maintained an exchange system relatively free of restrictions on current international transactions, the authorities might consider accepting Article VIII status upon joining the EC.

Mr. Lankester noted that much of the progress made under the previous stand-by arrangement, particularly a further substantial reduction in the current account deficit, had been due to a sharp compression of private consumption and investments, while absorption of resources by the public sector had grown. Moreover, it was an exaggeration to say, as the staff had done, that the economy had come full circle since 1979. In that year, Portugal's current account had been roughly in balance, but in the current year the current account deficit was forecast to be about $500 million; in 1979, Portugal's debt service ratio had stood at about half the current figure.

He appreciated the authorities' wish to see a further rise in economic growth in 1986, Mr. Lankester continued. But overrapid growth in demand could all too easily mean a reversal of the gains already achieved, particularly in the balance of payments but also the modest gains in reducing inflation. The staff's medium-term scenario demonstrated that Portugal could not afford to return to large current account deficits, which through their effect on debt service payments would all too rapidly require sharp reductions in imports and growth. Indeed, none of the medium-term scenarios foresaw more than a modest decline in the ratio of external debt to GDP, which would remain disturbingly high at some 75 percent.

To enhance Portugal's medium-term growth prospects, the authorities ought to press ahead with structural measures intended to improve productivity, Mr. Lankester suggested. Reforms in public enterprises, which still absorbed a disproportionate amount of national resources, together with further measures to reduce rigidities in the labor market, should be accorded high priority. Without modernization of the productive structure, Portugal might be unable to take advantage of the opportunities following accession to the EC. Like Mr. Templeman, he would appreciate further information on the restructuring loan to be made by the World Bank. Perhaps the World Bank representative could explain about his staff's plans for Portugal in connection with structural measures.

It was disappointing that the authorities had not met the program targets for fiscal policy the previous year, particularly because they had not increased administered prices as agreed, Mr. Lankester recalled. At present, the fiscal situation seemed to be deteriorating; the imbalance in public sector finances, although smaller than in 1982, seemed unsustainable. According to the table on page 13 of SM/85/241, one third of private sector saving was being absorbed by dissaving of the public sector, and the overall public sector deficit, which included public sector investment as well, accounted for nearly 60 percent of private savings. He was concerned by the staff view that, unless the authorities took new measures soon, further increases in the deficit were likely in 1986. The authorities ought to press ahead with fiscal measures, including the removal of price subsidies, such as those on petroleum products, and the introduction of a value-added tax; they must also maintain strict control over public sector wages. Although political contraints existed on moving forward with some of those measures at present, there would be great risks if policy were allowed to drift. Perhap some of the underlying reforms--for example, administrative arrangements--could be carried through in a low-key way even during the present period of political uncertainty.

The authorities had taken some useful first steps to modernize and reduce rigidities in the financial system, Mr. Lankester observed, although he shared the staff's concern at the high budgetary cost of the measures to improve bank profitability. As the creation of debt instruments for purchase by nonbanks developed, it should help the authorities' effort to control monetary policy, but they needed to do more to achieve a more market-oriented financial system. Moreover, even though the rate of inflation had fallen steadily so far in 1985, it remained considerably higher than in Portugal's main trading partners, a fact that underlined the importance of the authorities' maintaining control over monetary aggregates. In turn, such control would become much easier if they dealt properly with the fiscal imbalance.

The authorities would be well advised to take the staff's medium-term scenarios into account in framing their current external policy stance, Mr. Lankester concluded. The recent improvement in the current account allowed little room for complacency. Even under the most optimistic scenario, Portugal's debt service ratio would remain at or above 30 percent for the next ten years, and even those results were highly sensitive to adverse external developments. Achievement of the assumed rate of growth for exports would be crucial if there were to be room for further import growth, which in addition would require not only adequate competitiveness but also improved investment and supply-side policies.

Mr. de la Herrân remarked that the current political impasse in Portugal imposed a constraint on economic decision making, which could lead to to a loss of momentum in several policy areas as well as to delay bringing about long-awaited structural reforms. The authorities should gain more control over economic performance, recently characterized as stop and go, by assuming a steadier policy stance. In that respect, the narrowing of the current account balance from 1982 to 1984 had been impressive.

The discipline applied to domestic policy since end-1983 had been clearly reflected in monetary policy, Mr. de la Herrân pointed out. Indeed, it had continued to improve after the stand-by arrangement had been interrupted. The authorities had successfully tackled three major problems: they had lowered the cost of credit, benefited the banks by raising lending rates, and offered treasury bills to the nonbank public with the intention of encouraging more market-based financial activity. Furthermore, the rate of increase in domestic credit was expected to decline, and the distribution of such credit between the public and the private sectors was expected to improve. Nevertheless, the authorities confronted a tradeoff, in that they had to decide whether to curtail public and private credit in order to forestall potential pressures that could push the already high inflation rate still higher or whether to aim at an expansion of the currently restricted supply of credit by loosening their policy.

Thoroughgoing fiscal reforms were needed, Mr. de la Herrân considered. He hoped that the authorities could make some progress toward such reforms without having to wait for the end of the election cycle early in 1986. As it was, interest payments had been rising as a component of the general government deficit and were estimated at 8.9 percent of GDP for 1985. Despite some improvements since 1982, losses by public enterprises were still contributing greatly to the public sector deficit, which had reached the equivalent of 17.6 percent of GDP in 1984. Such losses imposed a major fiscal burden, and the authorities should urgently review the profitability of public enterprises' activities as well as consider reforms in their finances. Perhaps the staff or Mr. Zecchini could comment on the fiscal effects of consolidating the arrears of public enterprises and increasing interest rates on government bonds.

Portugal's current account deficit had narrowed from $3.2 billion in 1982 to $0.5 billion in 1984, Mr. de la Herrân noted. At present, the authorities should continue to correct domestic imbalances, mainly by reducing inflation to maintain at least the same level of external competitiveness. They should try to alleviate the encumbrance of the external debt, particularly the high debt service ratio, by keeping up a steady pace of borrowing that could allow for still better results in the current account balance. Finally, in view of Portugal's forthcoming accession to the EC, the authorities should try to undertake the recommended structural changes, which would indeed imply an initial cost but should yield the expected benefits in the medium term.

Mr. de Maulde remarked that, owing to political uncertainty, time would unfortunately be lost in the rehabilitation of the Portuguese economy, precisely when it would be of the utmost importance to lose no time. The country was facing great opportunities and great challenges. The opportunities arose from lower international energy prices, a lower exchange rate for the dollar, and handsome external demand for Portuguese exports, but it was far from certain whether the favorable circumstances would long endure; the major challenge arose from the country's entry into the EC on January 1, 1986. Thus, major policy efforts and innovations were called for to complete the adjustment process and to modernize an economy that would have to compete more and more with other advanced Western European economies as the transition period to full membership in the EC came to an end.

Until the next government took office, new policy efforts would have to wait, Mr. de Maulde observed; in the meantime, past achievements seemed to be unraveling. In view of the sketchiness and tardiness of Portuguese statistics, he found it difficult to document that impression fully, but, at least in public finance and wage awards, the authorities themselves recognized that their current policy had gone off course. In contrast, external performance appeared to have remained quite good in the first quarter of 1985, probably owing to an improved international environment, but also to the authorities' exchange rate policies. As Mr. Lankester had pointed out, the current slippages meant that the favorable external performance might soon worsen, thus jeopardizing the sacrifices that the Portuguese had imposed upon themselves during the past three years.

Portugal's public enterprise sector was a major hindrance to progress, Mr. de Maulde considered. A comprehensive restructuring loan from the World Bank had been carefully prepared and negotiated; it would have to wait. The tax system was in disorder; its overhaul would also have to wait. Also at a standstill were plans to modernize monetary, labor, and agricultural policies. A considerable task awaited the next government, which would need greater courage and responsibility as well as imagination and vision. Portugal's entry into the EC must be a success, for both the country and Europe.

Mr. Suraisry remarked that the progress achieved during the past few years had been remarkable: between 1982 and 1984, the current account deficit and the growth of external debt had been steeply reduced, substantially improving Portugal's credit standing. Indications for 1985 pointed to a continuation of strong external performance and a deceleration of inflation.

Although commendable, the progress achieved had not adequately incorporated structural improvements, Mr. Suraisry remarked. The industrial structure needed modernization, agricultural productivity remained low, and reform of the public sector was overdue. Unless the authorities dealt with structural weaknesses, Portugal was unlikely to benefit fully from membership in the European Communities; indeed, the adjustments associated with membership would turn out to be much more onerous. The authorities should encourage private sector activity and improve the structure of the economy, while maintaining the competitive position. A reduced role for the public sector was essential so that private sector investment could grow without an excessive increase in liquidity, which would tend to accelerate inflation and worsen the balance of payments.

Substantial efforts were required to make reforms in the tax system, restructure public enterprises, and eliminate subsidies, whose costs were not reflected in the budget, Mr. Suraisry continued. Like Mr. Templeman, he would appreciate any information from Mr. Zecchini or the staff about why the authorities had not reached agreement with the World Bank on a loan to restructure public enterprises. Early agreement on such a loan would help the authorities in their endeavors to rehabilitate the economy, as the prospective liberalization of trade associated with EC membership highlighted the need for restructuring. In addition, the authorities should take steps to raise more revenue and contain expenditures. For instance, increases in administered prices, as for petroleum products and electricity, would expand tax revenue and improve the profitability of some public enterprises.

Monetary policy should continue to foster private sector growth without an undue increase in liquidity, Mr. Suraisry said. He therefore welcomed the recent increase in credit ceilings for the private sector and the reduction in lending rates as well as recent institutional changes designed to strengthen the banking system and increase nonmonetary financing of the budget. Further steps to broaden the scope of financial markets were required to create the environment for more market-oriented management of monetary policy.

Exchange rate policy had played an important role in improving Portugal's external position, Mr. Suraisry concluded, and should be continued to maintain external competitiveness, especially in view of the prospective trade liberalization. The large size and high servicing costs of Portugal's external debt underscored the need to continue firm exchange and financial policies and to proceed steadily and firmly with structural adjustment policies.

The authorities deserved commendation for the recent steps to reduce rigidity in the labor market, Mr. Suraisry concluded. The goals of present policy reflected the authorities' awareness of the opportunities and challenges posed by membership in the EC, but they should take prompt action to reach those goals.

The staff representative from the European Department agreed with Mr. Polak that once again adjustment of the Portuguese economy had been concentrated on the cyclical side rather than on structural reforms, in which progress was necessary. In that sense, the program had not been fully implemented, as the Portuguese authorities themselves recognized. In particular, the structural measures envisaged to improve the financial position of public enterprises and contain the public sector borrowing requirement had been lacking.

Other factors had played important roles in the external adjustment of the Portuguese economy, primarily the decline in investment, the staff representative considered, but strong export performance had no doubt contributed greatly to the reduction in the current account deficit. On the basis of the latest indications, performance on most scores would perhaps be better than the official forecast envisaged, except on economic growth, which was likely to remain below 2 percent. In the past two months, inflation had decelerated markedly; by end-1985, a 12-month rate of inflation at some 16 percent, as opposed to the official target of 20 percent, seemed within reach.

Although it was difficult to interpret the latest figures on the public sector, the indications that were no major slippage from the official targets would occur, the staff representative remarked. Nevertheless, the official target was quite high and made it difficult to permit a sustained recovery of credit to the private sector without overrapid growth of monetary aggregates, which the staff considered to be the element of greatest concern. As of July 1985, monetary aggregates had grown by 10 percent in real terms during the past 12 months.

Developments during the third quarter of 1985 indicated that the current account deficit of the balance of payments, barring a rapid deterioration in the fourth quarter, would remain significantly below the target of $450 million, the staff representative explained. In fact, the authorities would now expect the current account deficit to be about $200 million. No doubt, external factors had played an important part in favoring the slowing of inflation and the improvement in the external accounts. It would be unfortunate if the authorities did not take advantage of the opportunities created by that favorable external environment, particularly with respect to inflation. In that sense, Portugal's prospects for 1986 were hardly encouraging. The likelihood that a government able to make fundamental economic decisions would take office before the first quarter of 1986 was small. In fact, the outcome of the forthcoming parliamentary election might be inconclusive, so that a new election might follow the presidential election. In that event, a government might not be fully in place until as late as mid-1986.

The authorities might be able to hold the line on the growth of overall domestic credit and keep tight control over external borrowing, particularly by public enterprises, the staff representative said. However, if sizable slippages emerged in the public sector deficit, the brunt of adjustment would again fall entirely on credit to the private sector. Recognizing the importance of holding the line in financial policy, the authorities were also trying to hold the line on spending under the central government budget and to continue to improve tax enforcement. It was clear that no additional tax measures would be implemented at least until the 1986 budget, under which a value-added tax would be introduced. Unfortunately, indications were not positive that work preparatory to tax reform would continue. There was also little prospect that administered prices, particularly of petroleum products, some other subsidized commodities, and electricity, would be increased soon. Although the recent deceleration in inflation created some room for maneuver, the authorities would probably find it politically difficult to increase such prices at least until the parliamentary elections. Thus, a new comprehensive round of price increases would probably have to wait until end-1985.

The consolidation of public sector debt to public enterprises and among public enterprises would not reduce the overall borrowing requirement of the public sector, the staff representative acknowledged. Nevertheless, the authorities' efforts in that respect should be encouraged by both the Fund and the World Bank. In fact, the World Bank was focusing on debt consolidation as one of the main reasons for the prospective loan for restructuring public enterprises because a greater transparency of the fiscal accounts would no doubt help in setting performance criteria for the public enterprises and in improving the management of the enterprises themselves.

In the present political circumstances, it was difficult to envisage that much progress could be made on the World Bank loan to promote institutional reform and the consolidation of arrears in public enterprises, the staff representative considered. Recently, the authorities had expressed interest in a scaled-down version of the public enterprise restructuring loan. In addition, an advance had been registered in institutional reforms with the creation of a secretariat, a technical advisory body charged with monitoring the performance of public enterprises, and also with the preparation of a construction program for some of those enterprises. Nevertheless, progress in that area had diminished somewhat after the end of the previous Fund program. In fact, the staff was unable to update the information on public enterprises' borrowing requirements for 1984; the figures provided for those enterprises' 1985 borrowing requirements were of dubious reliability.

During the discussions with the authorities, the staff had not raised the possibility of Portugal's assuming the obligations of Article VIII, the staff representative recalled. In principle, however, the Portuguese exchange system was virtually free of restrictions on current payments for international transactions, except for a tourist allowance. Perhaps during a future staff visit, once the new Government was installed, the staff might raise the question with the authorities.

As to why the improved profit position of enterprises had not led to higher investment, the staff representative explained, the financial position of both public and private enterprises in Portugal--except in export-oriented sectors--remained rather devitalized. The high burden of financial charges, with the cost of credit at about 10 percent in real terms, did not always permit substantial investments. Indeed, investment had fallen particularly in the construction sector, in which financial charges played a larger role and in which the decline of domestic demand had been of primary importance; other sectors oriented toward domestic demand had also experienced lower investment. In addition, there had been ample unutilized capacity in the export sector at the outset of the program. At present, as capacity limits were being approached, the staff expected some recovery of investment in export-oriented enterprises, but no major improvement could be expected for the rest of 1985.

Low unemployment compensation, until the recent reform, must have played a role in holding down collective dismissals, the staff representative from the European Department concluded. Recent changes had allowed reasonable compensation for people laid off or dismissed. However, individual dismissals were still subject to restrictive legislation. Progress in modifying labor legislation was unlikely to occur for some months. Before the most recent political crisis, the Government had prepared some modifications to the law, but the current caretaker authorities were no longer in a position to propose such modifications to Parliament, which had been dissolved.

The staff representative from the Exchange and Trade Relations Department commented that the staff would be happy to assist the authorities in examining the additional actions that would be necessary to satisfy the requirements of Article VIII status.

The staff representative from the World Bank observed that the proposed restructuring of public enterprises incorporated proposals to reorganize the relationship between the Central Government and public enterprises and to address the problems of arrears and financial imbalances. Some progress had been made, but not enough. In contrast, a fair amount of progress had been made in developing program contracts with individual public enterprises. It was likely to prove difficult to reach agreement on solving the problem of arrears between the Central Government, public enterprises, and some municipalities, and also to establish mechanisms insuring that such arrears would not recur. The staff's goal would continue to be to try to reach with the authorities an accord permitting the restructuring of the public enterprise sector on a schedule that would permit it to behave progressively more efficiently in the future.

Mr. Zecchini noted that Portugal was facing a period of substantial political uncertainty. It would be premature to speculate on the exact nature of the economic measures to be taken by the forthcoming Government. However, it was important to distinguish two aspects of Portugal's economic problems: the cyclical behavior of the economy owing to government policies, and the structural weaknesses of the economy. Both would be affected by Portugal's accession to the EC.

Portugal's adjustment effort had been substantial, Mr. Zecchini considered. There was no urgency in persevering with strong adjustment measures, which could prove self-defeating by leading to an implosion of the economic system that would be difficult to control. Therefore, the time had arrived to proceed toward a more balanced approach. There was little doubt that adjustment in some areas was going to be pursued still further, but it was important to put the economy on a growth path compatible with the adjustment that still had to be achieved in certain specific, limited areas.

Measures of structural reform had been implemented during the past few years, Mr. Zecchini recalled. For instance, the authorities had attempted to create a money market in order to have an additional instrument for managing monetary policy. Some measures had also been taken in the labor market. Moreover, a decree-law had established a secretariat to coordinate and monitor the financial requirements of public enterprises. In addition, the authorities had dismantled the previous system of subsidies and were trying to enforce a new system that could be much more effective. Such structural changes were important to modernize the Portuguese economy and make it more competitive with other EC countries on world markets. In fact, Portugal's accession to the EC would provide an unprecedented stimulus to strengthening the economic structure.

Portugal's debt-to-GDP ratio was relatively high, Mr. Zecchini remarked, and the authorities had attempted to stabilize and perhaps reduce it in the medium run. In 1984, there had been a decline in the share of short-term external debt in overall external debt.

The staff had correctly said that, to the extent that arrears were incurred within the public sector, any consolidation would not change the overall picture significantly, Mr. Zecchini observed. Some changes were planned in public enterprises, and the establishment of the secretariat was one step toward a much more effective management of the system. On the labor market, the recent regulations on dismissals were remedial, but they had been applied with great flexibility so as not to hamper a restructuring of the labor force in individual enterprises.

Portugal's exchange system was virtually free of restrictions, Mr. Zecchini said. Given that the external position was still fragile, it would be advisable to postpone further commitments, as implied by Article VIII status, until the effects of EC membership on the Portuguese economy could be fully assessed.

The staff representative from the European Department added that the measures taken by the authorities to reduce interest rates and to issue treasury bills to the banks for further sales to the nonbank public had represented only a first step in the planned comprehensive financial reform. Issues of treasury bills would create an alternative financial asset that enterprises could hold instead of time deposits, the cost of which for banks was extremely high. If disintermediation advanced through holdings of treasury bills, the mostly nationalized banks would require less support from the state or might be able to pass some of their profits to the budget.

Further steps in the reform would include the development of the money market through increased issues of short-term government paper, the staff representative continued. In addition, the bond and share markets could be developed more extensively; fund issues had been quite limited so far. However, demand for bonds was quite high: each issue of bonds by public or private enterprises or by the state was oversubscribed within a few hours. The staff had urged the authorities many times to speed up liberalization. With new management at the Bank of Portugal, it was to be hoped that progress could occur more rapidly; the urgency created by Portugal's accession to the EC, the loosening of capital controls, and the entry of foreign banks ought to promote further liberalization.

The Chairman made the following summing up:

Executive Directors welcomed the marked improvement in Portugal's external position over the past two years, as well as the recent deceleration of inflation. The tightening of financial policies under the stand-by program, the moderation of wages, and the maintenance of a strong competitive position were seen as having been instrumental in this adjustment.

Directors stressed the importance of ensuring the maintenance of the gains recorded thus far, and of proceeding decisively toward tackling the remaining fundamental weaknesses of the economy, so as to lay the basis for sustained growth without the re-emergence of external constraints over the next few years. In this respect, Directors warned that easing of financial policies could lead to an undesirably sharp revival of domestic demand in 1986. They expressed concern about the rapid growth of the monetary aggregates in recent months and the risks that the public sector deficit might exceed the already very high level targeted for this year, and that the private sector would be crowded out. Caution in this respect was essential in the light of the challenges associated with Portugal's accession to the EC. Directors urged the Portuguese authorities to tighten control over budget expenditures and to increase promptly key administered prices to secure the targeted reduction in subsidies and the improvement in the finances of public enterprises. The public sector borrowing requirement, currently equivalent to some 17.5 percent of GDP, was seen by Directors as clearly unsustainable. Financial policies for 1986 should be shaped by the objective of securing a further deceleration of inflation, and avoiding any marked weakening of the external position.

Directors emphasized that the urgency of tackling the long-standing weaknesses in the economy had been heightened by Portugal's prospective accession to the EC in 1986, which would require a strong performance of exports to compensate for the likely increase in import penetration. In this respect, Directors stressed the need to strengthen the productive structure in both industry and agriculture, to attract foreign investment capital and technology, and to mobilize domestic savings to finance investments in export-oriented industries. A steady reduction in the share of real and financial resources absorbed by the public sector was seen as instrumental in this respect. In this connection, it was noted that about one third of private savings had been absorbed by the dissavings of the public sector in 1984. Directors urged the authorities to proceed quickly with the reform of the tax system, including the implementation of a value-added tax at the beginning of 1986, to improve tax administration, and to ensure a decline in the ratio of public expenditures, especially current noninterest expenditures, to GDP over the next few years.

The need for more flexible and realistic administered prices was also emphasized, as were the other measures necessary to strengthen the finances of major public enterprises. Directors expressed the hope that negotiations with the World Bank for a public enterprises restructuring loan would be concluded expeditiously. Directors also encouraged the authorities to make more rapid progress in reducing existing rigidities in the financial and labor markets.

Directors stressed the need to maintain a favorable competitive position through a steady reduction in cost and price inflation and a realistic exchange rate policy to offset remaining inflation differentials between Portugal and its main trading partners. Directors stressed the magnitude of the foreign debt burden. The external constraints manifest in the medium-term scenarios showed clearly that the authorities would have to be cautious in their external debt management and avoid a substantial widening of the current account deficit. Directors welcomed the authorities' commitment, in the context of EC accession, to reducing trade restrictions. Several Directors expressed the hope that Portugal, upon its accession to the EC, might accept Article VIII status in the Fund.

It is expected that the next Article IV consultation with Portugal will take place on the standard 12-month cycle.

The Executive Board then took the following decision:

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

2. The Fund notes with satisfaction that Portugal maintains a system relatively free of restrictions on current payments and transfers for current international transactions and welcomes the authorities' commitment to the maintenance of this system.

Decision No. 8067-(85/133), adopted
September 9, 1985

3. SENEGAL - REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the second review under the stand-by arrangement for Senegal (EBS/85/185, 8/7/85).

The staff representative from the African Department stated that according to information received from the Senegalese authorities, all performance criteria for end-June 1985 had been observed. Implementation of the measure required to eliminate the prospective deficit in the wheat flour sector in 1985/86 had been delayed by a few months, mainly because of temporary shortages in certain foodstuffs, notably imported rice. However, the authorities had assured the Fund management and staff that the measure would be introduced shortly and that any losses incurred in the intervening period, which were estimated to be small, would be offset by savings in other areas.

Mr. Alfidja made the following statement:

> The staff report for the second review under the current stand-by arrangement reflects quite well the policies pursued by the Senegalese authorities during 1984/85 and the substantial progress made toward achieving the basic objectives of the program. The quantitative ceilings for end-March and end-June 1985 were observed, and economic developments during the period were satisfactory.
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> Real economic growth in 1984/85, though representing a major improvement relative to 1983/84, was estimated to be 1 percentage point lower than initially projected. Although there was a general improvement in weather conditions during the period, several parts of the country continued to experience drought, with some adverse effects on groundnut production. The repercussions of this drought, together with the effects of the unsatisfactory quality of seeds distributed and the increased traditional processing of groundnuts, led to a shortfall in the output and quantity of this crop marketed through official channels.
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> In April 1985, the Senegalese authorities introduced several measures aimed at strengthening the production and marketing incentives for groundnuts and minimizing government intervention and subsidies. These measures include the announcement of a substantial increase in the producer price of groundnuts before the beginning of the 1985/86 planting season, the termination of the levy for financing seed and fertilizer distribution schemes, and the sharp curtailment of the amount of freely distributed seeds. The subsidies paid to the oil millers were halved. Oil-milling companies are now permitted to make their own marketing and other arrangements, including buying groundnuts directly from individuals and private firms, in order to enhance the profitability of their operations. To stimulate cereal production and improve farmers' income, the authorities substantially raised the producer prices of maize, millet, and sorghum by 17 percent, of paddy by 29 percent, and of cowpeas by 83 percent. The producer price of cotton was also increased by 43 percent.
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> Developments in the fiscal sector in 1984/85 were in line with the program's objectives despite lower than expected revenue from the Price Equalization and Stabilization Fund (CPSP). This

revenue shortfall was offset by larger collections of income tax and taxes on goods and services, arising from the revenue measures introduced during the fiscal year. The authorities restrained the growth in current expenditure by making cutbacks in materials and supplies and by keeping the government wage bill at the planned level. Capital outlays were also lower than planned, largely because of the slow pace in the implementation of certain foreign-financed projects.

As pointed out in the letter from the Minister of Economy and Finance (EBS/85/185, Appendix I), the Senegalese authorities are keenly aware of the need to pursue their adjustment efforts with a view to achieving satisfactory economic growth and a viable internal and external financial position over the medium term. The 1985/86 program was therefore conceived as a further step toward eliminating structural imbalances, improving the supply situation, and restraining aggregate demand to a level commensurate with available resources.

In the fiscal sector, a further reduction in the overall deficit is envisaged in 1985/86 owing to an increase in revenue through improved collection of income tax, taxes on goods and services, and import duties. Efforts to collect tax arrears are also being intensified. On the expenditure side, current outlays are forecast to rise by about 5 percent, well below the expected rate of increase in the consumer price index of 10 percent. Efforts to restrain the growth of the wage bill are also being continued.

Considering the importance of the CPSP in the agricultural sector and for government finance, the authorities are taking steps to restructure and rehabilitate this agency. To strengthen the financial position of the oil refinery, the authorities have announced further increases in the prices of petroleum products at both the refinery and retail levels. As far as other public enterprises are concerned, the Government is taking steps to accelerate the ongoing reforms with technical and financial assistance from the World Bank.

Concerning the external sector, it is expected that the strong measures being pursued will substantially contribute to an improved external payments position in 1985/86. Export earnings are projected to rise on account of an increase in the sale of groundnuts, petroleum products, phosphates, and fish, as well as re-exports. With import payments expected to slow, largely because of the restraint on rice imports, the objective of a further reduction in the current account deficit in 1985/86 thus appears within reach.

In conclusion, the current program reflects determined efforts of the Senegalese authorities to build on the progress already made. Important steps have been taken to correct the structural weaknesses in the economy, in particular to improve agricultural production incentives and to reduce the role of the Government in the rural sector. The authorities believe that the scope and speed of the fiscal adjustment in Senegal during the past few years have been substantial in comparison with the fiscal imbalances recorded by many member countries, including some of the largest industrial ones. However, they intend to pursue their adjustment efforts and, as in the past, are hopeful that the international financial community will provide them with adequate financial assistance in their endeavors.

Mr. de Maulde commended the Senegalese authorities for having met the performance criteria for end-March and end-June under the stand-by arrangement. The program appeared to be well on track, and the authorities were adhering firmly to the adjustment effort. Despite the lower than forecast performance in the groundnut sector, the first part of the program in fiscal year 1984/85 had proved to be a success. The fiscal and external current account deficits had been narrowed; domestic savings had risen. Those results were the logical outcome of the major turnaround in economic and financial policies to which the Government had committed itself since mid-1983. The policy reforms implemented since that time, which had often implied social costs and had therefore required political courage, were beginning to pay off. Economic growth was picking up: real GDP had grown by 3 percent in 1984/85 and was expected to rise by 5 percent under the 1985/86 program. The target appeared realistic, especially as the weather had been good so far.

The 1985/86 program put particular emphasis on the continuation of structural adjustment and supply-side measures, Mr. de Maulde observed, particularly in the agricultural sector, which for decades had been plagued by insufficient producer prices and excessive state intervention, with too many inefficient bureaucrats developing regulations at the expense of the farm sector. The authorities had clearly reversed those policies by implementing well ahead of time large increases in producer prices for food crops and groundnuts. As a result, provisional forecasts pointed to better harvests for food crops, especially millet. Moreover, the liquidation of the Société Nationale d'Approvisionnement du Monde Rural (SONAR) and the Société des Terres Neuves (STN), as well as of all state operations related to groundnut production, should lead for the first time in many years to an absence of subsidies coupled with a sizable rise in farmers' incomes.

For some time, the CPSP, which handled rice imports, had remained a matter of concern, Mr. de Maulde recalled. Although the necessary reforms might be at a less advanced stage than for the agricultural sector, the authorities had begun to move in the right direction. They should implement the various measures called for by the studies already released.

The authorities were also proceeding at a satisfactory pace in restructuring public enterprises, a task in which the World Bank had played a useful role, Mr. de Maulde observed. In view of the policy reforms undertaken so far, the World Bank had decided to give Senegal a structural adjustment credit, including financing under the special facility for sub-Saharan Africa. Indeed, one of the reasons for the success achieved might be the coordination between the Government, the Fund, the World Bank, and the major bilateral donors.

On the demand side, the provisions in the 1985/86 program appeared quite classical, Mr. de Maulde continued. The planned improvement in the collection of customs duties and taxes was long overdue. On the expenditure side, the freeze imposed on civil servants' wages and salaries was a politically sensitive measure but represented the unavoidable counterpart to the rise in farmers' incomes, which was of major importance to the economy as a whole.

The Senegalese authorities had already achieved a reduction in the imbalances that had impaired the growth of their economy for many years, Mr. de Maulde concluded. Most of all, they had reduced distortions in the country's internal terms of trade that had unduly favored importers and consumers at the expense of producers and exporters. More remained to be done. The favorable results in terms of improved production and growth should help the authorities to remain on the right track.

Mr. Mtei commended the authorities for successfully implementing the stabilization program: they had met all quantitative performance criteria for end-March and end-June. That achievement had occurred despite the undermining of the program's principal assumptions by poor weather, as the persistent and severe drought that had played havoc in many African countries in recent years continued to affect Senegalese agricultural output, particularly groundnut production. In turn, changes in output affected the main assumptions under the program, so that, for example, the growth of real GDP had had to be scaled down from 4.1 percent to 3.1 percent, and a marked shortfall in exports of groundnuts was currently projected. Moreover, those adverse developments were reflected in the expected outturn for budgetary revenue as well as the balance of payments.

The authorities had reacted quickly and decisively by taking additional al measures, particularly those affecting the budget, to ensure that the program objectives would be attained, Mr. Mtei recalled. In that way, they had demonstrated great determination to reduce imbalances that had emerged over the years. They ought to persevere, as such imbalances would long persist: the baseline scenario for the medium-term balance of payments showed a relatively large financing gap for 1986/87. Furthermore, heavy debt service payments would continue up to the end of the 1980s. In the circumstances, an adjustment program should incorporate a reasonable, sustainable rate of growth. Although the assumption of a 4 percent growth rate in real GDP was consistent with the balance of payments objective, it left little room for any rise in per capita income, as the Senegalese population was growing by 2.9 percent per annum.

Rapid population growth underscored the need for concerted and continued efforts to diversify the economy, particularly in the agricultural sector, Mr. Mtei said. Fortunately, the shortfall in groundnut production attributable to the drought had been somewhat mitigated by increases in the production of cotton and cereals. Therefore, the authorities should continue implementing measures that would encourage production of those and other crops. Indeed, the rise in producer prices for maize, millet, sorghum, paddy, and cotton implemented in 1985 suggested that the authorities intended to build upon the gains already achieved.

Revenue measures to be implemented in 1985/86 would produce results only over the long term, Mr. Mtei commented. Nevertheless, a substantial increase in government revenue had been provided for, probably based on assumed real economic growth of about 5 percent in 1985/86. Should the assumption fail to materialize, as had happened under the current program, the authorities might have to make further difficult decisions to cut spending. However, such cuts might not be necessary, as the program had incorporated specific measures that could produce immediate results. Nevertheless, could the staff say how likely the authorities were to achieve their revenue growth target of 14 percent? Finally, he supported the proposed decision.

Mr. Goos recalled that at the first review of the stand-by arrangement for Senegal, he had expressed concern about what had appeared to be too gradual an adjustment approach in view of the country's precarious external situation. He had therefore recommended a strengthening of the adjustment effort beyond the program target wherever possible, as well as the adoption of contingency measures to counter unexpected slippages. At present, his concerns had been largely alleviated, both by the flexible and impressive implementation of the adjustment program so far and also by the more ambitious targets for 1985/86 than under the original program. That was certainly highly commendable and testified to the authorities' commitment to adjustment.

Furthermore, Mr. Goos continued, he was pleased to note that progress had also been achieved in restoring positive real interest rates, as suggested by the fact that the GDP deflator was projected to decline below the minimum rate on time deposits in 1985/86. However, he was disappointed that the staff continued to remain silent on that important instrument for stimulating domestic savings and external capital inflows. Apart from that point, he was in full agreement with the staff's analysis and recommendations.

There was no doubt that the authorities had to persevere in their adjustment efforts in all policy areas in order to achieve their growth objective within a sustainable financial framework, Mr. Goos concluded. The need for doing so was underscored by Senegal's continued need for exceptional external financing and debt relief, as well as by the medium-term scenarios suggesting that the country had considerable sensitivity to unforeseen internal and external developments. Such developments strongly argued for maintaining continued flexibility in the implementation of the adjustment program, and there also seemed to be an urgent need for containing the ongoing appreciation of the real effective exchange rate for the CFA franc in order to secure the economy's international competitiveness. Finally, he supported the proposed decision.

Mr. Coumbis expressed agreement with the staff appraisal of policies and developments in the Senegalese economy under the 1984/85 program. All performance criteria for end-December, end-March, and end-June had been comfortably met; the policies of the adjustment program had been successfully applied. Although the economy had been hard hit by another severe drought, all macroeconomic variables were close to the program targets. Real GDP was estimated to have grown by 3.1 percent instead of the 4.1 percent envisaged in the program, the GDP deflator had risen by 10 percent instead of 9 percent, and the external current account deficit was projected at 9.5 percent of GDP instead of 9.2 percent.

Under the 1984/85 adjustment program, Mr. Coumbis said, internal arrears had been further liquidated. Furthermore, the authorities had reacted promptly to an unforeseen drop in groundnut output and a shortfall in revenue by keeping government spending significantly below programmed levels. As a result, they had been able to reduce further the overall fiscal deficit on a commitment basis from 4.6 percent of GDP in 1983/84 to 3.3 percent in 1984/85. The authorities should be commended for such policies, which indicated their commitment to adjustment and their firm intention to keep the program on track. In addition, the external current account deficit had narrowed to 9.5 percent of GDP from 11.1 percent in 1983/84, despite the unforeseen reduction in the export volume of groundnut oil and cake. That improvement in the country's external payments position, in line with the specification under the program, had been principally attributable to appropriate fiscal and credit policies.

He was in agreement with the 1985/86 program, under which the authorities were to continue to combine appropriate supply-side measures with prudent fiscal, credit, wage, and external borrowing policies, Mr. Coumbis continued. If they successfully implemented the program, a further reduction in the overall fiscal deficit on a commitment basis to 1.4 percent of GDP and in the external current account deficit to some 6.8 percent of GDP could be expected. Furthermore, the authorities were correctly making efforts to strengthen fiscal administration, rationalize the structure of customs duties, and recover part of the outstanding arrears on domestic taxes and customs duties. On the expenditure side, they should maintain strict limits on current expenditure, especially the wage bill.

In spite of substantial progress made during the past two years in reducing imbalances, Senegal continued to face major structural and financial problems, Mr. Coumbis observed. The economy remained vulnerable: the agricultural sector was fundamentally weak, public enterprises needed reorganization, and the external deficit on current account remained unsustainably large. However, in April, the authorities had introduced several measures to strengthen production and minimize government intervention and subsidies. Furthermore, some impressive measures to be implemented would affect the agricultural sector, taxes and import duties, and public enterprises. The degree of their success would depend on how well they had been designed and how well public administrators could carry them out. Assistance from the World Bank in those areas would be valuable, as would be the authorities' determination to apply the corrective measures without a stop-go attitude.

The staff had clearly outlined its assumptions for the baseline scenario for the balance of payments, as well as the sensitivity of the results to alternative hypotheses, Mr. Coumbis concluded. Senegal could attain a viable external payments position by the end of the 1980s provided that the authorities pursued appropriate adjustment policies for several years and that donors and creditors provided concessional assistance and debt relief. The road of adjustment was difficult, but there was no other choice. In conclusion, he supported the proposed decision.

Ms. Bush commended the authorities for having taken the steps needed in the previous fiscal year to attain the fiscal target. Senegal's adjustment effort had progressed on two tracks: first, structural adjustment, especially in the agricultural sector, had provided for an improvement in the balance of payments while laying the basis for a longer-term sustainable pattern of growth and development; second, fiscal adjustment had reduced the financial imbalances. In the new program year, those trends were expected to continue.

Adjustments in producer and consumer prices as well as some marketing changes during the previous year had laid the groundwork for reform, Ms. Bush observed. Rapid progress was planned in the current year, notably in the groundnut sector, where a substantial increase in the producer prices and the elimination of the retainer should increase the amount available for export by eliminating the disincentives that had emerged in the previous year. In addition, the Government seemed likely to reduce its role substantially in regulating the marketing of input and output, and she urged the authorities to permit the emerging private sector to evolve without interference.

Producer prices for food crops were being raised to promote greater production of various substitutes for imported rice, Ms. Bush noted. While welcoming those increases, she wondered whether domestic operating costs could be contained to the extent needed to enable import-competing food production to become and remain viable.

Relative price developments in Senegal should follow price developments in the region and the world, in order to reflect changing world resource constraints, Ms. Bush considered. At present, the authorities were implementing substantial price increases in energy. Were they committed to permitting market forces to set those prices in the future, or would they continue to promulgate government decrees?

She welcomed the recent adoption of a comprehensive strategy broadening the application of reforms already implemented in rural development agencies, Ms. Bush continued. The increased role for initiatives on the part of farmers and other private-sector intermediaries was particularly appropriate. Her one concern on the structural side related to World Bank involvement. Although the World Bank was providing welcome assistance to the public utilities, and as all the structural reforms were progressing in a more rapid and comprehensive fashion than in many other countries, she wondered why the World Bank would be unable to complete discussions on a structural adjustment loan and make a disbursement until late in 1985/86. The kind of support provided by a structural adjustment loan seemed particularly appropriate to Senegal in its present state, and she would appreciate comment on the expected time frame.

Recent efforts at fiscal reform appeared to be well on track, Ms. Bush remarked. At the first review of Senegal's stand-by arrangement, she had expressed the hope that the better than expected fiscal performance in 1984/85 would mean that the 1985/86 budget deficit could be at the lower end of the projected range of 1.8-2.2 percent of GDP. At present, the new target was 1.4 percent, a welcome revision. In addition, the continued reduction in domestic arrears should provide some relief to domestic enterprises. Furthermore, substantial revenue increases were expected because of higher collection of arrears on taxes and customs duties, and the CPSP should be able to pay the Government what it owed for rice imports. Nevertheless, she would welcome staff comment on the possibility that other delinquent taxpayers might be unable to pay their back taxes, so that revenue increases might fall short of projections. In addition, the planned controls on expenditures appeared appropriate, especially the slower growth in the wage bill and the tighter control over wage drift.

Attainment of the fiscal and structural goals should permit adherence to the credit ceilings and the narrowing of the external current account deficit to 6.8 percent of GDP from 9.5 percent in 1984/85, Ms. Bush noted. Continued rapid declines in the ratio of the external current account deficit to GDP would be required if the financing gaps projected in Table 10 of EBS/85/185 were to be eliminated by the end of the 1980s. Those projections were based on the assumptions that "appropriate adjustment policies are pursued with determination"; such adjustments must include continued adequate producer price incentives if exports were to grow as projected. The scenarios presented in the staff report should be most useful to the authorities in planning the compensating efforts at domestic adjustment that they must make if groundnut exports fell short of target and if additional concessional assistance were not forthcoming.

Senegal's progress in its adjustment effort was due to the authorities' broadly based approach to both structural and fiscal adjustment, Ms. Bush concluded. She supported the proposed decision.

Mr. Suraisry said that Senegal's performance under the program was proceeding satisfactorily: the program was on track, and all performance criteria up to end-June 1985 had been met. As a result, the authorities had made steady progress toward restoring domestic and external balance.

They had sharply reduced the overall fiscal deficit, moderated the expansion of domestic credit, and diminished the external current account deficit.

He welcomed the continuing focus on structural problems in agriculture and public finance under the 1985/86 program, Mr. Suraisry remarked. The measures taken to strengthen agricultural production and marketing incentives had been appropriately timed to have a favorable impact on production during the new season. However, unless the operations and management of the Price Equalization and Stabilization Fund were improved, the reorganization of the agricultural sector would not be complete. The restructuring should be carried out quickly and in consultation with the World Bank. It was also encouraging that the Fund and the World Bank were working closely together to support Senegal's adjustment effort, in which a structural adjustment loan would prove helpful.

On public finance, Mr. Suraisry said, he supported the authorities' continued commitment to fiscal adjustment through a further reduction in the overall deficit as well as domestic arrears. The measures to raise revenue and control expenditure were welcome. Equally important, the authorities recognized the need for more fundamental reforms in public finance. They ought to strengthen public enterprises, reduce civil service hiring further if possible, and reform the tax system. Progress in those areas should help to mobilize much-needed additional savings for investment and growth.

Encouragingly, credit policy under the 1985/86 program was consistent with the proposed fiscal restraint, Mr. Suraisry continued. At the same time, the authorities should provide adequate credit for crop financing and other activities of the private sector. On institutional issues, he welcomed the steps taken to improve the financial position and liquidity of the banking system, which should help to restore the integrity of the system and increase its contribution to the country's economic development.

Senegal's balance of payments was expected to improve further in 1985/86 as a result of higher agricultural output and cautious demand management policies, Mr. Suraisry observed. Over the medium term, however, Senegal would require sustained adjustment efforts as well as external assistance, including debt relief. He supported the proposed decision.

Mr. Finaish noted that the Senegalese authorities had continued to implement effectively and successfully their adjustment plans for 1984/85. They had made progress in implementing structural reform, especially in agricultural production and marketing and the rehabilitation of public enterprises. At the same time, they had substantially tightened demand management by containing the fiscal deficit at an estimated 3.3 percent of GDP and restricting money supply growth to 3 percent, substantially lower than the growth in nominal GDP. As a result, all performance criteria and virtually all program targets up to June 1985 had been met despite adverse external developments and a significant weakening in the marketed output of groundnuts, Senegal's principal commodity.

The proposed program for 1985/86 appeared consistent with the adjustment needs of the economy, Mr. Finaish remarked. A significant further tightening of demand management and additional structural change were envisaged, including further action to reduce the role of government intervention in agriculture.

It was encouraging that the authorities recognized the need to continue their adjustment efforts toward achieving sustainable economic growth and a viable internal and external financial position over the medium term, Mr. Finaish said. The need for sustained adjustment efforts was underscored in the sensitivity analysis of the staff's medium-term projections, which showed that a slackening of adjustment would delay the attainment of viability in the balance of payments position and could also lead to sizable financing gaps. The large debt service burden also underscored the need to maintain the momentum of adjustment. In the coming years the authorities should continue a prudent demand management stance while intensifying structural reform, particularly to attain greater efficiency of public enterprises. He supported the proposed decision.

Mr. Polak commended the Senegalese authorities for their adherence to the adjustment strategy over the past two years. They had carried out significant improvements, and the resilience of the economy had grown stronger.

Notwithstanding the measures to raise government revenue, the ratio of revenue to GDP in 1984/85 had not only declined, as foreseen at the start of the program, but also fallen short of that reduced target figure, Mr. Polak observed. Therefore, it was of the utmost importance that tax administration be strengthened soon, especially customs administration. The measures that the National Commission for Tax Reform was expected to suggest in its report should be implemented promptly, and further progress should be made in addressing domestic arrears both incurred by the Government and owed to the Government.

He welcomed the progress made in public enterprise reform, Mr. Polak said, and he urged the authorities to maintain the momentum already established. For example, the plan devised for restructuring the CPSP should be fully implemented.

The favorable results obtained so far should further strengthen the authorities' resolve to persevere with their efforts and to maintain continued collaboration with the Fund and World Bank, Mr. Polak continued. As the medium-term scenario indicated, support from both institutions would remain essential to Senegal over the years to come. He supported the proposed decision.

It was encouraging that the success achieved in meeting the program objectives had continued through the second review of the stand-by arrangement, Mr. Pickering considered. It was important to stress the link between the authorities' commitment and the success of the program.

Nowhere was that commitment more evident than in the fiscal field, where the authorities' objectives for 1985/86 were ambitious, comprehensive, and attainable. They had undertaken to reduce domestic arrears of the Government and public agencies by CFAF 10 billion in 1985/86, which would bring such arrears by end-June 1986 to CFAF 36.7 billion, or about 3 percent of GDP. As the amount of domestic arrears in Senegal reflected not only arrears per se, but also other government commitments, could the staff explain how much further the stock of arrears could be reduced? The explanation would be important in assessing the adequacy of the target.

At the present stage of the Senegalese adjustment effort and in view of the likely prolonged nature of the adjustment, it was perhaps inevitable that the authorities' program should focus on the supply side, Mr. Pickering remarked. Thus, the authorities had appropriately been introducing measures in the agricultural sector aimed at expanding and diversifying domestic production. In view of the role of the CPSP, it would be important for them to act with determination in redressing that agency's operations. He hoped that the measures to be taken before the end of October would be carried out promptly and that significant progress would be achieved before the end of the stand-by arrangement. Undoubtedly, the World Bank would have to play the principal role in assisting Senegal's effort, but it was encouraging to note that the Fund supported it. He favored the proposed decision.

Mr. Romuâldez commended the authorities for having adhered closely to their adjustment program so far. They deserved continued support from the international community. Their efforts had been no less than heroic, especially in view of the drought in the north of the country in 1984/85 and the unevenness of rainfall during that fiscal year. He encouraged the authorities to continue with their rigorous demand management and to move forward with structural reforms.

The program for 1985/86 was stringent, perhaps ambitious, especially as the fiscal program had been designed to reduce the external current account deficit further, from about 9.5 percent of GDP in 1984/85 to 6.8 percent in 1985/86, Mr. Romuâldez observed. Nevertheless, the program appeared credible, given the record since 1983.

Among the significant adjustments in agricultural policy, particularly commendable were the authorities' efforts to restructure and rehabilitate the CPSP, Mr. Romuâldez continued. For instance, they intended to separate the commercial activities of the CPSP from its price equalization and stabilization functions. The regularization of the CPSP's rice accounts for previous years and the recovery of some receivables could be sensitive politically. However, the staff paper did not present the details or even the framework of the proposed reforms of the CPSP's involvement in rice imports and marketing. He would appreciate further elaboration by the staff.

The authorities' determination to maintain fiscal restraint was also impressive, Mr. Romuâldez said. A reduction in the overall cash deficit from 4.2 percent of GDP in 1984/85 to 2.4 percent in 1985/86 seemed to be an ambitious undertaking, as much in the aggregate as specifically on both the revenue and the expenditure sides. The program left little room for slippage.

The commitment of reducing government intervention in various sectors of the economy was welcome as well, Mr. Romuâldez commented. The comprehensive strategy for reforming public enterprises was especially suitable for the four major utilities. Nonetheless, he would have liked for the staff to have included in its paper some evidence of a plan or timetable for carrying out that strategy.

In conclusion, the authorities had performed impressively in adhering to a rigorous program and seemed determined to continue to do so, Mr. Romuâldez noted. He supported the proposed decision, and was pleased to note the strong cooperation between the World Bank and the Fund with the authorities.

The staff representative from the African Department remarked that since mid-1983, there had been substantial reductions in the overall fiscal deficit and the external current account deficit. However, progress in securing economic expansion had been slow for various reasons, including poor weather in the region for the past several years. The authorities themselves were far from satisfied with the recent performance of the economy, because it was leading to social and other pressures. For the future, the staff had projected a rate of economic growth of 4 percent, implying that real GDP would increase each year by only 1 percent per capita. In view of the constraints in the availability of external financial resources, a higher growth rate could not be envisaged at present, although the authorities would have preferred to make more progress. An encouraging fact was that production incentives had been greatly increased in recent years; under the 1985/86 program, the increases would continue.

During the past two years, the staff representative observed, one weakness in Senegal's performance had been consistent revenue shortfalls. Fortunately, the authorities had always responded promptly by adjusting expenditure. In 1985/86, a rise in revenue of 14 percent was expected and should be achievable, for three reasons. First, nominal GDP was projected to expand by some 13 percent. Second, the authorities had made a number of commitments to strengthening tax administration; he understood that they would be requesting follow-up technical assistance from the Fund to help in the implementation of certain recommendations made by a previous technical assistance mission. Third, and most important, there was a specific target in the program for collecting at least CFAF 8 billion of tax arrears in 1985/86; there was also an associated target for payments of import duties by the CPSP each quarter. However, if a shortfall in revenue should occur, the authorities had committed themselves to making economies in outlays on materials, supplies, and transfers, the only area in which they had room for maneuver.

As to interest rates, the staff had been assured, after discussions with the Banque Centrale des Etats de l'Afrique de l'Ouest (BCEAO), that the rate paid on time deposits was in fact closely governed by the money-market rate for overnight deposits, currently at 10.2 percent, the staff representative remarked. Officials of the BCEAO had explained that they kept interest rates in France closely in mind when determining their own interest rates. The Fund staff would continue to encourage them to maintain a flexible attitude and would review the matter with them in the period ahead.

Efforts were being made to reduce domestic costs of certain agricultural commodities, especially for the major enterprise involved in rice production, the staff representative said. However, the staff was not aware to what extent those efforts were successful.

Rather than flexible prices determined by the market, Senegal had a system of administered prices for petroleum products, the staff representative continued. However, the authorities followed developments in the world oil market as well as exchange rate changes, and they made the necessary adjustments from time to time. For instance, under the current program, they had made three upward changes in petroleum prices; given the recent exchange rate and oil market developments, he hoped that they could eliminate the cumulative deficit of the oil refinery by the end of June 1986, or perhaps earlier. The staff had encouraged the authorities to make price adjustments more frequently, to avoid the need for more traumatic large increases.

The planned reduction of the overall fiscal deficit in 1985/86 to an amount even lower than originally programmed reflected not only the authorities' own measures but also the lower availability of external resources, the staff representative explained. Given Senegal's lack of options in some of those areas, the deficit had to be lower than what the authorities had programmed previously. Should a revenue shortfall occur, they would obviously have to take offsetting measures, and they had proved in the past that they were prepared to do so. The staff could not overemphasize the importance of a vigorous effort to liquidate government arrears, and recover tax and customs arrears as well.

Reform of the CPSP was essential, particularly the separation of its stabilization functions from its commercial activities, the staff representative considered. Commercial activities regarding rice imports and marketing should be transferred outside the public sector, to the extent feasible. He hoped that the authorities would be able to adhere to their schedule of arriving at a decision in October. At the forthcoming discussions between the World Bank staff and the authorities, reform of the CPSP would be high on the agenda.

For historical reasons involving the need to improve fiscal discipline, there was a much broader definition of domestic arrears in Senegal than in a number of other countries, the staff representative said. In Senegal, domestic arrears through 1984/85 included not only undisbursed commitments, but also commitments for which payment orders had not been issued as well as outlays not recorded as commitments. If the same definition were applied to other countries, their arrears might well be larger. The Senegalese authorities were committed to liquidating all verified domestic arrears within three to four years.

As to greater specificity for reforms of public enterprises, the Fund had been leaving that part of the exercise more in the hands of the World Bank, the staff representative from the African Department concluded. The World Bank staff did have specific timetables in mind for the reform of public utilities and other public enterprises in Senegal; the timetables already agreed upon had been set out in EBS/85/185 and previous Fund staff reports.

The staff representative from the World Bank explained that the previous Friday the Loan Committee at the World Bank had considered the initiating memorandum for a structural adjustment credit for Senegal and had approved it. Thus, the World Bank staff had clearance to appraise the credit; the appraisal should be completed in October, and if all went well, negotiations could take place in November or December, so that the credit could be presented to the Executive Directors of the World Bank early in 1986. He was confident that the first tranche would be disbursed before the end of the 1985/86 fiscal year. The amount had not yet been determined, but the World Bank staff hoped to have at least $20 million disbursed under the first tranche.

Mr. Alfidja noted that the Senegalese authorities were continuing to restrain government employment. As in many West African countries, the underlying assumption in embarking on such a policy was that the private sector would hire at least some of the trained people seeking jobs. For that reason, he wished to assure Ms. Bush that his Senegalese authorities were in favor of a strong expansion of private sector activities and intended to do everything in their power to encourage it. Thus, any "interference" would be of a positive nature in order to stimulate rather than impede development of the private sector.

The Chairman commented that there were few instances of countries as poor as Senegal that were pursuing with such determination adjustment policies geared to promoting structural reform and a resumption of growth.

The Executive Board then took the following decision:

1. Senegal has consulted with the Fund in accordance with paragraph 4(c) of the stand-by arrangement for Senegal (EBS/84/267, Sup. 3, 1/18/85) in order to reach understandings on the policies to be pursued in 1985/86 and to establish suitable performance criteria as contemplated in paragraph 21 of the letter from the Minister of Economy and Finance dated December 3, 1984, attached to the stand-by arrangement.

2. The letter from the Minister of Economy and Finance dated July 29, 1985 shall be attached to the stand-by arrangement for Senegal, and the letter of December 3, 1984 shall be read as modified and supplemented by the letter dated July 29, 1985. Accordingly, the performance criteria referred to in paragraph 4(a) of the stand-by arrangement shall be those referred to in paragraphs 12, 18, and 20 of the letter dated July 29, 1985 and specified in the table annexed to that letter.

3. The Fund finds that no further understandings are necessary, and that Senegal may proceed to make purchases under the stand-by arrangement.

Decision No. 8068-(85/133), adopted
September 9, 1985

4. ALGERIA - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with Algeria (SM/85/185, 6/27/85; Cor. 1, 7/8/85; and Cor. 2, 8/23/85). They also had before them a report on recent economic developments in Algeria (SM/85/202, 7/18/85; Cor. 1, 8/27/85).

The staff representative from the African Department made the following statement:

The following information has become available since the staff report was issued.

There was a sharp increase in Algeria's gross international reserves in the first seven months of 1985: at the end of July, non-gold reserves stood at nearly SDR 2.9 billion, compared with SDR 1.5 billion at the end of 1984. This increase reflects in large part drawings on external loans contracted in 1984 and early 1985. As a consequence, it appears likely that the overall balance of payments surplus in 1985 could be larger than envisaged earlier.

The rate of appreciation of the nominal exchange rate of the dinar has slowed in the first half of 1985. Between December 1984 and June 1985, the nominal effective rate appreciated by 4.6 percent (annual rate), compared with 11.5 percent between December 1983 and December 1984.

Substantial increases for agricultural producer prices for the 1985/86 crop year were announced in August; the increases range from 25 percent for hard wheat to 44 percent for oats. Since the retail prices of bread and other cereal-based products were raised by only about 10 percent, the Government will be supporting the bulk of the increases in producer prices through higher consumer subsidies.

Finally, the cereal harvest for 1984/85 has been exceptionally good, reflecting mainly favorable weather conditions, with output expected to more than double from the 1983/84 crop year.

Mr. Salehkhou made the following statement:

The Algerian economy continued to register positive strides toward fulfilling its Five-Year Plan, and the rate of GDP growth accelerated from 3.5 percent in 1982 to 6 percent in 1984. This development is due not only to the oil and gas sector but also to the emerging new hydrocarbon sector, which showed rapid growth on account of better capacity utilization and the coming on stream of new plants. Likewise, the oil sector reversed its decline in 1983 and increased by 6.2 percent in 1984. At the same time, agriculture, beset by two consecutive years of drought, emerged in 1984 with a 4 percent increase in value added.

These positive developments in the last year of the economic plan 1980-84 set the stage for the attainment of higher goals during the present plan 1985-89.

Production and distribution

A carefully planned policy of high investment in terms of GDP (37 percent) aimed at self-sufficiency in all major areas of the economy led to the emergence of a more active industrial sector whose competitiveness is gradually being increased through product improvement and cost reduction.

In the meantime, the hydrocarbon sector remains the largest sector in the Algerian economy, having accounted in 1984 for 98 percent of merchandise exports and 43 percent of budgetary revenues. The expansion in the hydrocarbon sector covered also condensate production, which reached 14 million tons in 1984, compared with 12.3 million tons two years earlier. Condensate production is entirely exported to Europe and is used in the petrochemical industry. Production of liquefied petroleum gas also doubled in 1984 to 62.8 million tons because of the entry into service of a new plant.

Refining capacity was maintained at a high level for crude oil and reached 21.5 million tons in 1984, compared with 17 million tons in 1983. Furthermore, natural gas production continued to increase and by end-1984 reached 94 million cubic meters.

Natural gas production is destined mainly for exports; 20 percent is programmed for local industrial and household use, particularly for fertilizers and petrochemicals.

In the nonhydrocarbon sector, productivity improved by 11 percent in 1984 as enterprises under the reorganization scheme became more cost conscious. Heavy industry expanded strongly and reached 90 percent of targeted production in 1984. Light industries as a whole increased their coverage of the Algerian market, particularly in the building material sector, which staged a strong recovery. While some firms are producing beyond the absorptive capacity of the domestic market, steps are being taken to open new markets.

By the end of 1984, the construction sector had made great strides toward alleviating the housing shortage. A total of 110,000 units were built, representing an incrase of 10 percent in comparison with 1983.

Finally, the agricultural sector, after two consecutive years of drought, registered an increase in a number of key crops such as barley, which expanded by 77 percent. At the same time, the reorganization of agricultural policy, following the price liberalization measures adopted in 1982, is having positive effects on production, although in 1984 total vegetable production declined slightly. However, the effect of those measures may require longer time to materialize, particularly in land tenure and extension services. The liberalization of marketing and pricing systems offers important incentives to producers that will not fail to have a positive impact on agricultural production in the coming years, assuming sufficient rainfall and generally favorable weather.

Public finance and economic organization

The objectives of the 1980-84 Plan called for greater emphasis on cost-price relationships and for financial restructuring of public enterprises in order to stimulate economic activity. The traditional system of price control has been gradually changed to two systems: one covers essential commodities, whose prices are centrally fixed--the aim being to protect a certain segment of the population--and the other covers all remaining commodities, whose prices are allowed to vary in relation to cost at normal levels of capacity utilization and in line with the financial viability of the enterprise. At the same time, the authorities have ensured that productivity in the enterprise is remunerated at a wage level above basic wages, and a system of profit sharing has been introduced since 1982.

Owing mainly to the high rate of investment during the economic plan, the Government's policies on employment have been designed to maintain a positive edge between the rate of job creation and the rate of growth of the labor force. This will also prevail during the current 1985-89 Plan, when an estimated 950,000 new jobs will be created. While transport, commerce, and services with industry will provide the new jobs, the need to diversify the investment program toward infrastructural support in response to social demand will provide new opportunities in water development, housing, and social services. In fact, the predetermined annual real growth of consumption--at 6.5 percent above the rate of gross fixed investment--is aimed at giving the public a better standard of living after the austerity of the first Plan, 1974-77. This is but one aspect of the economic reorganization plan introduced since 1980, which covers all aspects of the economy with a view to increasing efficienty and improving the quality of products and services while maintaining prices at competitive levels.

In view of the large state sector in Algeria, the authorities undertook to reorganize public enterprises from the standpoint of both organic as well as financial structures. More than 70 state enterprises have been subdivided into 466 firms, each with a defined sectoral responsibility, flexible management, and clear financial results.

A technical specialization has also been defined for each enterprise, with separation of production and marketing. Expected to achieve financial results, enterprises are called upon to contain costs and adjust prices accordingly. Still, a number of enterprises require a strengthening of their capital base, and this is being achieved through equity participation by the Government, consolidation of their long-term debt through equity, and concessional loans by the Treasury.

Likewise, private sector activity is encouraged through access to bank credit, import licenses, and government contracts on the same basis as state enterprises.

The 1985-89 Plan stresses further the need to consolidate the reorganization of the economy and to increase its efficiency by relying on such instruments of regulation as the price and wage systems, together with fiscal and credit policies. Regional planning as well as the annual plan are to guide the achievement of the overall development program, providing the instruments for the necessary adjustments in view of internal and external constraints. Taking into consideration the projected deceleration in the growth of fiscal revenues from hydrocarbons, the authorities expect public enterprises as well as the general public to take a greater share in the development effort, particularly in the financing of housing and urban development. The priorities of the Plan are set on the development of agriculture and water resources in order to achieve self-sufficiency in food and limit the dependence on imports for the satisfaction of the needs of a growing population. Thus, the economy in 1985-89 is expected to grow at an average annual rate of 6.6 percent while agriculture is expected to grow by 4.5 percent per annum.

Financing of the development effort is secured through internal resources, with little or no recourse to external borrowing. In this respect, the Treasury plays a central role in coordinating the Government's operations in the current and capital accounts. Current operations cover budgetary revenues and expenditures as well as the subsidy fund (fonds de compensation), which started in 1983. It is to be noted that the subsidy fund receives no transfers from the budget and uses only revenues from taxes on nonessential items. Capital operations include expenditures on the equipment budget, public enterprise investment programs, and the mobilization of savings of public financial institutions.

The Treasury's current expenditures continued to show a surplus in 1984, equal to 19.1 percent of GDP. The improvement in the current account balance is due to a significant growth of hydrocarbon tax revenues and nontax receipts. On the other hand, capital operations continued to register a negative balance, although to a lesser extent in 1984. Equipment budget expenditures rose moderately in line with the Government's planned objectives, and the overall treasury deficit fell to 5.5 percent in GDP in 1984 from 8.7 percent in 1983, on account of the surplus in current operations. The deficit has been financed by recourse to credit from the Central Bank, which nonetheless was substantially less than in 1983.

The improvement in public finance will continue through fiscal year 1985, as future government revenue is expected to increase by 15.5 percent and credit to the Government to continue to decelerate. The overall treasury deficit should drop significantly by end-1985 and is estimated to be below 2 percent of GDP. The improvement in public enterprises, a continued rise in hydrocarbon receipts, and the tax reform are, with expenditure restraints, major reasons for the expected rise in total government receipts.

To channel the country's available resources to planned investment, a major reform is under way to improve the role of the government-owned financial institutions. Several draft laws concerning credit, interest rates, and the role of the banking system are being studied by the authorities with the view to their implementation. For instance, deposit rates may be revised in order to encourage savings. A more active role is also envisaged for commercial banks for the provision of medium-sized investment credit.

External performance

The continued rise in hydrocarbon exports during the 1980-84 Plan helped to maintain the current account of the balance of payments in equilibrium throughout the Plan period. In 1984, a surplus equivalent to SDR 91 million was achieved. Whith imports contained to 1 percent growth, their stability denotes a greater diversification of local industries in the supply of domestic products and import substitution, which resulted in a trade surplus of SDR 3.5 billion.

The increase in international interest rates in 1984 led to higher payments of interest. As a result of the deficit in the capital account, the balance of payments deficit led to a decline in reserves to SDR 1.5 billion in 1984 from 1.8 billion in 1983. This decline, however, reflects the determination of the Algerian authorities to reduce foreign indebtedness, as amortization payments exceeded foreign borrowing in 1984. The ratio of disbursed debt to GDP stood at 25 percent in 1984, compared with a peak of 48 percent in 1979. Since end-1984, reserves have built up to over SDR 2 billion, largely, according to the latest information, as a result of increases in export earnings as well as drawings on previously programmed and contracted foreign loans in line with the predetermined requirements of the internal and external equilibrium of the economy. As for 1985, while export of crude oil is expected to decline, exports of condensate as well as liquefied natural gas are expected to increase in compliance with sales commitments to major European countries.

All in all, hydrocarbon exports are expected to grow by 4 percent in volume. Export receipts will also be boosted by a retroactive settlement with Spain amounting to $250 million per annum for two years.

While nonhydrocarbon exports are also expected to grow in response to the Government's restructuring program aimed at improving quality and price, it will take some time before competitive products can benefit from promotional export procedures.

Imports, on the other hand, are expected to remain stable thanks to improved efficiency of public enterprises. A maximum rate of growth of imports of 6 percent is sustainable within the objectives of the Plan, and imports have to be contained in view of the constraints on the balance of payments.

Lower interest payments in 1985 in conjunction with the favorable developments in the levels of exports and imports will lead to a surplus in the current account of not less than 1 percent of GDP.

Concerning the authorities' program to develop nonhydrocarbon exports and the role that can be played by the exchange rate in introducing a more competitive price structure to reflect international competitiveness, it should be noted that little can be gained from an adjustment in the exchange rate of the dinar, given the present near-total dependence on hydrocarbon exports as well as a stable and programmed system of imports and price control. Furthermore, the present method of determining the value of the currency is consistent with the objective of stability in the economy. Finally, in a world environment full of uncertainties, the Algerian authorities continue to make frequent pragmatic adjustments, subject to annual evaluation of the development effort in line with the overall objectives of the economy.

Mr. Grosche observed that it was encouraging to see that Algeria's economy had developed favorably over the past year, although a number of the ambitious targets of the 1980-84 Five-Year Plan had not been fully achieved. Algeria had also made further progress in reducing internal and external imbalances through the pursuit of prudent domestic policies, had advanced its goal of diversifying the economic base, and had taken important steps toward improving the structure and efficiency of its economy. Despite those commendable results, however, some weakness persisted. Algeria's economy continued to depend greatly on oil and gas exports, making it vulnerable to any unfavorable market developments. Recent price trends on international oil markets did not bode well in that respect; moreover, Algeria might face a substantial revenue loss if, in order to maintain gas exports, the authorities had to adjust export prices to the level currently charged by some of Algeria's main competitors.

Because the achievement of the ambitious objectives of the new Five-Year Development Plan might be impaired by uncertainties with regard to hydrocarbon exports, Mr. Grosche considered, it was important for Algeria to rectify the lopsidedness of its industrial sector toward producing and refining petroleum and natural gas by strengthening the nonhydrocarbon sector, particularly agriculture. The authorities should broaden and diversify the industrial and agricultural sectors; by promoting labor-intensive investment in those areas, they could also ease pressures in the labor market. The increasing overvaluation of the Algerian currency continued to impair the competitiveness of the nonhydrocarbon sector. An adjustment of the exchange rate was therefore warranted, to enable Algeria to meet the objectives of the new Development Plan, and was certainly preferable to other alternatives that would entail unwelcome economic costs.

No further progress had been made in 1984 in dismantling the restrictive trade and exchange system, which was all the more regrettable, since the liberalization of 1982-83 had had a beneficial impact on the supply of foreign goods, Mr. Grosche noted. The authorities should speed up the process of eliminating the restrictive features of their exchange and trade policies. He supported the staff's recommendation not to approve Algeria's multiple exchange rate practices.

The efficiency of the banking system should be further improved, Mr. Grosche added. A more broadly based banking sector and a more flexible structure of interest rates would attract additional deposits. In that light, the preparations on reform of the financial sector, particularly the intention of the authorities to raise interest rates gradually to positive levels in real terms, were welcome.

Mr. Suraisry noted the progress that the Algerian economy had achieved since the beginning of the 1980s. As a result of prudent economic policies, the overall treasury deficit was expected to decline to a level of 2 percent of GDP in 1985, the current account had been in equilibrium, and the foreign debt had been reduced. Equally important, the annual growth rate had been over 4 percent of GDP during the period 1980-84. In view of the difficult problems that had faced the world economy in general, and many countries in particular, during that period, Algeria had achieved impressive and commendable results.

The authorities' current task was to consolidate those gains, Mr. Suraisry considered. The Development Plan that had ended in 1984 had laid the groundwork for achieving that goal. The authorities had implemented structural measures during the plan period that clearly demonstrated their determination to achieve better economic performance over the years ahead. They had made an important move toward increasing the efficiency of the economy by reorganizing and restructuring the public enterprises in a way that made it easier to measure their performance and to strengthen their financial position. Although the financial cost of restructuring those enterprises had been high, the move had been well timed to coincide with a period when the pressure on their financial resources had not been great.

The authorities' pursuit of a more flexible pricing strategy was consistent with the rehabilitation process and was necessary for reducing the fiscal deficit, Mr. Suraisry observed. Further adjustments in prices were essential for realizing the authorities' overall objectives. Given the structure of Algeria's economy, such adjustments could only be gradual, but it was important to continue the process. The authorities had recognized the important role that the private sector could play in the development process, both to help remove bottlenecks in certain areas and to complement the efforts of the public sector in the areas of production and services. The need for greater involvement of the private sector was likely to increase with the advancement of the diversification process under the Five-Year Plan. Moreover, the authorities had placed a laudable emphasis on increasing efficiency, granting public enterprises more autonomy, establishing a more realistic price system, and linking wage increases with productivity gains. Implementation of those fundamental economic concepts would make a sizable, positive contribution to the economy.

The authorities' progress on financial policies deserved approbation, Mr. Suraisry continued. Due to several factors, total government revenue was expected to increase substantially in 1985; concurrently, total expenditure was projected to increase very modestly, resulting in further reductions in the overall deficit. Resources would thus be freed for use in other productive channels. Externally, the authorities were clearly following a strategy that combined export growth and import substitution. The success achieved in reducing the country's dependence on oil exports had been noteworthy; however, the authorities should be careful. They should base their import substitution strategy on economic considerations to ensure the viability of the projects involved. That was essential for a successful diversification strategy and was also consistent with the efficient allocation of resources. Algeria's exports were predominantly oil-related, with less than 2 percent of total exports being nonhydrocarbons. Despite good progress toward export diversification, the authorities should intensify their efforts, which would require continued access to foreign markets.

The balance of payments developments over the medium term would be influenced by many factors, Mr. Suraisry added. However, the balance of payments was expected to benefit from a lower debt service burden. Because the ratio of disbursed debt to GDP had been reduced substantially in recent years, and because of the need to increase non-gold reserves, which had been equivalent to only 1.8 months of imports at the end of 1984, the recent borrowings from the international capital markets were not a cause for concern. However, those reserves had nearly doubled by the end of July, and Algeria should need to borrow less.

While understanding the staff's recommendation that it would be preferable to adjust the exchange rate sooner rather than later, Mr. Suraisry said that he tended to side with the authorities on that matter. In Algeria's economic setting and at its present stage of economic development, the exchange rate had a very small role to play as an instrument of economic policy. It was important, however, to keep the exchange rate under close review so that timely action could be taken when necessary. The authorities had shown flexibility in implementing their economic policies, and it was thus likely that similar flexibility would be applied to the exchange rate policy.

Mr. Finaish indicated that the strong performance of the Algerian economy in the past year reflected the prudent and pragmatic manner in which economic policy had been conducted within the framework of a well-managed centrally planned economy. A healthy rate of output growth as well as a large measure of financial stability had been maintained, despite the continued difficult environment due to the sluggish demand for Algeria's main exports: crude oil and other hydrocarbons. Real GDP growth in 1984 had accelerated to about 6 percent, the overall treasury deficit had been reduced from 9 percent to 5.5 percent of GDP, the current account of the balance of payments had registered a small surplus, the inflation rate had remained at a modest level, and the stock of external debt had been reduced further.

At least part of that performance could be attributed to the pragmatic economic strategy pursued in the past several years within the framework of the 1980-84 Plan, Mr. Finaish went on. The authorities had aimed, among other things, at reorganizing the economic system by improving the efficiency of the public enterprises and by introducing flexibility in decision making and resource allocation. Although the planned objectives had not been fully reached, the general outcome could be considered satisfactory, given the difficult external environment during the period. Agricultural performance had been disappointing, however, despite certain measures to boost production. It was appropriate for the authorities to increase their emphasis on agriculture, in light of the relatively low proven oil reserves in Algeria, and given the important role that the agricultural sector could play in the efforts toward export diversification. The recent substantial increases in producer prices, although they would imply a higher consumer subsidy, should have significant positive effects on production.

A particularly important aspect of policy efforts in the past few years had been the comprehensive restructuring of the public enterprise sector, the first phase of which had been completed, Mr. Finaish commented. Admittedly, the fiscal cost of the scheme had not been insignificant, but over the medium and longer term, the strengthening of the new, more numerous, and smaller enterprises should facilitate their development into more efficient and financially viable entities. Complementing the restructuring of public enterprises, price and wage structures had undergone significant reform. Enterprises were currently aiming to align prices with production costs at normal operating levels and large price increases had already been effected. Considerable efforts had also been made toward a major restructuring of wages, and preparations were expected to be completed in 1985 to establish a nationwide salary scale across both public and private sectors. That ambitious task was a major step toward modernizing the wage structure, which, if properly constructed, might provide a useful system of incentives and a better allocation of human resources.

In line with the broad strategy of the previous Plan, the new Five-Year Plan for 1985-89 aimed appropriately at consolidating the results already attained, with emphasis on achieving balanced economic growth through increasing efficiency and flexibility of economic management, Mr. Finaish observed. That policy had led to important achievements in the past few years that compared favorably with the record of many other countries in similar circumstances. The quantitative objectives of the Plan might prove ambitious, as expected by the staff, but the authorities seemed to be well aware of past experience and considered the Plan's targets as upper limits that would be under constant review in the annual plans.

The strong fiscal consolidation that had taken place in the past few years had played a crucial role in containing the impact on Algeria's domestic and external balances of the drop in revenue from oil exports, Mr. Finaish declared. The additional expected drop in the 1985 fiscal deficit to 2 percent of GDP, and the resulting deceleration in government borrowing, were further indications of the priority attached by the authorities to sound financial policies. Particularly notable were the implementation of the reforms in the tax system, and the restraint in the current expenditures, which were expected to show little change in nominal terms in 1985. Along with the positive effects of fiscal restraint on credit allocation, the authorities' efforts to widen and strengthen the commercial banking system should be useful in mobilizing private sector savings and channeling them toward productive investment. That was particularly important because fiscal adjustment had necessitated a sharp deceleration in public sector investment since 1982.

Two outstanding aspects in the external sector, shown clearly in the staff report, were the broadly stable current account balance and the authorities' determination and success in reducing the ratio of external debt to GDP, Mr. Finaish said. The policy of import restraint and fiscal adjustment had certainly been important factors in that regard. While many other indebted countries had undertaken substantial adjustment efforts in the past few years to deal with their payments imbalances, Algeria's ability to reduce its indebtedness at a consistent pace while maintaining a fairly high rate of growth was particularly encouraging.

While acknowledging the staff view that an upward drift in the real effective exchange rate might not help the prospects for export diversification, Mr. Finaish expressed uncertainty concerning the immediate consequences of exchange rate adjustments for a planned economy such as Algeria's, in which hydrocarbons constituted 98 percent of exports. The question that needed to be addressed was whether the considerations that had led the Algerian authorities to include debt service payments in the currency weights of the peg basket were outweighed by the other considerations raised by the staff. The answer was far from clear. In any event, the Algerian authorities were reviewing the matter of the exchange rate.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/85/132 (9/4/85) and EBM/85/133 (9/9/85).

5. SPAIN - 1985 ARTICLE IV CONSULTATION - POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, the Executive Board agrees to extend the period for completing the 1985 Article IV consultation with Spain to not later than September 23, 1985. (EBD/85/230, 9/3/85)

Decision No. 8069-(85/133), adopted
September 5, 1985

6. WESTERN SAMOA - TECHNICAL ASSISTANCE

In response to a request from the authorities of Western Samoa for continued technical assistance in connection with the drafting of income tax legislation, the Executive Board approves the proposal set forth in EBD/85/45, Supplement 1 (8/30/85).

Adopted September 5, 1985

7. RULES AND REGULATIONS AMENDED SINCE 1984 ANNUAL MEETING

The Executive Board approves the letter to the Chairman of the Board of Governors submitting for review by the Governors the texts of amendments to the Rules and Regulations adopted since the 1984 Annual Meeting and the proposed Resolution for the Board of Governors, as set forth in EBD/85/231 (9/3/85).

Adopted September 6, 1985

8. EXECUTIVE BOARD COMMITTEES - NOMINATION

The Executive Board approves the nomination by the Managing Director for the vacant positions on the Committee on Executive Board Administrative Matters and the Committee on Liaison with the CONTRACTING PARTIES to the GATT, as set forth in EBD/85/234 (9/4/85).

Adopted September 5, 1985

9. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 84/176 and 84/177 are approved. (EBD/85/227, 8/30/85)

Adopted September 6, 1985

10. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director and by an Advisor to Executive Director as set forth in EBAP/85/230 (9/4/85), and by Assistants to Executive Directors as set forth in EBAP/85/229 (9/4/85) and EBAP/85/231 (9/6/85) is approved.

APPROVED: May 15, 1986

LEO VAN HOUTVEN
Secretary