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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/59

10:00 a.m., April 18, 1984

W. B. Dale, Acting Chairman

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Also Present

P. Mentré de Loye, Consultant to the Managing Director. R. Sapunxhiu, Alternate Executive Director, IBRD. African Department: M. E. Massourakis, M. Zavadjil. Asian Department: D. M. Ripley. European Department: J. T. Boorman, D. A. Brodsky, P. B. de Fontenay, L. Hansen, R. P. Hicks, W. E. Lewis, H. O. Schmitt. Exchange and Trade Relations Department: S. Mookerjee, Deputy Director; M. Allen, A. B. Petersen. External Relations Department: Z. Zhang. Legal Department: W. E. Holder. Research Department: W. C. Hood, Economic Counsellor and Director; A. D. Crockett, Deputy Director. Advisors to Executive Directors: A. A. Agah, C. J. Batliwalla, K. A. Hansen, S. M. Hassan, L. Ionescu, H.-S. Lee, G. E. L. Nguyen, Y. Okubo, P. Pêterfalvy, D. I. S. Shaw. Assistants to Executive Directors: J. R. N. Almeida, M. B. Chatah, Chen J., I. Fridriksson, V. Govindarajan, D. Hammann, J. M. Jones, H. Kobayashi, G. W. K. Pickering, T. Ramtoolah, M. Rasyid, J. Reddy, D. J. Robinson, Shao Z., S. Sornyanyontr, Wang C. Y., M. A. Weitz.

1. GROUP OF TEN - DEPUTIES' MEETING - REPORT BY STAFF

The Economic Counsellor reported that the Deputies of the Group of Ten had met in Washington on the morning of April 13, 1984 to continue their discussion on the first two items on their agenda of studies, namely, the functioning of floating exchange rates, and strengthening multilateral surveillance.

On the exchange rate system, the Economic Counsellor went on, perhaps the most notable feature of the discussion had been the similarity of views, to the effect that the present exchange arrangements, while not perfect, were the most suitable for the times. It had been acknowledged that the short-term volatility of exchange rates was troublesome, and that the more objectionable features of the present arrangements among major currencies were the long periods of misalignment and the occasional large and sharp movements of rates. In general, however, those difficulties were to be ascribed not to the arrangements themselves, but to the environment, including economic policies, in which they had functioned. Little interest had been expressed in formulas for limiting exchange rate movements; and there had been a wide feeling that the experience of the European Monetary System could not be generalized. Capital controls had not been much in favor.

On the positive side, the Economic Counsellor noted, stress had been placed on the usefulness of directing domestic policies toward noninflationary growth, with suitable international coordination. Some participants had particularly stressed the need to reduce rigidities in domestic markets and to suppress protectionist measures. The general view had been that, while exchange market intervention should not be eschewed, especially in the face of disorderly conditions, it was not a substitute for consistent domestic policies directed toward stable noninflationary growth.

As to multilateral surveillance, the Economic Counsellor went on, considerable emphasis had been placed on the exercise of surveillance as a means of achieving the discipline and coordination of policies that were thought to be essential to the effective working of the present exchange arrangements. There appeared to be wide agreement on the need to give a broad interpretation to the range of policies to be taken into account in exercising surveillance over exchange rates. While anxious to improve and strengthen surveillance, the Deputies had not expressed any great dissatisfaction with the present practices. Some differences of view had developed over the advisability of using public statements by the Fund as part of the surveillance procedure. Some Deputies had been quite clear that confidentiality, informality, and gradualism should characterize the approach to surveillance, and its improvement. A few had been prepared to consider the usefulness of public statements in one form or another, but the idea of transparency had been put forward only in the spirit of an option for consideration. A number of specific suggestions had been made by Deputies, including the provision of more information on capital account developments in staff reports, and more attention to restrictions on capital flows in staff appraisals; more precision in staff reports on the differences between the authorities of a member and the staff on analyses and descriptions; perhaps more use of special ad hoc consultations; more follow-ups to conclusions of Board discussions of consultation reports; more use of the G-10 framework in multilateral surveillance of the major industrial countries; and continuing efforts to produce more symmetry in Fund surveillance between fixed-rate and floating-rate countries, surplus and deficit countries, and small and large countries.

The Deputies had not sought to reach firm conclusions or to make specific recommendations, the Economic Counsellor explained. They had planned to review a draft of a progress report to Ministers at their meeting on May 16, 1984 in Paris; the Ministers would receive that report at their May 19, 1984 meeting in Rome. The report would almost certainly present options rather than recommendations. It seemed likely that it would be confined mainly to the first two topics that he had just reviewed. It also seemed likely that the report would reflect the broad support that was apparent for the current exchange arrangements and for the general approach to surveillance in use.

Mr. Prowse recalled that the Fund staff had supplied some papers to the Deputies of the Group of Ten for use in their study. He wondered whether it would be possible for Executive Directors whose countries were not members of the Group of Ten to receive in return the other papers that were prepared by other agencies for the use of the Deputies.

The Economic Counsellor explained that one or two papers prepared by individual Deputies had been made available to the Executive Board. Deputies received their papers either from the Fund or from other international institutions, or from individual Deputies. The Secretariat of the Group of Ten itself produced no papers.

Mr. Prowse formally requested that the possibility of the papers prepared by individual Deputies or by other international institutions for the use of the Deputies of the Group of Ten being made available to the Executive Directors of the Fund whose countries were not members of the Group of Ten should be pursued, and the results reported to the Executive Board.

Mr. Erb remarked that even though the Deputies might put options before the Ministers and Governors of the Group of Ten, it did not seem likely that at the present stage the Ministers and Governors would be in a position to take any decisions. In particular, discussions of Fund surveillance were bound to continue in future meetings of the Deputies after the meeting of May 1984.

The Economic Counsellor agreed with the views expressed by Mr. Erb.

The Acting Chairman said that he would take note of Mr. Prowse's request.

The Executive Directors concluded for the time being their discussion of the studies being undertaken by the Deputies of the Group of Ten.

2. YUGOSLAVIA - REQUEST FOR STAND-BY ARRANGEMENT

The Executive Directors considered a request from Yugoslavia for a stand-by arrangement for a period of one year in an amount equivalent to SDR 370 million (EBS/84/65, 3/23/84).

Mr. R. Sapunxhiu, Alternate Executive Director for Yugoslavia, World Bank, was present for the discussion.

Mr. Polak made the following statement:

> Directors have before them a proposed one-year stand-by arrangement with Yugoslavia that reflects the continuing effort on the part of Yugoslavia to bring about major adjustments in its economy, in collaboration with the Fund.
>
> The three-year stand-by arrangement that ended last November was successful in its most critical aspect: it engineered a dramatic turnaround in the current account of the balance of payments, as a deficit with the convertible area of $1.8 billion in 1981 was reversed into a surplus of $0.3 billion in 1983. At the same time, the capital account remained weak through the entire period, and national reserves fell to a minimum. The improvement in the current account was brought about by harsh adjustment measures, including a decline in four consecutive years in real wages in the socialized sector, for a total decline of about 25 percent, and a major cut in investment expenditure, and was accompanied by persistent and increasing inflation.
>
> The experience of the previous arrangement forcefully demonstrated the great importance that must be attached to the avoidance and correction of price distortions. Most important in this connection has been the exchange rate. After a number of exchange rate actions under the previous program, Yugoslavia followed a clear-cut exchange rate policy during 1983, designed to bring about a real effective depreciation of 2 percent per month. This policy produced a major increase in the competitiveness of Yugoslavia's exports, which was mainly responsible for a 14 percent increase in the volume of merchandise exports to the convertible area in that year. Under the new program, the degree of competitiveness that was reached by November 1983 and that has since eroded somewhat will be re-established and then maintained by monthly adjustments in the rate.
>
> The capital account of the balance of payments remained, however, under pressure in 1983, with the result that the deterioration in this account, including errors and omissions (by $1.9 billion) offset almost the whole of the $2 billion improvement in the current account with the convertible area. This disappointing result was due to a number of causes. One was the persistence of negative real interest rates as increases in nominal rates repeatedly proved insufficient to offset the rising

rate of inflation. Other causes were the payments problems of some of Yugoslavia's customer countries, which led to delays in payments, and also expectations of exchange rate changes.

These considerations have persuaded the Yugoslav authorities on the need to adopt a formula for the interest rate that will make this rate positive by April 1, 1985. The formula is described in a technical note reproduced on page 40 of EBS/84/64. Forty percent of the necessary adjustment will be brought about on May 1, 1984. This will mean an increase in the interest rate on three-month dinar-denominated deposits from the present 12 percent to about 30 percent. This will be followed by four steps over the next 11 months. The staff would have preferred a more rapid rise to positive real rates of interest. However, the heavily indebted position of most Yugoslav enterprises requires that they be given some reasonable time to adjust to the new interest rate burden.

The proper price incentives on the international side need to be balanced by economic prices at home. The price freeze imposed in late 1983 will accordingly be lifted by May 1, 1984. Furthermore, in order to ensure that administrative prices will not again lag the general price development in the economy, there will be frequent adjustment of such prices throughout the year, as specified in the technical notes.

Finally, still within economic price formation, the program contains innovative and constructive elements with respect to wages, a subject that had proved difficult to come to grips with during the previous arrangements. On wages in general, a social compact is being worked out to limit increases on the basis of the income of each enterprise actually earned in the preceding period rather than, as previously, on the basis of the expected enterprise income. More precise measures have been agreed to induce movement of labor away from losing enterprises. To this end, aggregate wage payments in loss-making "work units"--sections of enterprises--will not be allowed to increase by more than two thirds of the increase applicable to the socialized sector as a whole in the same republic or province. Because this provision applies to aggregate wage payments of the unit, not to wage rates, it could be a powerful incentive toward shedding redundant labor. A somewhat different limitation is imposed on enterprises with overdue payments; here the purpose is to enforce financial discipline, which has sometimes been sorely lacking, rather than labor mobility. These various measures should also be helpful in reducing the subsidies to weak enterprises; the real amounts available for this purpose have, in any event, been cut for 1984.

All these measures in the general area of relative pricing are essential to bring about maximum adjustment in the payments position with a minimum further reduction, and preferably with an increase, in output. In the past, and in the absence of the proper price incentives, too large a proportion of adjustment had to be brought about by outright deflationary measures. For 1984, and especially for the rest of the decade, positive growth rates are envisaged, whose magnitude will to a large extent depend on the speed with which the country will want to reduce its indebtedness (see Table 1 on page 55 in Appendix III on the medium-term scenarios for external debt and the balance of payments).

The program as a whole will of course require the support of fiscal restraint, which was a constructive feature of the previous program, and of continuously tight monetary policy, which also prevailed last year. In the past, a monetary policy that was believed to be extremely restrictive proved less than effective in restraining inflation against strong cost-push pressures that were accommodated by sharp increases in the income velocity of money. The staff presents good reasons to believe that such increases will not occur again in 1984 but, correctly, cautions close monitoring.

Finally, there is a serious question whether the foreign exchange allocation system leads to the most effective use of foreign exchange on a national basis. This is, however, also a politically difficult issue, which needs to be handled carefully. The approach envisaged consists of two studies, one by the Yugoslav authorities and another by the Fund staff in which World Bank staff and private sector experts will collaborate. The conclusions of these studies will be considered in the mid-term review of the program.

On behalf of the Yugoslav authorities, I want to express their appreciation for the contribution that the successive staff missions have made to the Yugoslav adjustment process in the negotiation of this new stand-by arrangement. The cooperation between Yugoslavia and the Fund staff had been close throughout the three years of the previous arrangement. Much was learned by both partners during this earlier experience, and the arrangement now before the Board has benefited from these lessons. It represents fundamental changes in the management of the Yugoslav economy, made necessary by the intractability until now of some deep-seated problems. The arrangement also reflects the clear resolution of the authorities to overcome these problems, even if it takes unprecedented and unpopular measures to do so; the measures already taken bear evidence of their determination to make this arrangement a success.

Against this background, it can readily be understood that the negotiations between the Fund and Yugoslavia were drawn out over a number of missions. The Yugoslav authorities went to great lengths to assemble the required domestic support for this program. At a number of critical points in the negotiations, the staff has shown reasonable flexibility without which the agreement would not have been possible. The result of these labors deserves the full support of the Board.

Extending his remarks, Mr. Polak added a comment on interest rates in Yugoslavia. In the technical note on interest rates (Appendix I, Annex IV), it was made clear that the understanding between the Fund and Yugoslavia was limited to real interest rates on three-month deposits, and that the real interest rate would be 1 percent. However, the plans, not yet final, submitted by the Association of Yugoslav Banks foresaw a positive real interest rate of 6 percent for one-year deposits and 9 percent for two-year deposits, in addition to the 1 percent for three-month deposits. That the target was well above 1 percent also meant that for one-year and two-year deposits a possible level of real rates would be reached by the end of 1984, rather than on April 1, 1985.

Mr. Schneider recalled that when the Executive Board had reviewed the Yugoslav economic situation in July 1983 (EBM/83/113, 7/28/83), most speakers, including his chair, had urged the Yugoslav authorities to implement additional adjustment measures, not only to preserve the sovereignty of the country but also to continue with the fundamental reorientation of economic policies. EBS/84/65 clearly showed that the Yugoslav authorities were determined to overcome their deep-rooted problems and to put an end to the economic erosion that had been taking place in the country. The authorities were to be commended for the arrangements introduced in order to bring about the needed fundamental changes in the management of the economy. Their endeavors deserved the continued assistance of the international community, including the Fund. He therefore fully supported the proposed decision.

In 1983, Mr. Schneider went on, some doubts had been expressed not only by Executive Directors but also by the staff regarding the ability of the Federal authorities to obtain the necessary legislation to bring into effect the more painful elements of the adjustment process. There no longer seemed to be any question that the Yugoslav authorities had been successful in setting up the legislative framework, notwithstanding the high social cost of the adjustment program.

He commended the staff on the design of the program, Mr. Schneider said. Yugoslavia was a socialist country with a developed market mechanism as a whole, but with some important market instruments still missing. The present program combined those two features in an imaginative way. On the one hand, demand management measures had been shaped in accordance with the present characteristics of the economy; on the other, joint studies were envisaged on topics such as the foreign exchange allocation system, and new understandings were to be reached on the limitation of aggregate personal incomes paid by loss-making enterprises. The success of the program would certainly help the Fund in designing similar programs for countries with an economy similar to that of Yugoslavia.

Second, he appreciated what the staff had been doing in playing a catalytic role to bring about an international package of assistance for Yugoslavia, Mr. Schneider stated. The management's fine-tuned diplomacy had not only helped to save Yugoslavia's solvency, but also reduced the danger of so-called regionalization, which had played a major role in the area for the past few years. In so doing, it would reduce the hesitation of some commercial banks to extend further credits to countries that were already on their way to a successful adjustment of their economies.

Third, Mr. Schneider observed, the demand management program was very tight. Even though the current account target had been overfulfilled in 1983, and even bearing in mind the determination of the Yugoslav authorities to implement fundamental changes in the management of the economy, he wondered whether a program with such a small margin for error was not rather overambitious.

The staff had noted, Mr. Schneider went on, that the exceptionally good results of 1983 had been partly made possible by one-time factors. Moreover, the world recovery for the coming period was still very much in doubt. Although a very tight program might look promising at the present time, external circumstances might not be particularly supportive. It was therefore of the utmost importance that the program should be closely monitored in order to avoid slippages.

Turning to specific remarks on the new program, Mr. Schneider observed that the dramatic turnaround in the current account of the balance of payments in 1983 had almost been nullified by the deterioration in the capital account. Consequently, the program for 1984 had been designed to consolidate the improvement on current account, while avoiding a similar occurrence of outflows on short-term capital account. In that context, the main element in the 1984 program would be a sharp increase in interest rates on bank deposits.

He wondered why the Yugoslav authorities had been so reluctant to maintain a positive real interest rate level during 1983, Mr. Schneider remarked. He had also been rather surprised to read on page 10 of EBS/84/65 that the rise in inflation had been unanticipated. An aggressive depreciation of the exchange rate was bound to bring about changes in inflation. In the event, the tight monetary policy had been undercut by sharply declining real interest rates, leading to a rapid increase in the velocity of circulation of broad money. He therefore hoped that the underlying assumptions of the 1984 program were realistic, particularly as it was intended to remove the price freeze imposed in late 1983. It would be desirable for a flexible exchange rate policy to go in tandem with a more flexible interest rate policy, while continuing with a tight monetary policy.

As to incomes policy, he had been rather surprised that wage restraints, whatever form they might take, could be unconstitutional, Mr. Schneider observed. Incomes policy was an important part of the restructuring of the economy, and the legal arrangements described by the staff could easily lead to delays in adjustment. He recognized the significance, as well as the innovative character, of the constitutional measures already taken or to be taken in connection with incomes policy under the program; the Yugoslav authorities, like others, would have no choice but to accept the heavy burden of adjustment. He wondered how far labor mobility could be enhanced by placing limits on the payment of personal incomes to employees in enterprises that made losses in 1983, particularly in view of the political structure of Yugoslavia, which consisted of six rather independent republics and two autonomous provinces.

He had been struck by the fact that despite the fall in private consumption and the cut in the purchasing power of workers, nonwage incomes--comprising more than 40 percent of household incomes--had continued to be buoyant in 1983, Mr. Schneider stated. He assumed that such an outcome was due to the existence of an underground economy in Yugoslavia, and he wondered whether the staff could give some indication of the size of that economy, and what its existence could mean for the financial policies of the authorities.

As to fiscal policy, Mr. Schneider said, he would commend both the Yugoslav authorities and the staff for designing limits on the revenue side of the various budgets. Those limits were an ingenious approach that should be closely monitored, together with the limits on expenditures and on the public sector's net assets with the banking system.

On the foreign exchange system, Mr. Schneider stated, he would fully support the studies to be made jointly by the Yugoslav authorities and the Fund. The success of the adjustment process required a unified foreign exchange market and a more supportive role by the banking system. On a matter of detail regarding the foreign exchange system, could Mr. Polak or the staff explain why the interest on convertible deposits held by residents would be paid in dinars, an arrangement in force since the beginning of the year? Such an arrangement did not seem very logical; it might well offset, at least in part, the effect of the increase in real interest rates on dinar deposits.

Concerning the medium-term external debt and payments scenarios for 1983-90, Mr. Schneider remarked that the debt service ratio not only was very high at present, but would remain so through 1985, as could be seen in Table 1 of Appendix III. Only thereafter was a gradual decline in the ratio to be expected. It was therefore of the utmost importance that the authorities should keep the program on track in order to secure the continued support of the Fund and of official lenders, as well as of the commercial banks.

Mr. Lovato observed that, after three years of adjustment programs supported by the Fund, the Yugoslav economy was showing a substantial improvement in the current account, although still plagued by serious and persistent problems. First, despite the remarkable success in changing the outlook for current foreign payments, the overall balance had not improved, owing to the dramatic surge in capital outflows. Second, on the price front, the situation was worse than it had been at the time of the inception of the adjustment program, the improvements of 1982 having eroded in recent months. Third, the net financial position of Yugoslavia had deteriorated still further, as could be seen from Table 17. In particular, Yugoslavia currently ranked seventh largest in terms of quota shares for countries dealing with the Fund, with the Fund holding 416.6 percent of quota in Yugoslav dinars. Finally, and more seriously, the whole system of relative prices--including labor costs and real interest rates--seemed to be out of balance; it was certainly failing to give the appropriate signals to the economic agents. The situation reflected the difficulties encountered by an economy that had undergone a wide-ranging program of austerity measures, while maintaining significant price rigidities. In those circumstances, the macroeconomic policy actions had produced, as a side effect, artificial modifications in relative prices and unwarranted effects in the allocation of resources.

At a time when a new stand-by arrangement was being proposed for approval by the Executive Board, Mr. Lovato went on, it seemed appropriate to look back at the experience of 1981-83, identify possible weaknesses, and draw conclusions for the future. The Yugoslav economy had entered the current decade in a profoundly unbalanced state: the strong investment program of 1976-80 had not brought about any satisfactory increase in productivity; rather, it had imposed serious stresses on the domestic economy by squeezing consumption, negatively affecting the balance of foreign payments, and providing a stimulus to inflationary pressures. The main cause of those developments had been monetary policy. The maintenance for a long period of largely negative real interest rates on firms' borrowings had prevented the selection of investment projects according to economic efficiency. To avoid the gradual erosion of competitiveness, the primary emphasis ought to have been placed on a qualitative improvement in investment, in terms of productivity and export content, which would have been attained by means of an active and market-oriented monetary policy, possibly supported by a selective program of public investment and a mild exchange rate depreciation.

While exchange rate flexibility was needed to counter the growing gap in foreign payments, Mr. Lovato maintained, an excessive depreciation could have induced firms, primarily but not only in the export sectors, to relax their efforts to achieve economic efficiency and wage restraint, thus ultimately providing additional impetus to the underlying inflation. The policy actually implemented had had two main aspects: a restrictive monetary policy and aggressive exchange rate depreciation. Unfortunately, the restrictive monetary policy had never been fully applied. Despite the inevitable ambiguities in evaluating the monetary stance, real interest rates on bank loans had remained largely negative throughout the program period, as could be seen from Table 10 and Table 3 of Appendix V. As an aside, despite what the staff had written on page 5 regarding the monetary stance, the shrinkage in real M-2 in 1983 ought not to be interpreted as a monetary restraint in view of the further decline in real interest rates on bank deposits. Fixed investment had declined substantially, mainly due to the administrative measures incorporated in the 1980-85 plan for the express purpose of reducing the share of investment in gross domestic product. As a consequence, in the absence of adequate incentives to achieve cost efficiency and capital formation, industrial productivity had continued to decline.

Unfortunately, Mr. Lovato considered, the shortcomings caused by a defective monetary policy had not been offset by appropriate stimuli from exchange rate policy. Aggressive depreciation during 1982 and 1983 had provided ample room for price increases in the export sectors. The consequent rapid increase in inflation had made it necessary in the immediate future to resort to new and, he hoped, more convincing monetary restraint and further exchange rate depreciation. In those circumstances, a one-year program was clearly too short to tackle the real underlying causes of the current difficulties.

In brief, Mr. Lovato observed, even with the adoption of Fund-supported policies, the medium-term outlook for the Yugoslav economy was not at all satisfactory. Nevertheless, the current economic situation seemed to leave little room for any alternatives to the proposed program, which he therefore supported. There was still room for improvement in monetary policy, which was apparently to continue on a gradual path for the next few months, making it likely that positive real interest rates would begin to be seen only at the end of 1984. Even in the specific institutional setting of Yugoslavia, he had been struck by the gradualism that had characterized the interest rate policy of the past two years, and that had been proposed for the current program in Appendix I, Annex IV, particularly in view of the rapidly changing situation in connection with prices and the exchange rate. His own view was that less attention should be paid to adjusting the exchange rate and more to raising interest rates.

Finally, Mr. Lovato remarked that, while he had paid specific attention to certain fundamental problems in an attempt to find ways to bring about improvement, he had omitted a number of points on which the staff evaluation and policy prescriptions were entirely appropriate. Among them was the administrative management of foreign exchange resources. The staff had been correct to emphasize the urgency of reform in that field, despite all the difficulties arising from a federal political structure. Besides interfering with the efficient allocation of foreign exchange receipts, the present system might produce a scarcity of convertible currencies at critical moments. Moreover, the hoarding of such currencies by households and their circulation within the domestic economy could jeopardize the effectiveness of monetary control. Consequently, although he understood that the foreign exchange allocation system was a politically difficult issue, he encouraged the Yugoslav authorities to ponder carefully the possibility of moving to a more efficient use of their foreign exchange on a national basis.

Mr. Laske considered that, in the course of the three-year stand-by arrangement with the Fund, Yugoslavia had achieved an impressive improvement in its balance of payments position. The turnaround in the current account with the convertible currency area had been quite remarkable, especially as it had led to a rather larger surplus than originally envisaged, even though the staff had mentioned in a footnote on page 71 of EBS/84/65 that the statistics might overstate the improvement achieved. The staff had mentioned that the conversions of trade and other flows into U.S. dollars had been made by applying statistical exchange rates rather than the specific exchange rates used in each individual transaction. The reliability of such balance of payments statistics might thus be somewhat doubtful. When would the Yugoslav authorities be able to provide figures in a form that would enhance their credibility?

Despite the improvement in the current account of the balance of payments, Mr. Laske went on, serious problems persisted in various areas of the Yugoslav economy. First, the improvement in the current account had been achieved to a considerable extent by a severe compression of imports, which had declined in volume for three consecutive years. If the value of imports for 1982, which had already been drastically cut from 1981, had been maintained, the current account for 1983 would have been in considerable deficit. In other words, the increase in the volume of exports--including the redirection of exports from the nonconvertible to the convertible area--had thus not been strong enough to bring about a more satisfactory level of imports. The aggressive exchange rate policy pursued by the Yugoslav authorities had certainly contributed to the improvement in the current account. Nevertheless, the shift of emphasis from the domestic to the external sector would have to be not only maintained but even intensified. Another troubling feature of the current account over the past two years had been the decline in receipts from tourism, although a partial reversal of the decline seemed to have set in. While one of the causes had undoubtedly been the recession in other European countries, some of the decline had probably also been due to the delay in adjusting the exchange rate. With the economic recovery in progress in the industrial countries in Europe, the environment for Yugoslav exports and for tourism would certainly improve; even so, further active adjustment would be required.

The balance of payments outcome for 1983 had largely been determined by developments in the capital account, which in turn had been heavily influenced by outflows of short-term capital, Mr. Laske noted. The resultant decline in international reserves had been kept relatively small by substantial purchases from the Fund. Yugoslavia's reserves were very low, and the proposed stand-by arrangement provided for only limited additional net use of Fund resources, a situation that seemed quite justified in view of the substantial recourse to the Fund already had by Yugoslavia. He fully agreed with the staff that the authorities should pay particular attention to the capital account, while seeking continued improvement in the current account. It seemed clear that the objective could be achieved only by a rapid upward adjustment of interest rates. All interest rates had become negative in real terms in the past year, when price increases had been much greater than expected. The authorities had failed to react in time; in particular, they had not raised interest rates sufficiently. Early action in that field might have been beneficial for the flow of remittances.

More important, however, Mr. Laske considered, the emergence of negative real interest rates had contributed to the outflow of short-term capital, to the relatively low domestic savings, and to the accumulation of inventories in imported goods. He was glad that the authorities had agreed to re-establish positive real rates over time, although, like the staff, he would have preferred a faster approach toward that objective. It was understandable that the Yugoslav authorities were hesitant to move too vigorously in that field because of the great indebtedness of many enterprises. However, Yugoslavia had been struggling for a number of years with a shortage of international finance. Providing attractive rates of interest would be one effective way of dealing with the problem. The gradualism inherent in the adjustment formula for interest rates did not seem appropriate. He expected that the appropriateness of interest rates would be carefully examined at each quarterly review, and that the formula itself would be adjusted if a need to do so were found. Although the technical note on interest rates indirectly specified the targeted rate for 1985, it would have been more helpful to the reader if that rate had been explicitly mentioned in the body of the paper.

The passages in EBS/84/65 dealing with price setting, wage determination, and the financial position of enterprises demonstrated that the Yugoslav economy continued to suffer from structural maladjustments that adversely affected the efficiency and flexibility of the entire economy, Mr. Laske stated. The developments in producer prices, unit labor costs, and retail prices were all evidence of the lack of effective adjustment. While he did not disregard the cost and price effects of the exchange rate adjustments of 1983, they had to some extent been offset by wage and price determination processes that appeared to have been inconsistent with the objective of external adjustment. The authorities had twice introduced price freezes when the monetary situation had appeared to be getting out of hand. When they had eventually lifted the first freeze, pent-up price pressures had burst forth in a wave of price increases. Naturally, the same thing might occur once again when the present price freeze ended on May 1, 1984, unless sufficiently restrictive policies were introduced. The authorities foresaw only a modest decline in the annual rate of price increase from 60 percent to 50 percent. Nevertheless, he welcomed the authorities' intention to remove a number of prices from the price setting and price control system, and to adjust officially determined prices more flexibly. He hoped that the change would bring about not only smoother price movements but also a more stable price situation in the future.

Of equal importance, Mr. Laske considered, was the intended reform of wage determination. He had noted with great interest Mr. Polak's explanations regarding the limitation imposed on wage determination in unproductive and illiquid enterprises. The changes were expected to enhance labor mobility and to weed out enterprises that could no longer successfully compete. He imagined that the matter was politically sensitive, as it touched directly on equity in income setting and on job security. The results of the new approach would have to be closely watched, and he was looking forward to staff comments in the quarterly reviews. The change in the basis for calculating enterprise income from a forward-looking procedure to a backward-looking one was clearly of the greatest importance.

Workers in the socialized sector of the Yugoslav economy had been subject to considerable losses in real income in recent years, Mr. Laske remarked. To support the recovery and maintenance of international competitiveness, continued wage moderation would be needed. It was rather surprising, therefore, that income moderation in the socialized sector had been offset by strong rises in nonwage income. He wondered whether the term "nonwage income" meant in Yugoslavia income earned from economic activities outside government control. To the extent that it referred to income earned in entrepreneurial activity, could the demand effects not be harnessed by increased direct taxation of such income?

The policy of aggressively adjusting the exchange rate so as to gain a competitive edge in the convertible currency area had produced good results, Mr. Laske considered. The policy had however suddenly been discontinued toward the end of 1983, with a consequent loss of some of the earlier competitive gains. Although the authorities had resumed their aggressive exchange rate policy to try to regain some of the lost ground, the full benefits could probably be reaped only if the exchange allocation system were put on a more rational footing. He understood that a commission had in 1983 put forward proposals for rationalizing the system, but that they had not yet been acted upon. The introduction of more market-related elements into the allocation system would help to direct scarce foreign resources to those sectors of the economy where their use would be most beneficial. As a first step, increasing the share of foreign exchange earnings to be sold in the unified exchange market would be a step in the right direction. He hoped that the studies to be conducted during the summer of 1984 by the staff and the authorities would enrich the understanding of the exchange allocation system by all concerned and allow the Fund to make proposals for a substantive reform, as part of the midterm review.

He had noted the expanded list of performance criteria, some of which were obvious novelties, seldom or never applied before, Mr. Laske observed. The new criteria were germane to the economic system of Yugoslavia, where regulation continued to play a prominent role. Observance of the new criteria ought to secure the extension of the adjustment process from the external sector to the domestic sector of the economy. He agreed with Mr. Schneider that the program was tight, with little margin for error. It was, however, essential for keeping the situation manageable and for reaching a stage where exceptional assistance would no longer be needed. On the basis of the program he would support the requested stand-by arrangement.

Mr. Tvedt commended the close cooperation between Yugoslavia and the Fund in recent years. The proposed program would represent an extension of that cooperation, in which both the Yugoslav authorities and the Fund had shown considerable flexibility.

The staff paper showed that there continued to be substantial structural weaknesses in the Yugoslav economy, Mr. Tvedt remarked. Many of them had previously been reviewed by the Executive Board, and a more timely implementation of the policy measures recommended by the Fund would probably have placed Yugoslavia in a stronger position than it occupied at present. Indeed, most of the understandings and performance criteria not fully met under the 1983 stand-by arrangement had been reintroduced in the proposed program in a more definite form, and new adjustment measures had been put forward.

An important aspect of the present program was the attempt to put greater emphasis on economic price formation, Mr. Tvedt considered. Lifting the price freeze and allowing a larger number of industrial prices to be determined freely should lessen the degree of price distortion and help ailing companies that had not been allowed to charge prices reflecting supply and demand conditions for their products.

As to the pricing of labor, Mr. Tvedt commented that it was an important step forward to base wage increases on the income actually earned by the enterprises in a preceding period and to tighten wage restraint in loss-making and illiquid companies. However, in view of the need for increased labor mobility and for structural adjustments, some sort of link between productivity and wage determination was needed. He would be interested to hear the staff comment further on that point, particularly on the constitutional aspects.

The growth of household incomes in the recent past had been stronger than expected, Mr. Tvedt observed. As nonwage incomes accounted for almost 50 percent of household incomes, the nonwage component might represent an important source of unpredictability in household demand, and in the response to policy changes as well.

He fully agreed with the staff about the importance of a sharp increase in nominal interest rates, Mr. Tvedt continued. Apart from the likely benefits for external capital flows, substantially higher interest rates might also influence interenterprise credits and restore the financial discipline of enterprises, a topic that had been a matter of concern to the Executive Board on earlier occasions.

He also agreed with the staff in taking a rather cautious view of Yugoslavia's growth prospects, Mr. Tvedt stated. However, although the exchange rate policies in the proposed program were less aggressive than the previous arrangements, following a substantial one-time shift in trade flows from the nonconvertible to the convertible currency area, the staff envisaged a further significant increase in Yugoslav enterprises' market shares in the convertible currency area. Such an assumption implied that Yugoslav products would have to encounter very favorable conditions abroad, including, perhaps, high price and income elasticities.

The proposed program--if fully carried out--would represent a balanced approach to improving economic performance in Yugoslavia, Mr. Tvedt considered. He agreed with the staff that in a number of fields much remained to be done, and that in some respects the pace of adjustment could have been swifter. However, although Yugoslavia ought to rely less on Fund resources in the years to come, it was important that, in assessing future economic developments in the country, Executive Directors should take into account the different economic environment and constraints that applied there. In conclusion, he could support the proposed decision.

Mr. Erb remarked that there were two key elements in the Yugoslav program: first, the achievement of a stronger balance of payments position in the short term, and, second, structural reforms designed to improve the efficiency of the economy, so that a higher rate of real economic growth could be achieved and the balance of payments put on a sustainable basis over the longer term. Good progress had recently been made in swinging the convertible currency current account balance from a deficit of $1.8 billion in 1981 to a surplus of $300 million in 1983, but the capital account had remained weak. Some progress had been made in substituting price mechanisms for administrative controls as a means of reallocating resources toward a more efficient use, but much still needed to be done. A comprehensive and internally consistent set of policies would have to be implemented over the medium term if the restructuring were to be successful.

For example, Mr. Erb went on, the structural changes aimed at shifting resources from production for the domestic market to exports called for a realistic exchange rate and an efficient system for allocating foreign exchange. It would also be necessary to bring about flexibility in the movement of capital and labor and to adopt appropriate interest rate and wage rate policies, both to facilitate export growth and to improve the overall efficiency and growth of the economy. Attention should also be given not only to the recovery of gross fixed investment but also, perhaps more important, to the quality of investment. If distortions were to be avoided, subsidies would have to be reduced and eventually eliminated, while administrative controls and institutional rigidities would have to be relaxed to permit prices to move relative to one another and to create wage differentials necessary to reallocate human resources.

A political consensus in support of such fundamental changes was crucial to the success of the effort, Mr. Erb stated. He would encourage the Yugoslav authorities to continue their strong efforts to explain to the people of Yugoslavia the rationale behind those reforms, in order to build the necessary support in a complex political environment.

With the recovery of world trade, Mr. Erb continued, prospects for the current account of the balance of payments were encouraging. However, it was essential that the massive short-term capital outflow, amounting to $1.9 billion in 1983, should be sharply reduced. Large negative real interest rates had certainly been a major factor behind the outflow. Consequently, strict adherence to the exchange rate and interest rate commitments contained in the program would be critical in achieving the foreign sector targets during 1984. The steady real effective depreciation of the dinar over the past four years and the sharp increase during

1983 in the volume of exports were both encouraging signs. It was of course difficult to be sure when an equilibrium exchange rate had been reached. Although he had noted Mr. Polak's statement that the authorities would seek to maintain the degree of competitiveness that had been achieved by November 1983, it would be necessary to monitor exchange rate developments with great care.

He welcomed the statement that the authorities intended to liberalize exchange and trade policies as soon as the foreign exchange shortage had been overcome, Mr. Erb observed. Although such a commitment sounded rather vague, the authorities had evidently realized that liberalization could form an important part of the overall effort to create a competitive environment and foster greater economic efficiency in Yugoslavia. While action of the sort would not be without its short-term risk, it was essential to make a start.

The proposed study of the present foreign exchange allocation system was also of interest to the medium-term balance of payments outlook, Mr. Erb considered. He expected that the study would lead to a clearer understanding by the staff and the Board of the ways in which the present arrangements worked and of possible means to improve them. He looked forward to considering the findings of the study during the midterm review. In particular, he would like to see an assessment of the need for a complex allocation mechanism if the price of foreign exchange was correct.

The most obvious shortcoming in Yugoslavia's adjustment effort had been the steady overshooting of inflation targets ever since 1980, Mr. Erb remarked. He was still concerned about that aspect of the program, even though the staff cited a number of factors that should lead to a deceleration of inflation during 1984, at least after a possible surge following the removal of price controls on May 1, 1984.

As to monetary policy, Mr. Erb stressed that the existence of large bank deposits denominated in foreign currency together with sharp upward revaluation adjustments in dinars was bound to complicate monetary management and the control of inflation. Disturbances were bound to continue as long as inappropriate domestic real interest rates and remaining doubts about the exchange rate made the dinar an unattractive store of value. Real evidence of the problem could be seen in the gradual "dollarization" of the money supply in recent years, with the share of M-2 consisting of foreign exchange deposits rising from 26 percent in 1980 to 43 percent at the end of 1983.

On the fiscal side, Mr. Erb remarked that it was unusual for a member requesting the use of Fund resources to be in budgetary surplus and to offer plans for a further reduction in real public sector revenues and expenditures in 1984. That situation had certainly helped the anti-inflationary effort. He was particularly pleased that the major restraint in expenditure would be on subsidies, especially export subsidies.

In view of the very small economic growth rates for the past four years, the prospects for at least modest real economic growth in 1984, coupled with a further strengthening of the balance of payments, were good signs, Mr. Erb commented. As other Executive Directors had suggested, the steady drop in real fixed investment over the past four years had been a cause for some concern, although the ratio of investment to GDP remained high. That combination of circumstances seemed to indicate that an improvement in the quality of investment might be even more important than the absolute level. Unfortunately, the staff seemed to imply that the improvement in profits in export industries had to some extent permitted a speculative buildup of inventories, the subsidization of inefficient industries, and the accumulation of foreign exchange holdings, instead of contributing to a recovery of investment. It seemed evident, therefore, that there was a need for an improved investment climate and for incentives to raise the rate of saving.

In that connection, although the staff had mentioned a decline in the private savings rate, Mr. Erb noted, it had offered little supporting data. It would be interesting if the staff could be more specific. In any event, the channeling of profits into productive investment and a shift in resources toward more efficient economic sectors should be made easier by the achievement of positive real interest rates, continued restraint on real wages through the proposed limits on wage increases in loss-making firms and in firms with payments arrears, and by new limits on direct subsidies from the Joint Reserve Funds. The wage limits in loss-making firms should be particularly helpful in overcoming past rigidities in the movement of labor within the economy.

A major effort was being made again in 1984 by governments, commercial banks, the World Bank, and the Fund to provide special financing in support of the Yugoslav adjustment effort, Mr. Erb noted. However, for the Yugoslav balance of payments to be sustainable, continued dependence on such financing must clearly come to an end. The staff had suggested that dependence should end in the near future; but it then went on to say that it was not clear that the desired result would be achieved by 1985, when the proposed stand-by arrangement would come to an end. Yugoslavia's adjustment effort had already been supported by borrowing from the Fund in each of the past five years, and cumulative drawings would reach 326 percent of quota at the end of the proposed program. In December 1983, debt to the Fund had already exceeded $2 billion, and repayments to the Fund would increase rather rapidly to a peak of $465 million by 1988. Such large figures underlined the urgency of the adjustment effort and of the need to re-establish Yugoslavia's foreign creditworthiness.

Finally, Mr. Erb remarked, while the staff's medium-term balance of payments and debt scenarios had been helpful, it would be useful if the staff could also include in its medium-term presentation an analysis or discussion of the economic conditions--and the corresponding policies--necessary for achieving economic growth and a sustainable balance of payments position. He would completely reverse the staff's conclusion that for Yugoslavia the future growth path depended on the policy stance with respect to external debt. In his view, Yugoslavia's external debt prospects over the medium term would depend not only on the authorities' exchange rate policies, but also on more effective use of the country's resources. He noted that the medium-term scenarios all showed a reduction in foreign debt. If the authorities were to pursue successful adjustment policies and use foreign credit efficiently, might the result not be an increase in foreign borrowing potential? Thus, Yugoslavia might become a net borrower again.

Mr. Clark commended the staff for a helpful paper and supported the proposed decision. The most striking success in the economic performance of Yugoslavia during 1983 had been the substantial improvement in the current account balance with the convertible currency area. The authorities were to be congratulated for achieving that central objective of the program. Even so, the adjustment process in Yugoslavia still had far to go. It was, therefore, particularly regrettable that in 1983 the authorities had failed to observe several of the policy understandings reached with the Fund and that, after the last drawing had been made, two of the performance criteria had not been met. In addition, the authorities had reimposed a price freeze in January 1984. Perhaps the staff would like to confirm that under the proposed program the last drawing would not be available until all the policy measures--including the last installment of the interest rate adjustment--had been implemented.

The program for 1984 was a step in the right direction in many important areas, including real interest rates, the exchange rate, and foreign exchange allocation, Mr. Clark considered. Nevertheless, like other Executive Directors, he was rather worried that the pace of adjustment might be too gradual and that, in particular, the movement toward positive real interest rates might not be fast enough to prevent further capital flight. It would be essential to monitor developments in that field continuously; if the program seemed to be going off track, the authorities would need to take decisive action. In that connection, he welcomed the adoption of a performance criterion for reserves. By the end of the period covered by the proposed program, Yugoslavia would have received continuous Fund support for nearly five years. After such a period, it might have been hoped that external viability would have been achieved. As that outcome seemed rather unlikely, there ought certainly to be no slippage whatsoever from spirit or the letter of the program.

On the external policies of Yugoslavia, Mr. Clark observed, the substantial improvement in the current account with the convertible currency area had been accompanied by an even greater increase in short-term capital outflows. Part of the apparent excess might be due to an underrecording of imports; but part had no doubt been due to the heavily negative real rate of interest. He therefore welcomed the moves toward securing positive real rates, even though the steps taken might be too slow. But he also wondered how far the capital outflow might have been associated with the credit arrangements attached to the increased volume of exports. In particular, it would be interesting to know whether the same effect might be repeated as the counterpart of the further substantial rise in exports projected for 1984. He welcomed the proposed reviews of the foreign exchange allocation system. Given the shortage of foreign exchange in Yugoslavia, it was essential that whatever was available should be used as efficiently as possible. He hoped that the authorities would consider carefully any recommendation that emerged from the reviews.

The staff had usefully stressed the heavy burden of debt and debt service to be borne by Yugoslavia for the rest of the decade, and had made clear that the future growth path would depend critically on the availability of external finance, Mr. Clark said. He had noted the staff's comment that, in view of the annual increase of 2.5 percent in the labor force, it would be desirable to aim for a rate of growth at least as large. While such a growth rate would be desirable, it was certainly essential that the growth path should be consistent with a sustainable external position; using that criterion, Scenarios 1 and 2 in Table 1 of Appendix III seemed to be aimed at more prudent objectives than Scenario 3. Much of course would depend on what happened to the trade balance. The target of devaluing the real exchange rate to a level 25 percent below that of January 1983 was helpful, although the target considered appropriate in 1983--which had not been met--represented a depreciation of 30 percent. It would be essential that the devaluation, together with the other measures in the program, should in fact bring about a shift in the economy toward industries producing tradable goods.

Taking up the topic of structural adjustment in general, Mr. Clark noted that the staff had commented that a return to capacity growth with external balance would require changes in the structure of production away from sectors that supplied mainly domestic markets to sectors that could supply external markets as well. He would be interested to know from the staff how much progress had been made in that direction over the past three years. He did not entirely understand the meaning of the information provided in Chart 4 of EBS/84/65. The improvement in exports to the convertible currency area no doubt reflected some degree of adjustment, but, as the staff had indicated, some 50 percent represented a diversion of exports from the nonconvertible area. While such a change was not undesirable, it was not necessarily indicative of a more export-oriented production structure for the economy as a whole. Both devaluation and the phased introduction of real positive interest rates clearly had a central role in the adjustment process.

He had taken note of the lifting of the price freeze and of some price liberalization, of the wage restrictions on unprofitable enterprises designed to encourage labor mobility, and also of a reduction in, and rationalization of, subsidies to certain enterprises, Mr. Clark went on. Although those changes were welcome, he had also noted the staff's doubts as to how well they would work in practice, especially the wage measures. Given the experience of the past few years, during which performance criteria had been met and adjustment had still been slow, he shared the staff's doubts. The results would need to be monitored carefully, and he hoped that the midyear review would include a section discussing the practical effects of the measures, even if it had to be based on preliminary indications.

On two more detailed points, Mr. Clark said, first, that he was sorry not to have seen the usual section on Yugoslavia's relations with the World Bank. The objectives of the structural adjustment loan from the World Bank in 1983 had been relevant to the objectives of the Fund program, and he would have welcomed a discussion of the relationship between the two. Perhaps such a section could be included in the report on the midterm review. Second, the formula for setting nominal interest rates seemed to be based on retrospective inflation. He wondered whether the staff could comment on the implications of the formula for real interest rates, measured ex ante, when inflation was declining.

Mr. Joyce remarked that the three-year stand-by arrangement with Yugoslavia, completed in November 1983, had been considered a success, and the Executive Board was being asked to approve a further one-year stand-by arrangement to enable the authorities to continue the adjustment process. The aim of the new program, Executive Directors had been told, was to consolidate the improvements achieved in the external account during 1983, to avoid further outflows of short-term capital, and to bring about a reasonable increase in the country's reserves. Such objectives merited support by the Executive Board. Despite adverse economic developments in other countries and a rise in payments from abroad, Yugoslavia had achieved a dramatic turnaround in the current account of the balance of payments. Unfortunately, the outflow of short-term capital had more than offset the current account surplus, and Yugoslavia's reserves had fallen during the period. There might of course have been some under-recording of imports, so that the current account surplus itself might have been smaller than originally thought.

Nevertheless, Mr. Joyce went on, Yugoslavia had made considerable progress in 1983. All the performance criteria had been met, and the authorities had taken some decisive actions to deal with structural problems and to make the economy more competitive. On both scores, the authorities were to be commended, yet he was disturbed both about the past and about the future.

His chair had been critical of the stand-by arrangement for Yugoslavia in the past, Mr. Joyce recalled. As early as 1982, he had complained that the program appeared to be too lax, and that not enough had been done to deal with major structural problems. He had expressed similar concerns in March 1983. He had noted that although the authorities planned to do more in the third year of the program, progress might be too slow. In the event, that was what seemed to have occurred. The capital outflow during 1983 had undoubtedly been due to a number of causes, but the most important had been the failure of the authorities to raise interest rates sufficiently. Moreover, although the authorities had undertaken a major devaluation of the dinar, enabling Yugoslavia to become more competitive internationally, there had been no matching action on domestic prices. The result had been that, at the end of the three-year adjustment program, many of the fundamental problems still remained.

The situation raised serious questions about the design of such programs, particularly the understandings reached on the speed of adjustment, Mr. Joyce stated. It was of course only natural for Fund programs to go off track for one reason or another, but he had difficulty understanding how Executive Directors could approve a three-year adjustment program that was quite successful in itself, and yet left many serious problems to be tackled. The authorities' intentions under the proposed new program were laudable, but he wondered why the matters had not been addressed sooner. He appreciated the major steps taken by the authorities, particularly with respect to real wages in the public sector, the sacrifices imposed on the population, and the actions taken in the fiscal and monetary fields. He also appreciated the difficulties faced by the authorities in financing the public enterprises, in securing adequate external financing, and in reaching consensus among the republics. Similar problems existed in Canada.

Nevertheless, the problem remained that three-year programs were meant to provide enough time for most, if not all, of the basic structural changes to be carried out, Mr. Joyce said. Yet the country still seemed to be only beginning to try to make the pricing and wage system work effectively. To make matters worse, even in the area where the authorities had shown boldness and resolution--the exchange rate for the dinar--there had been backsliding as soon as the previous program had come to an end.

The Yugoslav economy continued to face serious weaknesses, Mr. Joyce observed, and measures would have to be implemented to strengthen the position over the medium term. On the demand side, the key factor in 1984 would be to control inflationary pressures. On the supply side, measures were needed to increase sensitivity to external developments further and to achieve a more efficient allocation of resources domestically. The authorities were to be commended for their intentions. However, given the time it would take to correct Yugoslavia's structural difficulties, the measures should be introduced without delay and be pursued without slippages. Control over inflation would have to play a central role in view of the plan to increase price flexibility, which was likely in the short term to result in continued strong pressures on prices. However, he did support the current plan to ensure that monetary expansion was sufficient to permit at least some growth in the economy.

He could agree in general with the staff appraisal accompanying the request for the new stand-by arrangement, Mr. Joyce stated. The elimination of price distortions would be a key element in medium-term adjustment. The positive characteristics of the proposed arrangement had been well documented by the staff, and he would do no more than emphasize that the authorities' intentions regarding interest rates and pricing policy should be implemented as scheduled on May 1, 1984, if the program were to remain on track. He was glad to see that the implementation of those intentions had been made a performance criterion.

On the other hand, he was disturbed to see that the staff appeared to give only qualified support to the program, Mr. Joyce went on. He had noted, for instance, that the staff had said that "on balance" it agreed that the proposed program was adequate to achieve its objectives, although with at least three qualifications. First, the staff was not certain that the system for allocating foreign exchange was working adequately yet; he agreed that the exchange rate arrangements were still insufficiently flexible, and that they would need to be re-examined at the time of the midterm review. Second, the staff was not yet confident that the new wage measures would prove to be effective. The Government could assist the process by restraining the subsidies to enterprises. The planned reduction of subsidies in real terms through the Joint Reserve Funds was a positive step, but the authorities should work toward their rapid elimination.

Efforts to restrict personal incomes in enterprises in deficit, so as to encourage a transfer of labor, were also welcome, Mr. Joyce commented. However, it might have been preferable to relate wage developments in those enterprises more directly to productivity in the enterprises themselves. He was also uncertain about the actual impact of the wage restraint measures if the authorities intended them to apply only to the basic work units that contributed to losses within the enterprises, while those units that did not directly incur losses would be immune from the restraint. He would welcome staff comment on the system. Third, the proposed changes in real interest rates needed to be watched carefully. He was not optimistic that the authorities' expectations would be fulfilled. Interest rates would remain negative in real terms throughout most of the program, although he had noted Mr. Polak's statement that the Association of Yugoslav Banks intended to move to higher real interest rates on longer-term maturities and to achieve positive real rates for those maturities by the end of 1984. Nevertheless, unless interest rates were to increase more rapidly during the period, he feared that capital outflows would continue. At a minimum, the situation needed careful watching.

As to pricing policies, Mr. Joyce said that he noted the intention of the authorities to lift the price freeze on May 1, 1984. He also noted that the proportion of prices that would be freely determined was to be increased. Nevertheless, it was noteworthy that 45 percent of prices--perhaps not an exceptional proportion in a socialist economy--would still be subject to some degree of government control. He urged the authorities to work toward further reductions. Furthermore, although administered prices were to be adjusted more regularly, they would be increased merely in line with costs. To be truly viable, price increases should also be sufficient to provide resources for capital expansion.

He hoped that the Fund program would continue to have a catalytic effect, and that flows of official assistance, and of medium-term export credits, would increase, Mr. Joyce stated. The commercial banks should also begin to play a more forthcoming role if the Yugoslav economy were to move forward as intended, so that Yugoslavia could generate the foreign exchange that it would need to service its international obligations, including its debts to the commercial banks. Such events were likely to take place only if the international banking community were convinced that the successes to date were neither temporary nor illusory, and that the Yugoslav economy had indeed turned the corner. Despite some reservations about the pace of adjustment, he did support the proposed program and welcomed the imposing array of performance criteria.

Mr. Ismael expressed general agreement with the thrust of the staff appraisal. Under the previous stand-by arrangement, the Yugoslav authorities had made substantial advances in reducing the current account deficit in convertible currencies. Nevertheless, their performance had fallen short of meeting other key targets connected with prices, interest rates, and credit. There had also been a slippage toward the end of the program period in maintaining the momentum of the adjustment effort. A timely implementation of corrective measures would have contained the inflationary pressures and arrested the outflow of capital.

The program under the proposed stand-by arrangement aimed at safeguarding the momentum of improvement in the current account and at improving the balance on the capital account, Mr. Ismael noted. The program also sought to decontrol prices in favor of market-determined prices and to restrain wages in such a way as to encourage the transfer of labor from declining to expanding sectors of the economy. The performance criteria and other measures envisaged under the program seemed adequate to meet the stabilization objectives. He could therefore support the proposed decision.

Mr. Zhang remarked that the three-year stand-by arrangement with the Fund that had been completed in November 1983 had achieved substantial results. There had been a sharp turnaround in Yugoslavia's current account balance with the convertible currency area, from a deficit of $1.6 billion in 1981 to a surplus of $0.3 billion in 1983, together with an increase in the volume of exports to the convertible currency area by 14 percent between 1982 and 1983, in contrast to a fall of 6.8 percent between 1981 and 1982. The improvement had been to a large extent attributable to the continued policy of deflation in the domestic economy. The fall in gross social product in 1982 and 1983 had amounted to 4.5 percent.

In those circumstances, Mr. Zhang went on, the Yugoslav authorities had decided to change their policy and to seek the maximum possible adjustment in the payments position with as little further reduction in total output as was practicable, and preferably with some increase instead. At the same time, the authorities had realized that, in order to bring about adjustment with growth, they would have to introduce fundamental changes into the management of the economy, as well as finding solutions to deep-seated structural imbalances.

The request for a new one-year stand-by arrangement with the Fund was intended not only to consolidate the achievements of the previous arrangement in the external sector, but also to carry out essential medium-term reforms elsewhere in the economy, Mr. Zhang noted. The policy measures contemplated under the arrangement, if fully implemented, would provide a more viable basis for future economic growth in Yugoslavia. The adoption and implementation of some of the new policy measures would involve difficult and unpopular decisions by the authorities, and their courage in that respect was highly commendable. He would support the request for a new stand-by arrangement.

Two studies on the foreign exchange allocation system were to be prepared, one by the Yugoslav authorities and one by the Fund staff, Mr. Zhang remarked. The purpose of the studies was to identify the problems in the present system and to make specific recommendations for improvement. While the studies were to be highly welcomed, in view of recent experience with another country he wished to enquire how any differences in the conclusions of the two studies would be resolved, and whether any of the conclusions would be used as the basis for new conditions for future purchases under the arrangement.

The staff had reported that the volume of exports to the convertible currency area had increased by 14 percent from 1982 to 1983, and that there had been a real effective depreciation of the dinar by 25 percent, Mr. Zhang noted. The staff considered that those developments showed the effectiveness of depreciation in enhancing the competitiveness of Yugoslav exports. However, he doubted whether the staff conclusion was correct in view of the figures set out in Table 14 on page 71 of EBS/84/65. There it was shown that between 1982 and 1983 the value of exports in terms of U.S. dollars had increased by nearly 14 percent, an increase entirely accounted for by a rise in the volume of exports, while the unit value had remained unchanged. Why a 25 percent real effective depreciation in the dinar had not been reflected in the export unit value in terms of U.S. dollars certainly needed explanation. Furthermore, those developments clearly indicated that the increase in the volume of exports between the two years had been the result not of an increase in competitiveness, but rather of an improvement in the domestic supply of export commodities and of a recovery of export markets. Naturally, the increase in the supply of commodities had been prompted by the increase in dinar prices resulting from the depreciation.

In short, Mr. Zhang concluded, there did not seem to be any strong evidence to show that the large real effective depreciation during the past year had successfully lowered the export unit value in terms of U.S. dollars, or that the demand in the convertible currency area for Yugoslav exports was in fact price elastic. In that connection, it was interesting to note that the staff apparently believed that it was unwise to be dogmatic about the reliability of measuring the degree of competitiveness of Yugoslav exports by the depreciation of the dinar exchange rate. He wondered how that comment fitted into the policy recommendation by the Fund.

Mr. Blandin remarked that the case of Yugoslavia demonstrated in a surprising fashion the crucial role of the financial community in making a successful adjustment possible. Once again, the Fund had been the catalyst and he associated himself with Mr. Polak and other Directors in commending the management and staff for their efforts over the years.

The three-year stand-by arrangement approved in January 1981, Mr. Blandin went on, had led to some notable results during 1983, in particular an improvement in the external current account in convertible currencies by $1.9 billion; a reduction in broad money, M-2, by 12 percent and in domestic credit by 17 percent; and a decline in total domestic demand by 3.5 percent, thus freeing resources for external adjustment. However, some less favorable changes had also occurred in 1983, the most worrying being the appearance of a large capital account deficit, compared with a positive balance in 1982, and the surge of inflationary pressures. He could not but regret that the series of understandings mentioned on page 7 of EBS/84/65 had not been fully adhered to by the end of 1983.

As to the program proposed for a new stand-by arrangement, Mr. Blandin said, he had no reason to doubt the staff assessment. The staff seemed to have adopted a classical approach, rightly putting particular emphasis on the improvement of the capital account and the correction of price distortions.

The deficit on the trade balance was expected to decline by 5.5 percent, mainly because of an increase in exports by 11.6 percent, Mr. Blandin noted. In 1983, the improvement in the trade performance had reflected both strong growth in the volume of exports and a fall in imports from the convertible currency area. However, the staff had noted that the improvement had been offset by a deterioration in trade with the nonconvertible currency area, and he wondered whether such a shift would not occur again in 1984, thus compromising the equilibrium that it was hoped to obtain vis-à-vis the nonconvertible currency countries. Insofar as Yugoslavia's trade with Western countries was concerned, he agreed with the staff that a flexible exchange rate policy was necessary to avoid any adverse movements in the trade balance, and to maintain the degree of competitiveness reached by November 1983. Receipts from tourism were expected to rise significantly, while some uncertainties still remained concerning workers' remittances. It seemed evident that positive results in that field were linked to the economic recovery in Europe--mainly in Germany--and to the level of domestic interest rates.

Concerning the domestic economy, Mr. Blandin said, he fully shared the staff view that monetary and fiscal policies should remain restrictive, so as to contribute to the adjustment process and lower inflationary pressures. Restrictions would be all the more important because an increase in flexibility in the pricing policy and adjustments in interest rates would initially raise retail prices and stimulate inflationary pressures. He therefore welcomed the intention to move progressively to positive real rates of interest. The five-step increase to April 1, 1985 seemed appropriate in view of the indebtedness of most Yugoslav enterprises.

He agreed with those speakers, including Mr. Polak, who had said that the external adjustment ought to be balanced by action on the domestic side, Mr. Blandin observed. He welcomed the decision to lift the price freeze imposed in 1983 and the commitment of the Yugoslav authorities to undertaking frequent adjustments of prices throughout the year. On the wage front, the steps currently envisaged seemed constructive and commendable. Nevertheless, it was evident that the move toward greater flexibility in wage determination would be difficult, and that the progress in that field would have to be closely monitored at the midterm review.

It was difficult, Mr. Blandin considered, to obtain a clear picture of the effectiveness of the foreign exchange allocation system. He endorsed the cautious and pragmatic approach envisaged by the authorities, and he looked forward to reviewing the conclusions of the two parallel studies. He supported the proposed decision.

Mr. Mtei said that he too would support the request of the Yugoslav authorities for a stand-by arrangement. Although the real depreciation of the dinar had been 25 percent compared with the target depreciation of 30 percent in 1983, the staff had stated that it was unwise to be dogmatic about the level of Yugoslavia's competitiveness within a certain range. Instead, the staff had focused on the fact that considerable improvements in the country's competitiveness had been recorded in the course of the year. One of the staff's concerns was that a larger depreciation might have risked pushing an already high inflation rate still higher.

A point on which he wished to comment, Mr. Mtei went on, was the apparent readiness of the staff to accept the undertakings of the authorities regarding their policy intentions, although two performance criteria had been breached after the final purchase had been made under the previous stand-by arrangement. The Fund had been seen to be playing a constructive role in helping to mobilize financial assistance from bilateral donors as well as commercial banks, and thus to have played an indispensable role in the adjustment efforts currently under way in Yugoslavia. He welcomed such flexibility by the staff and management. He hoped that it would be at the service of other members that were prepared to implement appropriate adjustment policies.

Domestically, the results achieved by the Yugoslav economy during 1983 had been rather mixed, Mr. Mtei considered. On the one hand, the gross social product had declined by a further 2.5 percent, after a 2 percent drop in 1982. Gross investment had continued on a declining trend, and inflation had remained high. On the other hand, the program had had some positive effects in terms of management of the economy, and had certainly strengthened the current account of the balance of payments. It was true that the improvement in the current account had been due in part to a decision by the authorities to pursue a flexible exchange rate policy, which had induced an expansion of production for exports. The intention to continue with the flexible approach to managing the exchange rate was therefore welcome, especially in view of the high rate of inflation and the need to improve the performance of exports further.

The substantial outflow of capital in 1983 had offset the improvement in the current account, Mr. Mtei observed. The staff believed that one of the main reasons for the outflow had been that real interest rates were negative. In that connection, he noted the authorities' intention to set interest rates with reference to the rate of inflation. However, with inflation expected to be some 50 percent in 1984, it seemed likely that a steep rise in rates would further discourage investment, already on the decline for four consecutive years. In the circumstances, it was important that efforts should be made to bring inflation under control, thus obviating the need for such large adjustments in interest rates.

Monetary and fiscal policies were expected to remain restrictive in 1984, Mr. Mtei noted. The efforts being made to reduce subsidies were a step in the right direction. It was also appropriate for the authorities to cast their adjustment program within a longer-term framework, in view of the need for structural change in the economy. The authorities' commitment to a policy of price and exchange rate flexibility should be helpful in channeling resources into the most productive sectors. Could the staff comment on the fields in which Yugoslavia was expected to improve its competitive advantage, and indicate the effects on Yugoslavia of the growing wave of protectionism in major markets?

Yugoslavia seemed to have made progress in putting its economic house in order, Mr. Mtei commented, but further sustained efforts were required to bring about the needed structural changes in the economy that would lead to stable growth and a viable balance of payments position. He saw a continued role not only for the Fund but also, in particular, for the World Bank, which had more expertise in supply-side policies. Commercial banks would also have a role to play in maintaining the flow of resources into Yugoslavia, in order to help alleviate pressure on the country's balance of payments.

Mr. Delgadillo said that he agreed with most of the staff's appraisal and supported the proposed decision. Given the special features of the Yugoslav economy, considerable progress had been made in recent years. Performance under the 1981-83 stand-by arrangement had included a reversal in the current account deficit and a decline in domestic demand. Unfortunately, the improvement in the current account had been accompanied by a large deterioration in the capital account. The program for 1984 was intended mainly to correct the imbalance, thus allowing for some accumulation of foreign reserves. A central element in the restoration of external balances would be the authorities' interest rate policy. The expected increase in real rates, together with appropriate financial policies, should lead to a diminution of short-term capital outflows.

It was also essential to assure an appropriate level of raw material imports in order to enable the country to achieve its export target, Mr. Delgadillo observed. The continuation of an attractive exchange rate policy would lead to further improvements in the competitive position of Yugoslavia's industries, and to gains in market shares in the convertible currency area. However, many difficulties still remained in connection with the foreign exchange system and the unification of the exchange rate. The studies to be made in parallel by the authorities and the staff could prove helpful in that respect.

The maintenance of price flexibility was another basic ingredient of the program, Mr. Delgadillo considered. The elimination of the price freeze and the continuation of restrictive incomes policies were the necessary complement to the exchange and interest rate policies if the program were to be viable. Prudent fiscal policies, involving the reduction of both revenues and expenditures in real terms, had in the past contributed substantially to the external adjustment; they should therefore be continued. Even though the proposed program could lead to a moderation in price increases, it seemed evident that the authorities expected inflation to continue rather rapidly. Moreover, he had noted that the staff had expressed concern in connection with practices for allocating foreign exchange, with incomes policies, and with interest rates. On balance, nevertheless, the program had been designed in such a way as to help to overcome the difficulties being faced by Yugoslavia. If carried out in detail, further improvements were likely to take place in the external sector and thus enhance the prospects for stable growth in the medium term.

Mr. Prowse stated that in general he agreed with the staff appraisal although there were one or two points on which he would like to seek clarification. He also supported the proposed decision and the program that it embodied. In particular, he agreed with the staff appraisal that on balance the program was likely to be adequate. He took that view although in the past his chair had emphasized the magnitude of the changes being carried out in Yugoslavia with the support of Fund programs, an observation that was still valid. Some Executive Directors had noted with disappointment that the economy had not been reformed and restructured by the end of the three-year program ended November 1983. It was of course necessary to realize the magnitude of the task facing the Yugoslav authorities. The Fund's participation in the economic management of Yugoslavia had not lasted long in view of the difficulties of reaching the objectives set by the authorities; the economy was still not a market economy.

The present discussion did serve to focus attention on two questions arising from the Fund's association with centrally planned economies, Mr. Prowse remarked. How far should the Fund accept responsibility for restructuring the whole economy on some other model? Was the Fund setting itself objectives which it was not really equipped to achieve? He was of course not asking the staff to provide answers during the meeting, but it was certainly appropriate for the Executive Board to reflect on the issues. In that connection, he was looking forward to the studies on Yugoslavia's foreign exchange arrangements, which would form one part of what seemed likely to be an important midterm review. There were many aspects of the program that he would be prepared to adopt, with hope rather than with certainty, and Executive Directors would do well to note the extreme complexity of the performance criteria. It would be a remarkable achievement if the authorities were to finish the program year without some adjustment in the criteria.

On a number of points, the staff might be said to be lukewarm, Mr. Prowse went on. For instance, on page 18 of EBS/84/65, the staff had said that it would have been preferable to buttress the balance of payments position by a more rapid move to positive real rates of interest. The staff had explained why it had not insisted on such a rapid move, but it might well still be the case that that would be the appropriate course, and the midterm review would be a good opportunity to consider the situation. Then, the staff had said that in its opinion the proposed exchange rate action was compatible with a surplus on the current account in convertible currencies. That was not a particularly strong assessment, and he wondered whether the Executive Directors ought not to be receiving a more positive evaluation. Generally, the staff had said that it could not feel confident that the new measures affecting wages would prove to be fully effective. The staff took that view although the authorities had brought about a harsh adjustment of real wages in the previous program. Finally, the staff had questioned how far what was being proposed for interest rate action was adequate and how far it could be achieved. In view of the various doubts expressed by the staff, he had concluded that the midterm review would be important. He would look forward to the staff comments on the purpose of the Fund's support for Yugoslavia's program.

While the measures proposed for 1984 were significant and even substantial, Mr. Prowse commented, some of them certainly reflected the slippage in policy implementation during 1983. For instance, the price freeze that was to be lifted had been reimposed only at the end of 1983, and the country's competitiveness had been allowed to slip. Interest rates should have been moved more strongly in line with the understandings embodied in the 1983 program; if they had been, the capital outflow would almost certainly have been dampened. All in all, it was critically important that everything in the 1984 program should be implemented, the most crucial being the interest rate adjustment. His own view was that Executive Directors might rapidly come to the conclusion that interest rate adjustment ought to be faster, despite the problem of indebtedness of the Yugoslav enterprises.

Speaking generally, Mr. Prowse remarked, the program was an excellent example of the willingness of the staff and management to be flexible in negotiation and perhaps even to compromise in order to reach a result, even if it was not the Fund's preferred position. On the other hand, it was clear that the authorities too had been willing to compromise. The outcome was a mature and flexible one, for which he commended management and staff. Nevertheless, there were points beyond which flexibility in agreeing to programs should not be taken.

On performance criteria, Mr. Prowse said, he had not previously come across the criterion limiting the growth in total public sector revenue. It would be interesting to hear the staff's reasons for adopting it. He would also be interested to know whether, in saying that the Joint Reserve Funds were outside the public sector, as it did on page 20 of EBS/84/65, the staff was speaking in terms of performance or in a national accounting sense. If those Funds were not part of the public sector, he wondered how the staff could expect them to conform to the performance criterion, and indeed whether the level of subsidies or support to ailing industry by the Funds could be made subject to criteria.

Another point on which he would welcome enlightenment, Mr. Prowse stated, was the staff observation on page 20 of EBS/84/65 to the effect that the need for burden-sharing, as well as the need to build up reserves, might have warranted a somewhat higher level of Fund assistance. In particular, he would be interested to know whether the burden was to be shared within the economy, or between the Yugoslav economy and the external sector.

Finally, Mr. Prowse confirmed that he supported the program and understood that the Yugoslav authorities were attempting a difficult task and that their achievements to date had not been small. Nevertheless, there remained the underlying question of what the Fund should be trying to attempt in the economy of Yugoslavia, and the economies of similar countries.

Mr. Malhotra stated that he would support the proposed decision. The three-year program ended in November 1983 had achieved considerable progress, although a lot remained to be done. Broadly, the focus of the 1984 stand-by arrangement seemed to be correct. The staff emphasis on correcting the interest rates was appropriate, since without that correction there could be little improvement in the capital account of the balance of payments. He appreciated the difficulties that the Yugoslav authorities would have in moving immediately to real interest rates, but he would have liked progress in that area to be somewhat more rapid than was being proposed.

During the past two or three years, inflation seemed to have worsened rather than improved, Mr. Malhotra noted. He was disturbed by the effect of the large depreciation of the dinar on domestic prices. Considering Tables 13 and 14 of EBS/84/65 together, Yugoslav exports did not seem to have increased over the past three years. In nominal terms, exports had amounted to some $10.2 billion in 1981 and were estimated at $9.9 billion in 1983. While there had undoubtedly been some increase in export receipts from the convertible currency area in 1983, the improvement seemed due to the authorities' efforts to correct the balance with the nonconvertible currency area rather than to the improved competitiveness of the dinar. As to the point regarding the appropriateness of the devaluation, which had been raised by Mr. Zhang, more scientific analysis was required to assess the impact of such a large depreciation and to see whether it had really helped to improve export receipts substantially. In most circumstances, he would have imagined that a depreciation of 25 percent should have resulted in a much larger volume of exports than had been the case. On the other hand, the effect on inflation had been considerable, and the future evolution of prices was uncertain. Indeed, he wondered whether the reaction to high inflation rates was to be still greater depreciation. He would welcome further comments by the staff.

The authorities had taken bold measures to contain wages, Mr. Malhotra considered. The staff expected that the decline in real wages of 25 percent in three years would improve the mobility of labor, especially away from industries that were not making profits or were having cashflow problems. He would be interested to know whether there really was sufficient evidence to conclude that, in the circumstances of the Yugoslav economy, the decline in wages would bring about more mobility of labor. On the face of it, the assumption seemed open to question.

The debt situation of Yugoslavia was likely to remain difficult, Mr. Malhotra observed. He greatly appreciated the international efforts that had been made to tackle the situation and to put together reasonable financing packages, an effort that would have to be continued over a period of time. In conclusion, he emphasized the importance of an appropriate interest rate policy for the healthy evolution of the capital account of the balance of payments.

Mr. Abiad commented that the Yugoslav authorities had clearly been making serious efforts to adjust in difficult circumstances. Progress had been made in several areas. The current account position, for instance, had strengthened, reflecting an improved export performance brought about partly by the provision of enhanced export incentives and partly by a reduction of imports. That reduction had been associated both with a shift in demand for imports from the convertible to the nonconvertible currency areas, and with a deceleration in the growth of nominal income and a sizable decline in real wages, reflecting the impact of the wage restraint policy. Some cost-price distortions had been reduced, reflecting the introduction of major price changes, while flexible exchange rate and interest rate policies continued to be implemented.

Despite the determined pursuit of tight fiscal, monetary, and incomes policies, weaknesses persisted in certain areas, Mr. Abiad observed. In the first place the rate of price increases had turned out to be well above the projected level partly because of a slower than expected decline in private consumption and a faster than forecast growth of nonwage incomes. Second, the increase in credits to enterprises had been larger than expected. Third, some of the current account improvement had been attributable to a compression of imports. Such a development could not be expected to continue in 1984 as any further reduction of imports would bring about shortages in the production of exportable commodities. Fourth, during the last quarter of 1983 the authorities had failed to live up to certain understandings regarding the limits on nominal personal income growth, the level of interest rates on specific bank deposits, and the transfer of excess public sector revenue to blocked accounts. Furthermore, the performance criteria relating to the exchange rate and public sector revenues had not been observed after the last purchase under the previous stand-by arrangement.

On the financial program for 1984, Mr. Abiad said, he had no difficulty with the staff's assessment of the underlying adjustment path or of the adequacy of the policies to meet the program's objectives. Clearly, the improvements in the convertible current account, the avoidance of short-term capital outflows, and the needed revival of economic growth, even at a modest rate, could hardly be achieved without a continuation of tight financial policies. At the same time, the 1984 program stressed the importance of exchange rate adjustment in order to bring about the needed growth in the volume of exports to the convertible currency area. In that connection, on an earlier occasion one of the problems facing Yugoslav exports had been said to be related to "quality and design inadequacies." At that time, the view had been taken that such problems could hardly be overcome by exchange rate adjustments, however large. If that were so, the implication was that the problem was a structural one requiring appropriate supply-side policy instruments for its solution. He would welcome a staff comment on whether actions other than exchange rate measures were being envisaged to address that particular problem. In conclusion, he had no difficulty with the proposed decision.

Mr. Templeman recalled that some speakers had raised the question of the appropriate role of the Fund in Yugoslavia in the future. Mr. Erb, in his intervention, had made the point that the Fund's support for structural reforms in Yugoslavia was linked to the need to reach a sustainable balance of payments position over the medium term. Such an aim was an appropriate one for the Fund to support. However, he did not believe that it was the business of the Fund to persist in providing financing for a country that had achieved a sustainable balance of payments position but wished to continue reforms of the domestic economy. Those reforms might be in the interest of the country; they would not justify further financial support from the Fund.

The staff representative from the European Department, replying to questions by Mr. Schneider and Mr. Laske on nonwage incomes in Yugoslavia, remarked that the Yugoslav authorities made a distinction between the so-called socialized sector and the nonsocialized sector when it came to wage performance. The 25 percent measured decline in real wages pertained to the so-called socialized sector only. Some of the alternative sources of income, like those in agriculture and services, had kept up private consumption, but they were not necessarily part of an underground economy; they were simply not socialized. Among the nonsocialized activities there might be some that in other contexts would be considered underground; they were certainly not captured in the national accounts. As to how large the incomes were, it was impossible to tell, since they were not captured by normal measurements. On the positive side, the figures seemed to indicate that those sectors that sought to attract workers and resources had had less of a decline in real incomes than the others.

Continuing his reply, the staff representative recalled that Mr. Schneider had raised the question why interest on foreign currency deposits held by residents in Yugoslavia was paid in dinars. It should be noted that workers resident abroad who made deposits in foreign exchange accounts in Yugoslavia continued to be paid in foreign currency. It was only when they returned home and continued to hold those deposits that their interest was to be paid in dinars. One of the main reasons for the change had been that of equity. The staff had been rather dubious about the wisdom of the measure, which was unlikely to make dinar deposits more attractive; rather, it would have the effect of encouraging workers abroad to resist sending their savings home. As an alternative approach, the staff had persuaded the authorities to agree to increase the rate of return on dinar deposits until they reached positive real levels by the end of 1984.

As to the difference between measuring trade using statistical exchange rates and using real exchange rates when trying to obtain an estimate of the improvement in the current account--a question raised by Mr. Laske--the staff representative said that the figures available to him suggested that trade flows had been overstated by some 2 percent through using statistical exchange rates in 1983. In actual amounts, the calculated difference could not be more than some $100 million, so that the swing was still impressive. The staff had been pressing the Yugoslav authorities, who had set in train procedures whereby at some time during 1984 they would be able to shift from accounting exchange rates to actual exchange rates in presenting balance of payments figures.

Recalling that Mr. Tvedt had inquired whether a link ought to be established between productivity and wages, the staff representative explained that he interpreted the question to be whether the formula would in fact limit wage increases to increases in productivity or whether it would still permit wage increases in excess of increases in productivity. So far as could be forecast, the formula, if applied to loss-making enterprises, would force further reductions in real wages in those enterprises and thus presumably pull wage payments in real terms down to bring them more closely into line with the productivity of the enterprises concerned.

Two speakers had inquired why it was unconstitutional to limit wage payments in enterprises and why previous efforts at incomes policy had been found unconstitutional, the staff representative noted. Within the self-management system of Yugoslavia, it was thought that the workers of an enterprise had the right to determine the distribution of the value added of that enterprise. Consequently, any restrictions on payments as personal income that interfered with the right of workers to dispose of the value added of the firms were unconstitutional. The reason why the staff's particular formulation about loss-making enterprises was constitutional was that it was based on the proposition that workers should not have a right to wage payments in excess of the value added of their own firms. In a sense, the changes to the system would have the effect of making wages more responsive to differences in productivity and therefore also to changes in production.

Responding to a question by Mr. Erb about the decline in the savings rate, the staff representative regretted that no figures had been provided to substantiate the point. The staff had prepared a table of household incomes and expenditures, in which the decline had been quite visible. It had not been included in EBS/84/65, because of a number of statistical difficulties. It seemed likely that the paper that the staff would prepare for the midterm review would contain such a table. As to Mr. Erb's point that there might in future be some justification not necessarily for reducing the outstanding foreign debt but for increasing it if the have to be closed. The only case in which the gap would have to be closed would be that in which it was assumed that the relative prices had been correct at the beginning of 1980, which had probably not been so.

However, the staff representative continued, the sort of gap shown in Chart 3 did create a presumption of further upward pressure on prices. Chart 2 in EBS/84/65 showed the way in which, at least in recent years, changes in import prices had preceded changes in domestic prices but had been followed quite regularly by subsequent accelerations in the domestic price level. In the course of 1983, however, the increase in import prices had not yet been matched by a parallel increase in domestic prices. Consequently, it seemed likely that some more price increases were still to be expected. The conclusion he drew from those charts was that there was an increased need for determined vigilance to prevent the inflationary impulse from becoming self-accelerating. In consequence, the staff agreed with Mr. Joyce that the control of inflationary pressures was extremely important; at the same time, it helped to explain why the staff was not too sanguine about a rapid deceleration of inflation during 1984.

Taking up the question of why the wage policy for loss-making enterprises was restricted to work units within the enterprises that made the losses, the staff representative explained that that was one of the ways in which the staff had hoped to adapt to the constitutional requirements of Yugoslavia. It would be unconstitutional to penalize a profit-making work unit for the losses incurred by other work units. Initially, the staff had said that since much of the distribution of losses within an enterprise must be due to pricing between the units of that enterprise, the whole enterprise should bear the loss. However, the Yugoslav authorities would not accept that point, and agreement had been reached on the present formula. It did mean that one section within an enterprise might be severely penalized while another suffered no loss of wages. The staff had tried to be tough in pursuing the objective but flexible in ways of adjusting the particular approach to the institutional and legal constraints within which the economy was operating.

A number of Executive Directors, including Mr. Joyce, had asked why interest rates were to remain negative throughout 1984, the staff representative recalled. The staff shared the concerns of Executive Directors. On the other hand, even a reduction in the extent to which interest rates were negative could have a positive effect on capital flows. The mere fact that interest rates were negative did not mean that all domestic savings were exported abroad. The more negative the interest rate became, the stronger the incentive to export capital, and vice versa. Consequently, the staff expected some reduction in the capital outflow during 1984. In some countries, indeed, the staff had found that capital flows could become positive before interest rates became positive in real terms. The staff's original position had been that interest rates should become positive by June 1984. It hoped that the results might still be substantial.

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Replying to questions raised by Mr. Clark relating to the dates of disbursements in relation to test dates for adherence to performance criteria, the staff representative mentioned that in paragraph 2a of the stand-by arrangement it was specified that purchases should not exceed the equivalent of SDR 280 million until April 15, 1985. In other words, the last purchase, amounting to SDR 90 million, would take place after the last adjustment of the interest rate on April 1, 1985. The last purchase had deliberately been placed after the end of the first quarter of 1985 in order to make sure that the interest rate changes desired by the staff would in fact have taken place. Mr. Clark had also raised a question whether the capital outflow was related more to generous export credits by the Yugoslav authorities than to interest rate differentials. The provision of generous export credits by Yugoslav exporters might not be unrelated to the fact that if the exporters collected payments sooner, they would earn interest rates on deposits in dinars, which were heavily negative in real terms, whereas if they postponed collection of payments from abroad, they could conceivably acquire an interest rate nearer those prevailing elsewhere. Other so-called reasons for the capital outflow also seemed to be related to the persistence of negative interest rates in Yugoslavia.

As to how much progress had been made in shifting production from industries supplying mainly domestic markets to those supplying exports, the staff representative remarked that while the line in Chart 4 on page 6 of EBS/84/65 indicating predicted output performance was a statistical estimate, it was statistically insignificant. He hoped that when the staff came to recalculate the line for the first half of 1984 for the midterm review, it would find a steeper slope, and one that was statistically significant. The method used in Chart 4 was clearly one useful way of measuring the structural adjustment that was resulting from a medium-term program.

Commenting on the relationship between the Fund and the World Bank in connection with the program in Yugoslavia, the staff representative noted that the requirements for setting railway fares and electricity tariffs, which had in effect become performance criteria in the Fund's stand-by arrangement, had been extracted from various World Bank loan agreements in connection with those sectors. The World Bank had had difficulty in persuading the Yugoslav authorities to comply with its requirements; what the Fund staff had done was to set a minimum for the amount of adjustment that the World Bank regarded as fundamental and, by turning them into performance criteria, ensuring that there should be no backsliding. Naturally, the performance criteria were meant as a floor and not as a ceiling on prices. It seemed likely that in further discussions the World Bank would persuade the Yugoslav authorities to raise the prices still further, because the World Bank and the authorities had entered into a long-term program that would involve raising the prices charged by railroads and electricity tariffs to more economic levels. All that the Fund staff was trying to do was to ensure that the progress so far achieved should not be nullified.

In setting the particular performance criteria and asking for the relevant undertakings, the Fund staff had had the active cooperation of the World Bank staff, the staff representative continued. There had also been cooperation between the World Bank and the Fund on the interest rate question; one of the World Bank agreements with Yugoslavia had contained a provision about minimum lending rates and when they should become positive. The timetable proposed by the World Bank was considerably longer than that envisaged by the Fund, and the Yugoslav authorities had originally argued that the adjustment period should not be made shorter than the time incorporated in the World Bank agreement. However, the World Bank still had said that the time that it had inserted in its agreement was to be regarded as the minimum then achievable; the World Bank would be pleased if progress could be achieved more quickly.

Finally, Mr. Clark had raised a question about relating interest rates to retrospective inflation rates rather than prospective inflation rates, the staff representative recalled. When the staff had first proposed its formula to the Yugoslav authorities, they had noted that if inflation rates were to decelerate rapidly in the coming months, real rates of interest would rise very rapidly. However, the staff had agreed with the Yugoslav authorities that the point was perhaps an academic one, at least for the duration of the stand-by arrangement.

Responding to a question by Mr. Joyce regarding the persistence of inflationary pressures, the staff representative remarked that while it was necessary to control the sort of inflationary impulses that were not related to exchange rate action, it would be self-contradictory to try to pitch the inflation target at a figure below anything that might be expected as a result of depreciation. After all, in a sense, exchange depreciation was intended to operate through an increase in domestic prices. Consequently, without giving any encouragement to higher inflation, it was necessary to accommodate some rise in prices. What the staff had tried to do was to introduce a number of policies, including the increase in interest rates, that would bring about dishoarding, and thus a downward pressure on prices. Naturally, there was some further inflation in the pipeline as a result of the exchange rate policies that had been followed in the recent past. In that connection, Chart 3 in EBS/84/65 showed that there had been a large gap between the increase in export unit values in dinar terms and industrial producer prices, which did not necessarily have to be closed. The only case in which the gap would have to be closed would be that in which it was assumed that the relative prices had been correct at the beginning of 1980, which had probably not been so.

However, the staff representative continued, the sort of gap shown in Chart 3 did create a presumption of further upward pressure on prices. Chart 2 in EBS/84/65 showed the way in which, at least in recent years, changes in import prices had preceded changes in domestic prices but had been followed quite regularly by subsequent accelerations in the domestic price level. In the course of 1983, however, the increase in import prices had not yet been matched by a parallel increase in domestic prices. Consequently, it seemed likely that some more price increases were still to be expected. The conclusion he drew from those charts was that there was an increased need for determined vigilance to prevent the inflationary impulse from becoming self-accelerating. In consequence, the staff agreed with Mr. Joyce that the control of inflationary pressures was extremely important; at the same time, it helped to explain why the staff was not too sanguine about a rapid deceleration of inflation during 1984.

Taking up the question of why the wage policy for loss-making enterprises was restricted to work units within the enterprises that made the losses, the staff representative explained that that was one of the ways in which the staff had hoped to adapt to the constitutional requirements of Yugoslavia. It would be unconstitutional to penalize a profit-making work unit for the losses incurred by other work units. Initially, the staff had said that since much of the distribution of losses within an enterprise must be due to pricing between the units of that enterprise, the whole enterprise should bear the loss. However, the Yugoslav authorities would not accept that point, and agreement had been reached on the present formula. It did mean that one section within an enterprise might be severely penalized while another suffered no loss of wages. The staff had tried to be tough in pursuing the objective but flexible in ways of adjusting the particular approach to the institutional and legal constraints within which the economy was operating.

A number of Executive Directors, including Mr. Joyce, had asked why interest rates were to remain negative throughout 1984, the staff representative recalled. The staff shared the concerns of Executive Directors. On the other hand, even a reduction in the extent to which interest rates were negative could have a positive effect on capital flows. The mere fact that interest rates were negative did not mean that all domestic savings were exported abroad. The more negative the interest rate became, the stronger the incentive to export capital, and vice versa. Consequently, the staff expected some reduction in the capital outflow during 1984. In some countries, indeed, the staff had found that capital flows could become positive before interest rates became positive in real terms. The staff's original position had been that interest rates should become positive by June 1984. It hoped that the results might still be substantial.

Commenting on Mr. Zhang's question about a resolution of any possible disagreements between the recommendations of the study being conducted by the Yugoslav authorities and those of the study being conducted by the staff with the cooperation of the authorities on the foreign exchange allocation system, the staff representative explained that if attempts at persuasion on both sides failed, a negotiated compromise would be reached that would provide the maximum benefit and the minimum cost acceptable to both sides. It was conceivable, although not a necessary outcome, that a new performance criterion might be agreed at the time of the midterm review. It seemed more likely that the outcome of the studies would be to provide input for the negotiation of a stand-by arrangement in 1985, if one were to come to pass. Naturally, if the staff concluded that circumstances were so severe as to require a new performance criterion at the time of the midterm review in November 1984, such a criterion would be negotiated in the same way as others had been in the past.

Some speakers, following Mr. Zhang, had asked about the relationship between exchange depreciation and export performance, the staff representative mentioned. Mr. Zhang had observed that despite the large depreciation, there had been little if any reduction in the unit values of Yugoslav export goods expressed in dollar terms. He himself was not surprised that that should be so. He had never expected otherwise, insofar as Yugoslavia was a fairly small country exporting both agricultural commodities and a large range of manufactures. In the markets to which Yugoslavia exported most of its products, the country was a price taker not a price setter. No action by the Yugoslav authorities was likely to affect the dollar value of the country's exports significantly.

The purpose of the devaluation, the staff representative went on, was to create a disparity between the export unit values in dinar terms and domestic prices. Chart 3 of EBS/84/65 showed that, particularly since 1983, a sharp divergence had arisen between changes in export unit values, on the one hand, and changes in dinar prices and in industrial producer prices, on the other. The result was to encourage producers in Yugoslavia to sell more of their output abroad. To the extent that they did so, Mr. Zhang was correct in saying that the improvement in the export performance of Yugoslavia had been brought about by a change in domestic supply conditions, rather than by the change in the exchange rate. To the extent that the change had begun to take place, the staff was considerably encouraged. Another point revealed by Chart 3 was that unit labor costs in Yugoslavia during the past four years seemed to have been moving closely in line with industrial producer prices, whereas the normal expectation would be that industrial producer prices would start rising more rapidly, leaving unit labor costs behind so as to create wider profit margins in exporting industries, and thus induce resources to shift from supplying domestic markets to supplying foreign markets. The staff would examine that peculiarity again at the time of the midterm review. It might be related to the concept prevalent within the self-management economy of Yugoslavia that workers could in principle determine the distribution of the total value added by their firm.

Commenting on Mr. Mtei's suggestion that the interest rate level might provide a disincentive to investment, the staff representative from the European Department commented that, in the past, investment had been falling despite the fall in the real interest rate. It had done so largely because foreign exchange had been so scarce that imported capital goods and even imported raw materials and intermediate goods had been kept out by various policy measures. One reason why foreign exchange had been so scarce, and therefore a depressant of domestic investment, had been that interest rates had been too low, not that they had been too high. Low interest rates had encouraged capital outflows, and thus reduced foreign exchange receipts below what they would otherwise have been. Had interest rates been higher, more foreign exchange would have been available to finance capital goods and intermediate goods. As to the manufactures in which the comparative advantage of Yugoslavia might be improved, the staff did not wish to make predictions. A further reduction in the exchange rate was likely to stimulate exports in quite a number of sectors.

The Executive Directors agreed to continue their discussion of the request by Yugoslavia for a one-year stand-by arrangement at 3:00 p.m.

3. EXECUTIVE DIRECTOR - REPORT BY ACTING CHAIRMAN

The Acting Chairman, in restricted session, made a report on the circumstances surrounding the absence of an Executive Director.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/84/58 (4/9/84) and EBM/84/59 (4/18/84).

4. MADAGASCAR - STAND-BY ARRANGEMENT - EFFECTIVE DATE

1. On December 21, 1983, the Fund approved the request of the Government of the Democratic Republic of Madagascar for a stand-by arrangement (EBS/83/255) for the period ending on March 31, 1985, in an amount equivalent to SDR 33 million. Under that decision, the approval of the stand-by arrangement is to become effective on the date on which the Fund finds that:

(a) satisfactory arrangements have been made with respect to the financing of the estimated balance of payments deficit for 1984; and

(b) adequate measures in the producer prices of agricultural commodities have been adopted.

2. On March 19, 1984 the Fund found that condition (b) above for the coming into effect of the stand-by arrangement had been met.

3. In view of the pledges and indications for supplementary assistance given to Madagascar during the Aid Donors' meeting of April 5 and 6, 1984, the Fund finds that condition (a) above has also been met. Accordingly, the stand-by arrangement shall become effective on April 10, 1984. (EBS/84/82, 4/6/84)

Decision No. 7668-(84/59), adopted
April 10, 1984

5. COMPENSATORY FINANCING FACILITY - RECENT EXPERIENCE WITH EARLY DRAWING PROVISION

The Executive Board approves the recommendations regarding the final calculation of the shortfall in respect of drawings by Chad and Senegal under the early drawing provision of the compensatory financing decision, as set forth in EBS/84/76 (4/4/84).

Decision No. 7669-(84/59), adopted
April 9, 1984

6. ETHIOPIA - TECHNICAL ASSISTANCE

In response to a request from the National Bank of Ethiopia for technical assistance, the Executive Board approves the proposal set forth in EBD/84/117 (4/11/84).

Adopted April 17, 1984

7. COST OF LIVING SUPPLEMENTS FOR PENSIONERS, EFFECTIVE MAY 1, 1984

The Executive Board approves the recommendation regarding the payment to the Staff Retirement Fund of the amount required to fund the difference between the amount prefunded under the Plan and the cost of living supplement to be effective May 1, 1984, as set forth in EBAP/84/74 (4/10/84).

Adopted April 17, 1984

8. IMF INSTITUTE - RELEASE OF INFORMATION TO HIGH-LEVEL OFFICIALS

The Executive Board approves the proposal to release certain documents to high-level officials of member countries participating in a seminar conducted by the IMF Institute on the role of the Fund in the international monetary system, as set forth in EBD/84/114 (4/9/84).

Adopted April 13, 1984

9. APPROVAL OF MINUTES

a. The minutes of Executive Board Meeting 83/172 are approved. (EBD/84/109, 4/3/84)

Adopted April 9, 1984

b. The minutes of Executive Board Meetings 83/173 and 83/174 are approved. (EBD/84/112, 4/6/84)

Adopted April 12, 1984

c. The Minutes of Executive Board Meetings 83/175 through 83/177 are approved. (EBD/84/115, 4/11/84)

Adopted April 17, 1984

10. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/84/61, Supplement 1 (4/6/84), EBAP/84/72 (4/6/84), EBAP/84/73 (4/9/84), EBAP/84/77 (4/16/84), and EBAP/84/80 (4/12/84) is approved.

11. STAFF TRAVEL

Travel by the Managing Director as set forth in EBAP/84/75 (4/11/84) is approved.

APPROVED: September 25, 1984

LEO VAN HOUTVEN
Secretary