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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/158

10:00 a.m., October 31, 1984

J. de Larosière, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	W. B. Tshishimbi
C. H. Dallara	
	H. G. Schneider
B. de Maulde	X. Blandin
A. *Donoso*	M. *Teijeiro*
M. Finaish	T. Alhaimus
H. Fujino	T. Yamashita
G. Grosche	B. Goos
	M. Rasyid, Temporary
R. K. Joyce	L. Leonard
A. Kafka	
	N. Coumbis
R. N. Malhotra	A. S. Jayawardena
	J. E. Suraisry
	T. de Vries
A. R. G. Prowse	K. G. Morrell
	O. Kabbaj
F. Sangare	
M. A. Senior	J. L. Feito
	A. Lindø
N. Wicks	
Zhang Z.	Wang E.

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

Also Present

R. Sapunxhiu, Alternate Executive Director, IBRD. African Department: J. B. Zulu, Director; O. B. Makalou, Deputy Director. Asian Department: P. R. Narvekar, Deputy Director. European Department: B. Rose, Deputy Director; J. T. Boorman, L. M. Hansen, R. Johnson, H. B. Junz, W. E. Lewis, H. O. Schmitt. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; M. Guitián, Deputy Director; S. Mookerjee, Deputy Director; J. O. Bonvicini, A. B. Petersen. External Relations Department: C. S. Gardner, Deputy Director. Fiscal Affairs Department: V. Tanzi, Director. IMF Institute: M. Nihevc, A. Rant, Participants. Legal Department: G. P. Nicoletopoulos, Director; W. E. Holder. Middle Eastern Department: S. H. Hitti. Research Department: W. C. Hood, Economic Counsellor and Director. Secretary's Department: J. W. Lang, Jr., Deputy Secretary; A. P. Bhagwat. Treasurer's Department: D. Berthet, T. B. C. Leddy. Western Hemisphere Department: M. Caiola, R. A. Elson. Bureau of Statistics: W. Dannemann, Director; J. B. McLenaghan. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: A. A. Agah, E. A. Ajayi, S. E. Conrado, L. K. Doe, K. A. Hansen, S. M. Hassan, H.-S. Lee, G. E. L. Nguyen, P. Péterfalvy, E. M. Taha, D. C. Templeman, N. Toé, A. Vasudevan, M. A. Weitz. Assistants to Executive Directors: E. M. Ainley, W.-R. Bengs, R. L. Bernardo, Chen J., V. Govindarajan, D. Hammann, G. D. Hodgson, H. Kobayashi, S. Kolb, M. Lundsager, K. Murakami, J. Reddy, D. J. Robinson, J. E. Rodríguez, A. A. Scholten, Shao Z., S. Sornyanyontr, A. J. Tregilgas, A. Yasseri.

1. DEATH OF PRIME MINISTER GANDHI OF INDIA

The Chairman stated that he had sent the following message of condolence to the Indian authorities:

> On behalf of the Executive Directors, the management, and the staff of the International Monetary Fund, I wish to express to you our sense of dismay and profound loss over the tragic assassination of your Prime Minister, Indira Gandhi. Please accept and convey to your authorities our deepest sympathy for the people of India and the family of Mrs. Gandhi.

2. YUGOSLAVIA - REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the review under the one-year stand-by arrangement for Yugoslavia approved on April 18, 1984 (EBS/84/207, 10/3/84).

Mr. R. Sapunxhiu, Alternate Executive Director, IBRD, was also present.

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

> The following information has been received since release of the staff report for the midterm review of the stand-by arrangement for Yugoslavia.
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> The staff has received official notification that deposit interest rates were increased on October 1, 1984 to 47 percent for three-month deposits, 52 percent for one-year deposits, and 55 percent for two-year deposits. Also on October 1, the discount rate of the National Bank of Yugoslavia was increased by 13 percentage points to 47 percent, and interest rates for selective credits granted by the National Bank of Yugoslavia were raised by 10 percentage points.
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> At the end of September 1984, external reserves amounted to $2,030 million compared with the target in the program of $1,800 million.
>
> As part of the stand-by arrangement, the Yugoslav authorities undertook to eliminate or reduce certain export subsidies by October 1, 1984. The foreign trade committee of the Community of Interest for Foreign Economic Relations (CIFER) has approved these proposals, but a formal decision will be taken only in November at a session of the Assembly of the CIFER. However, it is intended that the decision will be made retroactive to October 1.

Following the lifting on September 1, 1984 of the 30-day notification requirement for certain goods in the liberalized category, the producer price index rose by about 5 percent in September, the same rate as in August. The retail price index increased by a similar magnitude. The year-on-year increases for the two indices were 57-58 percent in September.

The weak performance of exports to the convertible area in August continued into September when exports rose by about 1 1/2 percent over the level one year earlier. Compared with the same period a year earlier, exports to the convertible area rose by 10 percent in the first quarter, by 13 1/2 percent in the second quarter, and by 2 percent in the third quarter of 1984. No details are available to the staff on the export figures for August and September. An analysis of these figures will be made during the upcoming staff mission to Yugoslavia.

Imports from the convertible area rose significantly in September, when the year-on-year increase was 11 1/2 percent. This is a continuation of a trend experienced throughout the first three quarters of the year.

Mr. de Vries made the following statement:

In the past four years, and especially since mid-1983, substantial adjustment has been achieved by the Yugoslav authorities.

The stand-by arrangement being reviewed today had as its predecessor a three-year stand-by arrangement that ended last November. Under that earlier arrangement, a major turnaround in the current account of the balance of payments was achieved as the adjustment effort was progressively strengthened. But it was bought at the price of a severe compression of imports by means of outright deflationary measures and the stagnation since 1980 of real disposable household incomes. The purpose of the present stand-by arrangement is to continue strengthening the current account position, especially with the convertible currency area, but to combine it with a renewed increase in imports and with a steady increase in production. A second major purpose of the present program is the correction of capital flows, through an increase in interest rates and a more predictable and more appropriate exchange rate policy.

As pointed out by the staff, developments in the first months under the new stand-by arrangement have been in conformity with the objectives laid down. In January-July 1984, there was a further improvement in the current account with the convertible currency area as the rise in exports outstripped that in imports, while industrial production increased by 5 percent. Especially noteworthy are the gains in exports to industrial countries. At the same time, there has been a major turnaround in the capital account, most notably the disappearance of those short-term capital exports that previously showed up as a negative item under the heading "errors and omissions."

These results were achieved by a number of important policy changes. First, the real and unwarranted appreciation of the dinar, which occurred in late 1983, has been reversed in 1984; the targeted level of real depreciation of the dinar is now maintained by frequent and--in their outcome--predictable adjustments in the nominal exchange rate.

Second, a dramatic increase in nominal and real interest rates is being implemented. That increase will continue under the present stand-by arrangement until real interest rates become positive by April 1, 1985. The considerable increase in interest rates that has so far occurred is already making itself felt, even though interest rates have not yet become positive in real terms. Apart from the turnaround in the capital account already noted, its effect is apparent in the increase in dinar deposits of households at the expense of their foreign currency deposits.

Third, and in addition to the two key areas of monetary and exchange rate policy, budgetary policy is making its contribution to the adjustment process. The laws and regulations governing federal finances are quite effective in maintaining budgetary equilibrium, but, in the past, a progressive tax and revenue system led to an increase in public revenues and created the temptation for public expenditures to outstrip the rise in the national product. High inflation rates gave additional momentum to this process. To reverse it, and decrease the size of the public sector in the economy, the stand-by program provides for measures to reduce the growth of public sector revenues. At the same time, this policy is designed to channel resources to the enterprise sector, which has to bear the burden of the considerable increase in interest rates. A curious by-product of this part of the program, laid down in a specific performance criterion, has been that the Yugoslav authorities, having been quicker in reducing expenditures than in reducing revenues, have had to ask the Board for a waiver allowing them the temporary accumulation of excess budgetary revenues.

A fourth factor in bringing about the required adjustment has been the stagnation in real disposable household income. There has been an exceedingly sharp decline in real wage incomes in the socialized sector over the past four years, amounting to about 30 percent. This decline has been offset by the growth of other sources of income. Deposits denominated in foreign currencies have yielded considerable capital gains and are widely held. In addition, many workers, especially in the service and government sectors, have taken a second job to maintain their income. Finally, incomes in the private sector, especially in agriculture and tourism, have continued to rise. While some sectors of the economy and many individuals have thus been shielded from the wage reduction in the socialized sector, the result of these developments has been a considerable unplanned redistribution of income that cannot continue indefinitely. Moreover, while total disposable household income has remained more or less unchanged, output has grown, so that the household sector as a whole has borne part of the burden of bringing about the desired improvement in the external accounts.

The fifth policy change has been the effort to achieve a more efficient allocation of resources through a quantum jump in price flexibility. The price freeze, imposed at the turn of the year, has been lifted, and a measure of flexibility in administered prices has been achieved in a way that has limited the concomitant inflationary impact. In addition, aggregate wage payments in loss-making "work units"--sections of enterprises--will not be allowed to rise in line with the increase applicable even to the socialized sector. Because this provision applies to aggregate wage payments of the unit, not to wage rates, it could be an incentive toward shedding redundant labor.

As provided for in the stand-by arrangement, separate studies of the operation of the foreign exchange allocation system were made by the Yugoslav authorities and the Fund staff. Directors are of course aware that, under the decentralized Yugoslav constitutional system, the allocation of foreign exchange involves difficult adjustments between the various republics and autonomous provinces, and between public enterprises and the federal and local government authorities. In view of these circumstances, the substantial degree of conformity in the conclusions of the official study and the staff study is remarkable. Important measures to improve the economic efficiency of the system have been implemented, and more measures can be expected. Such a favorable evolution of the system would of course be assisted by a further strengthening of the external accounts and a concomitant increase in the supply of foreign exchange.

Thus, a series of stand-by arrangements between the Fund and Yugoslavia has been gradually producing important and encouraging results. The experience has been painful and difficult, but positive on balance. A question remains: How far has one aspect of the experience been unnecessarily painful? The Yugoslav authorities feel that the Fund may have entered into unnecessary and painful detail when it came to establishing the performance criteria. The list of performance criteria, set out with commendable clarity by the staff on pages 20-23 under no fewer than 12 headings, in a sense makes the point. That same detail has led to the necessity of repeated waivers and frequent Board discussions of Yugoslav developments; the Article IV consultation with Yugoslavia is scheduled for next month. If it is thought to be a matter of judgment whether all that detail was necessary to make the program work, then the judgment of the Yugoslav authorities is unambivalent and clear, and it will no doubt exert an effect on negotiations about a possible successor stand-by arrangement.

The recent rather belligerent statements about the Fund that have appeared in the press are a case in point. I am happy to be able to inform the Board that the Yugoslav Minister of Finance has himself initiated contact with the Fund to make clear that these statements were made by opposition parliamentarians and not by government spokesmen, let alone by the Minister himself. In the words of the Minister: "It would have been absurd for the Government to come to a conclusion when a Fund mission is about to arrive." Yet the unrest in the Yugoslav representative body is evidence that the Fund has gone too far afield in detailed prescription and might have done better to stay with more global targets and instruments.

With a considerable adjustment effort now behind them, the Yugoslav authorites have shifted their attention from the immediate situation to the medium term. A comprehensive plan for the period to 1990 as a guide for policy is in an advanced stage of preparation. For the economy as a whole, the strategy involves (1) a greater openness of the economy, with exports and imports rising faster than the national product, (2) an emphasis on the technological development of the country, and (3) the resumption of sustainable economic growth. In this way, a consolidation of the adjustment process without a further reduction in personal incomes is to be secured.

On the external side, the authorities plan to allocate $3 billion of a targeted current account surplus in the years up to 1990 to repaying external debt, and to allocate close to $2.5 billion to increasing reserves. A multiyear rescheduling of debt falling due over the next four years is part of that program. The percentage of repayments to be refinanced would decline from year to year. The Yugoslav authorities are hoping to receive support from the Fund in their endeavors at multiyear rescheduling as a basis for their further adjustment efforts and in view of the economic results already achieved. They are also counting on financial support from the international financial institutions, particularly the World Bank. In the light of their experience since 1981, the Yugoslav authorities have come to the basic policy decision that their future development must be planned without net recourse to external finance.

Mr. Coumbis recalled that, during the discussion on Yugoslavia's request for a stand-by arrangement (EBM/84/60, 4/18/84), his chair had expressed some concern about recent economic developments in the country, and about certain aspects of the Government's adjustment program. The staff had reported a dramatic increase in capital outflows in 1983, together with some deterioration on the price front. It had also been noted that interest rates on loans and deposits had remained negative throughout the adjustment period, while the aggressive policy of depreciation during 1983 had provided ample room for export price increases but had contributed to the dramatic surge in inflation in that year.

The performance of the economy thus far in 1984 had been mixed, Mr. Coumbis continued. The convertible current account had continued to improve, and the surplus in 1984 was expected to be slightly larger than in 1983. Moreover, there had been a dramatic improvement in the capital account, especially short-term capital, and, as a result, an overall external surplus of $500 million was expected in 1984, compared with a deficit of $465 million in 1983. However, the rate of inflation remained high for the second consecutive year, a worrying development, as it had occurred even though fiscal and credit policy had been restrictive and final domestic demand had fallen continuously since 1981.

The authorities had taken decisive steps to raise real interest rates to positive levels, Mr. Coumbis noted. Interest rates on three-month deposits and the discount rate had been increased in two steps in 1984 to 34 percent, and further increases were to take place on the basis of a formula agreed with the staff in order to make real rates positive by April 1985. The higher rates had already had a favorable effect on short-term capital movements, but the authorities should be urged to step up the pace of the adjustment, so that interest rates would reach the desired level before April 1985.

In their letter of intent, Mr. Coumbis noted, the authorities had undertaken to bring the real effective exchange rate back to the 1983 level in two stages, by end-April and end-June 1984, and to maintain that rate throughout the rest of the program period. The objective of their aggressive exchange rate policy was to shift resources to sectors producing import substitutes and exports of goods, and he wondered whether there was any evidence that the shift had actually occurred. After all, the increase in exports by 13.5 percent in 1983 and 8.7 percent in the first seven months of 1984 had been due mainly to the shift in exports from the nonconvertible to the convertible area, and total exports in 1984 were expected to be approximately no higher than in 1981. Moreover, the dollar unit value of exports had stagnated in 1983 and fallen by 0.9 percent in the first seven months of 1984, even though the real effective exchange rate for the dinar had declined by 25 percent in 1983 and remained unchanged in 1984. Those developments indicated that exporters probably had preferred increasing their profit margins to enhancing their export shares. The data for August 1984, the latest month for which actual data were available, indicated a significant decline in exports in that month.

There was no evidence of a shift in investment toward export or import-substituting industries, Mr. Coumbis observed. Moreover, total investment in 1984 was expected to decrease for the fourth consecutive year.

Developments in 1984 showed that some of the doubts and reservations that his chair had expressed about the Yugoslav economy in 1983 had been well founded, Mr. Coumbis said. However, to some extent, the problems facing the economy had clearly been connected with the authorities' efforts to make needed structural adjustments. Moreover, many short-term developments in the balance of payments were satisfactory. Working within the framework of the Fund-supported stabilization program, the authorities had finally introduced a series of measures to lay the foundation for sustained economic growth. In particular, they had increased the mobility of labor, improved the allocation of foreign exchange, and lifted the price freeze introduced in 1984; they were adjusting administered prices more frequently than in the past, had limited both payments from the joint reserve funds and the growth of total public sector revenue, and had restrained personal income payments by unprofitable enterprises. Most of the measures had required legislative approval, a difficult and time-consuming task. The authorities were clearly committed to continuing their successful balance of payments adjustment policies, while taking all necessary steps to correct the structural weaknesses in the economy.

Mr. Prowse considered that the key element of the proposed decision was the statement that no additional understandings were necessary regarding the circumstances in which Yugoslavia could make purchases under the stand-by arrangement. He agreed with the staff appraisal and accepted the draft decision.

The staff report re-emphasized the uncertainties inherent in programs for centrally planned economies, Mr. Prowse continued. In that connection, Mr. de Vries's points on the nature of the performance criteria for Yugoslavia were well taken. When the stand-by arrangement for Yugoslavia had been approved in April 1984, he himself had underscored the complexity of the performance criteria and had said that he doubted whether the authorities could avoid requesting waivers of, or changes in, the criteria. In fact, the Executive Board had had to grant waivers in June and August 1984. He had had no difficulty in accepting the waivers, but the need for them suggested that more attention should be paid in future to the nature of performance criteria for centrally planned economies. At the same time, it was important to stress that all the performance criteria for Yugoslavia had been met, the drawings had been made on schedule, the program appeared to be on track, and considerable progress had been made: the improvement in the external current account had been consolidated; the deterioration in the short-term capital account had been reversed; in contrast with the usual seasonal pattern, international reserves had increased from January to July. The staff had properly concluded that economic developments thus far under the program had generally been in line with its expectations, and that if the authorities showed perseverance, their present policy course would lead to the attainment of the main short-term program targets.

While there was no case for either modifying the existing performance criteria or formulating new ones, Mr. Prowse went on, the recent encouraging developments masked considerable uncertainty about the authorities' prospects for achieving their longer-term objectives. In that connection, it was important to stress that inflation was still a problem and that the external accounts were still a cause for concern. Actual data for June and preliminary figures for August 1984 indicated that exports--which had been improving--might have started to weaken; the data for September suggested that exports had continued to weaken. Even more important, there had been a negative swing in the medium-term and longer-term capital accounts, and the present sizable net capital outflow was a cause for serious concern.

It was not clear to him how the studies of the foreign exchange system would contribute to the goal of achieving a fully convertible dinar, Mr. Prowse commented. The staff clearly had not endorsed the present system, and its proposals in that area differed somewhat from those of the authorities. The staff had been unable to say with confidence whether or not the measures recently adopted and proposed would be sufficient to foster the development of the foreign exchange market; it had merely concluded that a fundamental review of the foreign exchange system would be needed if a market for foreign exchange did not emerge in the coming period.

Nor was it clear to him whether the authorities' broad objectives were being achieved, Mr. Prowse remarked. Indeed, although the Fund-supported program was certainly meant to do more than improve the external sector, not even the nature--let alone the details--of the larger objectives had been clearly described. The staff had mentioned on page 9 that structural adjustment was required to return the economy to "capacity growth with external balance." Presumably, that statement meant that the intention was to contain inflation while encouraging greater efficiency and improved resource allocation. Did the statement also mean that the economy was to grow at the highest rate compatible with a sustainable external position? Did it imply certain assumptions about access to foreign and domestic savings, or about the degree of competitiveness? The objective of "capacity growth with external balance" seemed to be an appropriate response to the main problem facing the economy in the past, namely, the imbalance between domestic and external objectives; the pursuit of growth objectives had resulted in an unsustainable external position, so that the authorities' efforts in the future would have to be aimed at establishing a better relationship between their various major goals. However, the staff had not clearly shown how successful the authorities had been in achieveing both internal and external balance under the stand-by arrangement. It had reported that inflation was still serious--the rate being approximately 60 percent--and that there was only limited evidence of movement toward structural adjustment. The staff's uncertainty about the precise extent of actual structural adjustment in Yugoslavia was a reflection of the general problem of designing appropriate stabilization programs for centrally planned economies or even modified forms of such economies; it also brought to mind the general difficulty in achieving structural reform under Fund-supported programs.

The uncertainty about the possibility of achieving structural change under Fund-supported programs was reflected in the Yugoslav authorities' difficulty in fighting inflation, Mr. Prowse continued. They were obviously concerned about inflation but seemed somewhat confused about the best way to contain it. Moreover, there was no evidence that the staff either clearly understood the sources of inflation in Yugoslavia or could measure the contribution to inflation made by various sources. For instance, the staff had mentioned that it was difficult to assess the contribution to inflation made by the exchange rate adjustments and had merely concluded that exchange rate policy should be kept under review. Although it had also mentioned the difficulty in gauging both the underlying rate of inflation and the likely rate of increase in the price indices during the coming several months, the staff had concluded that the rate of monetary growth provided for under the program was "appropriate to restrain price increases beyond those inevitably associated with the relaxation of the price freeze."

The staff's conclusions seemed inconsistent, Mr. Prowse remarked, and while the authorities understandably were unsure what steps to take next to combat inflation, those they had taken were not reassuring. For instance, apparently they had recently decided to introduce new price controls, and, as the staff had mentioned on page 9, "mechanisms have been established to restrict credit to enterprises charging 'excessive' prices or withholding goods from the market," although the meaning of the term "excessive" was unclear. In addition, other measures, perhaps including taxation of "excessive profits," were being considered. Although none of those moves was aimed at the liberalized section of the economy, he agreed with the staff that the tendency toward administrative price control was a cause for concern. Could that trend provide evidence that the authorities were unconvinced that price flexibility could play a role in making structural changes and attaining sustainable growth?

The authorities might not be confident that means of controlling inflation other than controls would prove workable, Mr. Prowse added. For instance, the staff report gave the impression that the authorities did not agree with the staff that interest rates should be increased faster than had been initially agreed. The staff's opening statement that deposit rates had been raised to high levels was welcome, but the rates remained negative in real terms.

Unless inflation were brought under control, the objective of providing incentives to shift production from the domestic to the export sectors would be undermined, Mr. Prowse remarked. The basic incentives were the depreciation of the dinar--which should encourage producers to sell abroad--and the creation of wage differentials to encourage a shift in labor to the sectors where expansion was desired. The staff report did not clearly show how much progress in those areas had been made; at best, the evidence was inconclusive. In 1984, there seemed to be a closer correlation than in the past between growth performance and exports, but that outcome might be due more to the pickup in activity in trading partners than to a shift in resources to export production in Yugoslavia. Moreover, the staff had concluded that the evidence showing that wages in unprofitable and otherwise unsatisfactory industries had been limited was sketchy. More detailed information would be needed before judgments could be made on the effectiveness of the authorities' various measures to encourage resource mobility and alter the structure of production.

Given the gaps in knowledge about the quantitative effects of the authorities' present policies, the Fund should not suggest at the present stage either adjustments in Yugoslavia's performance criteria or additions to the criteria, Mr. Prowse considered. After all, the immediate program objectives had been largely achieved. However, there was a clear need for further consideration of how applicable conventional Fund policy prescriptions--particularly for medium-term adjustment--were to centrally planned economies. The staff report had not acknowledged the impact on the design of performance criteria of the uncertainty about the appropriateness of Fund policies for planned economies, and he looked forward to the scheduled seminar discussion on the matter.

A recent press report suggested that the authorities had announced ambitious economic targets for 1985--including increases in exports and industrial output--and their intention to discuss an adjustment program with the six Republics, Mr. Prowse noted. However, another recent press report on problems in making economic decisions in Yugoslavia; had concluded that during the previous decade official policies had in effect sought to move the economy in many different directions at once, thereby making it impossible to increase productivity and efficiency. The press had also reported that Yugoslavia intended to seek long-term financial arrangements--rather than one-year packages--during forthcoming negotiations with the Fund and other creditors. Did the authorities believe that Fund credit could be covered by the negotiations? According to the press reports, Yugoslavia's Finance Minister had stated that, in the future, the Government would refuse to sign letters of intent required by the Fund as a precondition for gaining access to its resources, and would instead provide occasional reports on the performance of the economy. A comment on the press reports might help to allay concerns about them.

Mr. Wicks remarked that he agreed with the staff appraisal and accepted the proposed decision. After an unsteady start, the program had been brought back on track, and, in a number of important areas, the authorities had taken more steps than had been required under the Fund-supported program.

Although progress in the real economy had been made, he agreed with the staff comment on page 23 that "the current situation is not without its concerns," Mr. Wicks continued. The rate of inflation was still high, and the medium-term prospects were not fully promising; continued assistance from commercial and official creditors was likely to be needed for some time. The most important task facing the authorities was to encourage further adjustment by building on their progress in increasing the flexibility of the pricing system and in reducing the scope of administrative controls. That effort would necessarily release accumulated pent-up inflationary pressures, and, while the authorities' gradual approach to adjustment was understandable, it had potential dangers and disadvantages, including in particular possible slower than expected adjustment of interest rates and the exchange rate. Apparently the effects of their gradual approach to interest rates had already reinforced a tendency toward speculative stockbuilding. That the authorities seemed to be contemplating additional administrative price controls was worrying, as a considerable proportion of prices was already under varying degrees of control. They should be strongly encouraged to avoid controls, which had directly reduced the effectiveness of the interest and exchange rate adjustments. In any event, the continued inflationary pressures were clear evidence that administrative price controls had not been effective.

The authorities were to be commended for adhering to the formula for introducing positive real interest rates, and there had already been a sharp reduction of short-term capital outflows over the first seven months of 1984, Mr. Wicks noted. Nevertheless, the higher than expected rate of domestic inflation had meant that real interest rates were lower--and, presumably, monetary policy looser--than had been the intention under the adjustment program. Given those facts, and the damaging effects that negative real interest rates continued to have on the economy--adding to the incentives to accumulate stocks and, perhaps, contributing to the resilience of private consumption--the authorities should be strongly urged to move more quickly toward positive real interest rates. They should especially be encouraged to remove the interest rate subsidies for certain economic activities, including imports. However, the necessary interest rate increases would inevitably affect the liquidity position of heavily indebted enterprises, and he wondered what measures the authorities might have in mind to deal with that problem.

A major objective of the program was to provide strong incentives to shift resources to sectors producing export goods and import substitutes, Mr. Wicks noted. To that end, it would be essential to improve price flexibility in general and to continue an appropriately flexible exchange rate policy in particular. Export profitability had increased substantially since 1981, but there was little other evidence that the desired structural adjustment was taking place. Indeed, the lack of discussion on the matter in the staff report was disappointing. Chart 1 was not discussed in the text and, in any event, contained little, if any, valuable information. He wondered whether the change in the slope of line in Chart 1, compared with the comparable chart in the previous report (EBS/84/65, 3/23/84), was significant. In any event, the slope in the present chart would be much different if the two entries in the upper right-hand corner were excluded; and it was incorrectly assumed that the activities represented by each entry in the chart had the same weight in the economy. Moreover, for the purpose of the chart it had been assumed that the export/output ratios had not altered from the output index base year, 1980, to mid-1984; that assumption was a bold one. Future reports on Yugoslavia should contain more information on structural adjustment.

The performance of convertible currency exports in 1984 had been encouraging--despite the less favorable data for August and September--especially as the export rise had been concentrated on industrial countries, Mr. Wicks remarked. However, the substantial real fall in the volume of capital goods imports over the previous two years was a cause for concern; in the longer run, it could weaken Yugoslavia's export capacity.

He fully agreed with the staff's conclusions on page 27 concerning Yugoslavia's foreign exchange allocation system, Mr. Wicks said. The system's adverse effects had been compounded by the shortage of foreign exchange, and in the present system should be seen as merely a first step toward a more efficient, market-based system. Accordingly, the reforms recommended in the two studies should be implemented without delay.

The staff had estimated that, over the remainder of the 1980s, an average of $2.8 billion in debt would fall due each year, Mr. Wicks remarked. From 1986, when the first repayments under the 1983 and 1984 refinancing packages would fall due, the scope for rescheduling would become increasingly limited. Indeed, with new money, rescheduled debt, and World Bank and Fund repayments all exempted from further rescheduling, by 1988 some $1.5 billion of maturing debt would be privileged.

In the coming period, Yugoslavia would have to depend increasingly on foreign exchange generated from current account surpluses and on normal flows induced by restored confidence, Mr. Wicks said. The authorities had nearly completed the formulation of a medium-term development plan, and he looked forward to learning more about it during the coming Article IV consultation. He hoped that the plan envisaged progress along the line of staff Scenarios 1 or 2 in Appendix V, rather than Scenario 3. The staff projections clearly indicated that adjustment along the lines of Scenario 3 would be risky, as the current account surpluses would be smaller and total debt and the debt service ratio would be larger than under Scenario 2. Economic growth would initially be higher under Scenario 3 than under Scenario 2, but it would taper off under the burden of increasing debt service repayments and beginning in 1988 would be lower under Scenario 3 than under Scenario 2. Continued determined adjustment was essential not only for the external position, but also for growth prospects in the medium term.

Commenting on the prospects for a follow-on program, Mr. Wicks noted that in his opening statement Mr. de Vries, referring to the performance criteria, had mentioned that "if it is thought to be a matter of judgment whether all that detail was necessary to make the program work, then the judgment of the Yugoslav authorities is unambivalent and clear, and it will no doubt exert an effect on negotiations about a possible successor stand-by arrangement." Mr. de Vries might have meant to hint that the authorities would not agree to a follow-on stand-by arrangement unless the staff reduced the number of performance criteria. He certainly hoped that that was not the case, as each of the present criteria could be justified. If the staff believed that a number of performance criteria were needed to protect the Fund's resources, it should not hesitate to say so.

Mr. Schneider remarked that the staff report confirmed the appropriateness of the stand-by arrangement, which had been necessary to consolidate the gains made since 1979 and to support the ongoing adjustment. Encouraging progress had already been achieved under the stand-by arrangement, and further improvement could be expected if the authorities continued their determined adjustment efforts in a flexible manner. As the performance criteria had generally been observed and there had been no major disruptions in the implementation of the program, the proposed decision was acceptable.

The program's main objectives were to consolidate the improvements in the convertible current account and to reverse the sharp deterioration in the convertible short-term capital account, Mr. Schneider continued. The desired sustainability of the balance of payments should be achieved through structural changes together with appropriate demand management.

The improvement in the external current account in 1983, including the shift in trade from the nonconvertible to the convertible area, had been sustained through the first seven months of 1984, Mr. Schneider noted. A major factor in that success had been the increased demand in industrial countries. No further compression of imports had occurred; in fact, an increase in imported inputs of raw materials and intermediate goods had been possible. Even more important, the real depreciation of the dinar over the first half of 1984 had provided significant support for exports. However, as the staff had indicated, exports had apparently weakened in the second half of 1984; the latest available data suggested that there had been a significant decline in exports in August and September 1984. The exchange rate would have to be monitored closely if the recent gains were to be maintained in the coming period, and if the expected structural changes resulting from shifts in relative prices were to occur. There had already been a shift in the composition of industrial output in the direction of exports.

Gradual implementation of a revised system for allocating foreign exchange could help to provide a solid basis for enhancing market efficiency, Mr. Schneider considered. The present system was complex; like the staff, he was reluctant to support it. There was as yet no evidence that it would eventually lead to the emergence of a foreign exchange market.

The economic situation in Yugoslavia was still fragile, and the application of available economic policy instruments must be carefully coordinated to meet the authorities' various objectives, Mr. Schneider commented. The present wage policy--together with the exchange rate policy--was particularly important, and the need to continue it in the coming period should be stressed. Real wages in the socialized sector had declined further in recent months, owing partly to a shift in income distribution from personal income toward earnings of productive enterprises, but real disposable income, as well as real consumer spending, had declined only moderately, suggesting that the so-called underground economy was still flourishing. Nevertheless, the further reduction in real personal income in the socialized sector had obviously boosted the economy's competitiveness. The continued decline in gross fixed investment was apparently due mainly to the continued restraints on bank credit, and he wondered whether monetary and credit policies should not be relaxed somewhat, especially in view of the lag in monetary growth. Further room for maneuver in monetary and credit policy existed because, at the present stage of adjustment, reducing inflation in the short run was not as urgent as making progress toward achieving the longer-run structural objectives.

Attention should be paid not only to the volume of investment, but also to its quality, Mr. Schneider considered. New, innovative investments would play a major role in ensuring sustainable economic growth in excess of the targets under the present program. The time was ripe to consider such investments, as the groundwork for improving the allocation of resources had already been prepared by the liberalization of prices, the establishment of wage differentials, the shift in income toward productive enterprises, and the consideration of a new foreign exchange allocation system.

He was pleased that the reversal in the capital account had been possible even though real interest rates remained negative, Mr. Schneider commented. The authorities had little choice in the short term but to continue raising nominal interest rates, as called for under the program. In the longer run, further relief through the capital account might be expected if the international financial community responded positively to Yugoslavia's recently announced decision to seek a substantial rescheduling of its large foreign debt. Such rescheduling would be possible only if the authorities were able to make further convincing progress in adjusting the economy.

Mr. Goos said that he was pleased that the Government's economic policies had been largely consistent with the stand-by arrangement. All the performance criteria had been met, and the authorities' actions with respect to personal income and energy prices had exceeded the program requirements. The proposed decision was therefore acceptable.

Nevertheless, the staff report gave the impression that the program was running less smoothly than had been hoped, Mr. Goos continued. Waivers had had to be granted for the nonobservance of certain undertakings, and there was evidence of fairly widespread disagreement between the staff and the authorities in a number of areas, such as pricing policy, interest rate policy, and export projections. The authorities were not to blame for all the difficulties in implementing the program. As Mr. de Vries had noted, they had been able to reduce expenditures more quickly than revenues and had had to request a waiver allowing them to accumulate excess revenues temporarily.

However, the apparent lack of consensus among the staff and the authorities on important policy areas was worrying, particularly in the light of the staff's conclusion that "there is still only limited evidence of the required structural adjustment," Mr. Goos continued. Indeed, overall economic developments since 1979--when Yugoslavia had introduced the first of several adjustment programs supported by the Fund--had been less than satisfactory. In 1979-83, the country's external debt had increased from some $15 billion to $20 billion; in terms of quota, Yugoslavia ranked among the largest users of Fund resources. Despite the considerable external support, real income had been declining since 1980, and unemployment had reached approximately 1 million persons; according to unofficial estimates, employment in the underground economy had reached roughly 2.5 million persons. Those developments, together with the many unsolved problems--low productivity, lack of confidence in the future course of the economy, and the reduced attractiveness of Yugoslavia to foreign tourists--clearly indicated the need for continued and decisive adjustment.

The rather favorable evolution of the balance of payments in recent months had not eliminated his concern about the persistent high rate of inflation and the large external debt, Mr. Goos commented. In any event, the improvement in the external accounts had apparently been due to substantial cuts in consumption and investment; the underlying strength of the economy had played a much smaller role. The recent acceleration of inflation had resulted largely from the lifting of the price freeze and from increases in administered prices. The rate of inflation might well be expected to fall as soon as prices became consistent with actual costs and supply and demand conditions. That outcome, however, would depend crucially on the implementation of the restrictive monetary policy provided for under the program, and on the continuation of a cautious incomes policy. He shared the staff's concern about the recent tendency to increase administrative price controls, and he strongly endorsed the staff's recommendation to accelerate the adjustment of interest rates to positive real levels in order to discourage the accumulation of stocks and to foster domestic savings and capital inflows.

The staff's scenarios suggested that, even if the current account developed favorably, Yugoslavia's debt burden would remain heavy until the end of the 1980s, Mr. Goos remarked. The country would continue to depend on sizable external borrowing or debt rescheduling, and although Yugoslavia's debt service ratio would probably remain significantly smaller than the ratios of major Latin American debtor countries, Yugoslavia would be able to instill the confidence needed to attract external financial support only if the authorities remained committed to consistent adjustment policies. Yugoslavia had already incurred a large debt to the Fund, and in coming years it could not expect to receive as much financial support from the Fund as it had in the past. In passing, he noted that Scenarios 2 and 3 seemed more realistic than Scenario 1, which was based on very optimistic export projections. There was no reason to assume that the recent weakening of exports would continue in the future, but it should be seen as a sign that a cautious policy approach was called for.

The authorities' intention to make the dinar fully convertible was welcome, although it would probably be achievable only in the longer run, Mr. Goos said. Meanwhile, their attention in the exchange rate area was focused on rationalizing the foreign exchange allocation system. The staff's points about the system were well taken. In theory, it was possible to design a sophisticated allocation system that ensured that scarce foreign exchange was channeled to the most productive uses. In practice, however, allocation systems failed to act as planned, and the authorities would therefore be well advised to create a free exchange market as soon as possible. Reducing administrative control of the allocation of foreign exchange would alleviate the burden on local governments of the difficult coordination procedures under the existing allocation system.

Mr. Finaish observed that performance under the stand-by arrangement had been quite satisfactory, and the authorities' program had remained on track. The delay in implementing revenue-reducing measures and the procedure for lifting the price freeze had constituted a temporary departure from the program's timetables but were not expected to have any lasting impact, as measures had been introduced to deal with both problems. Furthermore, the authorities had gone further than required under the program in such areas as personal income payments and the adjustment of administered prices. Nevertheless, progress in some major areas had remained limited, particularly in controlling inflation, although the outcome had been in line with the expectations under the program. An overall assessment of the performance under the stand-by arrangement over the previous several months could perhaps most suitably be based on the progress in achieving the three major program objectives, namely, improving the convertible capital account, shifting resources to sectors producing export goods and import substitutes, and further adjusting relative prices to ensure sustained growth over the long term through more efficient resource allocation.

Significant progress had been made in the first half of 1984 in improving the convertible capital account, Mr. Finaish continued. The deficit on that account had been reduced by more than 60 percent, and the substantial net outflow of short-term capital in the first seven months of 1983 had nearly been eliminated in the same period in 1984, a significant achievement following the deterioration in 1983 in the external position due mainly to the sharp adverse shift in the short-term capital balance. Interest rate policy had been expected to be the main instrument in improving the convertible capital account, but the recent improvement was actually attributable more to special factors, such as the increase in advance payments received for construction work abroad. Another factor had been the accelerated repatriation of export revenue, but the staff did not seem certain of the extent to which that development had been a reflection of interest rate changes. The staff could usefully elaborate on the sustainability of the improvement in the capital account beyond 1984.

Establishing strong incentives to shift resources to sectors producing export goods and import substitutes had been expected to be achieved mainly through restrictive demand management and flexible exchange rate policies, Mr. Finaish continued. Developments thus far seemed consistent with that objective. Final domestic demand in the first seven months of 1984 apparently had been substantially more restrained than total output.

The exchange rate had been adjusted in line with the provisions of the program, Mr. Finaish noted. Accordingly, the real exchange rate in mid-1984 had been brought back to the level of late 1983 and had been maintained thereafter. There was already evidence of the positive response of the external sector to the authorities' efforts; developments in the convertible current account in the first seven months of 1984 had proved to be more favorable than the staff had projected. For 1984 as a whole, exports were expected to increase by about 6 percent, compared with a decline in 1982 and stagnation in 1983. That development was certainly welcome, as a sharp improvement in the export performance was needed to enable Yugoslavia to deal more adequately with the external debt burden. As the staff had noted, however, Yugoslavia continued to face protection against its agricultural exports. As long as that barrier persisted, the benefits of the authorities' efforts to improve competitiveness through various measures, including depreciation of the exchange rate, would not be fully realized.

Apart from exchange rate and interest rate measures, the authorities had tried to improve resource allocation through relative price adjustments, particularly by taking significant steps to allow relative commodity prices to be more responsive to market conditions, Mr. Finaish observed. Those steps had been taken at the risk of aggravating the still unabated rate of inflation. The contribution of those measures to the desired structural reorientation of the economy was not expected to be sufficiently evident in the short term. At present, it was useful to note that the authorities had embarked on that adjustment course, even though it had entailed difficult decisions and considerable efforts to mobilize domestic support.

He looked forward to hearing the staff's comments on the remarks by Mr. de Vries and others on the degree of detail and complexity of the performance criteria for Yugoslavia, Mr. Finaish remarked.

Despite the persistence of the high rate of inflation, and the rather limited progress in dealing with some of the structural weaknesses of the economy, the improvement in the external sector had been substantial, and the program was on track, Mr. Finaish concluded. The proposed decision was acceptable.

Mr. Leonard noted that Yugoslavia had been using Fund resources in support of its adjustment efforts almost continuously since May 1979. Its long-standing relationship with the Fund had undoubtedly helped Yugoslavia make important improvements in a number of key economic areas. If the difficult policy adjustments responsible for those improvements could be sustained in the coming period, Yugoslavia should be able to achieve a viable, self-sustaining balance of payments in convertible currencies by the end of the 1980s.

However, Mr. Leonard continued, not all aspects of Yugoslavia's economic performance had been encouraging. The rapid increase in the rate of inflation had been particularly worrying. To some extent, it had been the inevitable result of the exchange rate actions and the lifting of the price freeze, which had been crucial to the achievement of lasting adjustment. However, there was reason to suspect that the persistence of inflation in Yugoslavia over the previous four or five years was a symptom of fundamental imbalances in the economy.

The stand-by arrangement was intended to restore equilibrium to the balance of payments and to promote adjustment by making the economy more responsive to market incentives, Mr. Leonard commented. The objective of strengthening the balance of payments had largely been achieved. The authorities were to be commended for the dramatic shift of more than $2 billion in the current account balance since 1982; a surplus of $500 million was projected for 1984. The impressive growth of exports during the previous two years could not have been achieved without the authorities' commitment to the flexible exchange rate policy, and they should be urged to maintain that policy in the coming period. The improvement in the current account had greatly benefited the authorities in their efforts to restructure Yugoslavia's external debt obligations in 1984 and to secure new financing from commercial and official creditors. Nevertheless, if Yugoslavia were to restore a sustainable balance of payments position, strong export growth would be required for some time, especially if the country's dependence on workers' remittances were to be reduced and capital goods imports restored to a more normal level. Stronger export growth would require a shift in investment resources to the export sector, and he wondered whether there was any evidence that such a shift had occurred. Such evidence would be of particular interest, given the overall decline in gross fixed investment during the previous year.

The overshooting of the revenue target was remarkable, and he had no difficulty in supporting the attendant waiver of the relevant performance criterion, Mr. Leonard said. The increase in revenues had been offset by the rise in net assets of the public sector held by the banking system.

The authorities' decision to constrain credit and monetary growth during the second half of 1984 to a greater degree than originally planned was encouraging, Mr. Leonard commented. It was essential that monetary policy should not accommodate the strong inflationary pressures and should not permit the present rate of inflation to become entrenched. Raising interest rates to positive real levels would also help to strengthen monetary policy; given the high rate of inflation, the authorities' failure to make that adjustment was a cause for concern.

Positive real interest rates were needed to attract workers' remittances and to give firms a solid basis on which to make decisions concerning investment and holdings of stocks of inputs and finished goods, Mr. Leonard added. The staff report gave the impression that the authorities had mixed feelings about further raising interest rates, but he agreed with the staff that the rates should be increased to real positive levels. In addition, the authorities should examine ways of crediting interest to savings accounts more often than once a year. More frequent crediting not only would improve the reliability of monetary and credit data, but could also encourage domestic savings and help to deepen the financial system.

Many of the macroeconomic policy adjustments needed to ensure a strong medium-term performance had been made, Mr. Leonard noted. However, there were indications that the authorities had not made a full commitment to one of the objectives of the stand-by arrangement, namely, a more flexible and efficient economic system. The price adjustments scheduled for May 1, 1984 had been delayed and were to be implemented in stages, thereby postponing some of their inflationary impact, but also delaying the desired improvements in incentives, efficiency, and profitability. Approximately 45 percent of prices were still controlled to some degree, and while the price adjustments that had been made were welcome, they were not an adequate substitute for a pricing system that was more directly responsive to market forces.

The foreign exchange system had been opened up to some extent, Mr. Leonard noted, but the authorities' continued heavy reliance on administrative means of allocating foreign exchange diminished many of the benefits of the flexible exchange rate policy. The staff had noted that the authorities were concerned about enterprises that charged "excessive" prices, temporarily withheld goods from the market, and gave unjustified wage increases. Those developments were signs of market failure and of a lack of competition in the productive sector of the economy. The authorities had responded thus far by introducing some administrative mechanisms to attempt to alter the behavior of enterprises, but they had not been applied consistently. If the positive effects of price and exchange rate liberalization were to be felt throughout the economy, the productive sector would have to be more open and competitive. Further progress in that direction in the coming period would be welcome.

He was generally encouraged by the achievements under the stand-by arrangement, Mr. Leonard concluded. The authorities were to be complimented for their adjustment efforts. The proposed decision should be approved.

Mr. Zhang said that he agreed with the staff's appraisal of the authorities' achievements under the stand-by arrangement. Developments in most sectors during the first seven months of 1984 had generally been consistent with the program objectives; policies had been implemented as expected, and the authorities had observed all the performance criteria except those for which waivers had been granted. The authorities were to be commended for their efforts.

However, Mr. Zhang went on, he shared the staff's concern about the rate of inflation, which had been higher--at 57-58 percent year-on-year--from January to September 1984 than in the same period in earlier years and was expected to accelerate in the coming period. The present inflation was the inevitable result of the Government's decisions to devalue the currency and to liberalize prices, in keeping with the program objectives. The highest priority under the program had been given to consolidating the improvement in the convertible external account; to that end, the shifts in relative prices, including the exchange rate, had been essential. Indeed, the staff had stressed that "it was deemed more important at this stage to accept the inflationary consequences to alter relative prices than to reduce the inflation rate in the short run." The authorities had decided to sacrifice internal price stability in order to attain a more important, external objective. There was a clear link in Yugoslavia between devaluations and domestic prices, and the price liberalization had had an immediate effect not only on the level of prices, but also on the financing and operations of individual enterprises. It would be useful to know whether inflation had been evolving consistently with the Government's expectations, and also whether the impact of the price liberalization measures on the economy as a whole would not have been different if they had been implemented either more slowly or somewhat differently.

The staff report had not discussed in detail the effect of the price liberalization on the financial and productive operations of individual enterprises, Mr. Zhang noted. Without that information, it was difficult to evaluate the overall effect of the price liberalization on the economy. If the liberalization were to be effective, enterprises should be in a position to adjust their operations to the new situation in a relatively smooth manner. In fact, many enterprises had incurred financial losses or had become very illiquid as a result of increases in interest rates and the rising cost of inputs owing to the price liberalization. In addition, unemployment had apparently been rising. The staff report did not contain data on the number of enterprises affected by the liberalization measures, the revenue losses they had incurred, and other information needed to judge the impact of the price liberalization policy. He wondered whether the authorities had helped enterprises incurring losses or had permitted them to go bankrupt. It would be useful to know whether price liberalization had on balance encouraged enterprises to increase their efficiency. If not, were financial disciplinary measures available for that purpose? He wondered whether the authorities planned to introduce in the near future new policy measures to deal with the acceleration of inflation and the rising unemployment.

The recent change in the distribution of income was another cause for concern, Mr. Zhang commented. There had been a continuing sharp drop in real personal income from employment in the socialized sector, together with increases in nonwage income from self-employment and interest earnings. Those changes had in turn resulted from price liberalization, inflation, and rising unemployment. Redistribution of income away from wage earnings would certainly have social implications, and he wondered what steps the staff had advised the authorities to take in the incomes area.

There had been a significant adjustment effort, and the achievements in the external sector had been remarkable, Mr. Zhang concluded. However, it could be argued that some policy actions, particularly the price liberalization and the curtailment of private consumption, had not been sufficiently rapid. The sustainability of the recent achievements could be undermined by the serious consequences of inflation, unemployment, and income redistribution. Many adjustment programs, although successful from an economic point of view, could have adverse social effects that could not be ignored for long without undermining the consensus in support of the programs. That matter should be carefully examined during the next review under the stand-by arrangement.

He fully accepted the proposed decision, Mr. Zhang said, but he agreed with the authorities that the performance criteria for Yugoslavia, particularly those under the present stand-by arrangement, had been unnecessarily detailed. The staff should have that conclusion in mind when it negotiated future arrangements for Yugoslavia.

Mr. Dallara said that he was pleased that thus far in 1984 the authorities had succeeded in implementing the necessary measures, that economic developments had generally been as anticipated, and that the main targets for 1984 were achievable. However, there were some causes for concern--particularly the rate of inflation--and there was still only limited evidence that the authorities had made the basic structural adjustments needed to restore external balance while maintaining adequate economic growth. The staff had clearly shown that much of the improvement in the balance of payments had been due to import compression, and that increasing attention should be given to measures to promote structural adjustment.

The recent increase in the rate of inflation in excess of the target had followed the pattern exhibited under Yugoslavia's previous Fund-supported programs, Mr. Dallara noted. The relaxation of price controls and the adjustments in administered prices had inevitably resulted in a short-term resurgence of inflation, but the faster than expected inflation rate for 1984 as a whole would have important consequences for the program, particularly in the interest rate and exchange rate areas. He wondered whether the available data accurately portrayed actual developments with respect to inflation, and whether the consequences for the program--including the need for further policy action--of the higher than expected rate of inflation had been fully evaluated. In that connection, the staff should comment further on the adequacy of the price indices. Greater freedom of movement in relative prices was the key to the structural change needed to increase the efficiency of resource allocation, including improved mobility of capital and labor. Accordingly, the prices of labor, capital, domestic and imported goods and services--namely, wage rates, interest rates, and exchange rates, respectively--must provide the right incentives and send the right signals; prompt and forceful action by the authorities was needed in all three areas. He attached importance to the authorities' continued commitment to limiting the wage bill in unprofitable and illiquid public enterprises, and to their intention to take fully into account in setting policies the production, income, and employment opportunities in the private sector.

The authorities' experience with price deregulation in 1984 merited further examination, Mr. Dallara considered. The surge in consumer demand in April 1984--prior to the relaxation of price controls--had been short lived. He was pleased that the price controls on a large number of items had been eliminated on September 1, 1984, that a number of administered prices had been adjusted, and that such adjustments would be made more frequently in the future. However, certain new price measures constituted a worrying sign that the authorities intended to continue controlling prices. Those measures did not cover prices that had already been liberalized but constituted additional administrative interference through, for instance, retaliatory credit restrictions on firms charging "excessive prices," special imports that might be in short supply, and possible taxation of "excess profits." The authorities should be urged to avoid resort to such measures to the extent possible.

The staff had explained that exchange rate movements had had a delayed and partial effect on exports and import substitutes, Mr. Dallara remarked. That development was cause for concern, as it could prevent the balance of payments from benefiting fully from exchange rate movements.

The convertible trade balance was somewhat stronger than had been expected, the services account was somewhat weaker, and the convertible current account was on track, Mr. Dallara noted. Similarly, the overall external balance had evolved roughly as had been expected. However, the evolution of the nonconvertible current account had probably been much less favorable than had been expected, and export performance in August and September 1984 had been weak. To strengthen the balance of payments further, the authorities would have to maintain an active exchange rate policy and fully pass through the effects of exchange rate movements. An active interest rate policy and further reductions in trade and payments controls were also required. The staff's proposal to increase interest rates more rapidly was appropriate, and he was pleased that the interest rate on three-month deposits had been increased by 13 percentage points on October 1, 1984, and that related adjustments had been made in the discount rate, the selective credit rate, and the one-year and two-year deposit rates.

The present, transitional exchange allocation system was not helping to reach the goal of an efficient national market in foreign exchange, Mr. Dallara commented. Even if the exemption of one-to-one trade from the current surrender requirement were eliminated, and even if the failure to reduce exchange allocations for firms benefiting from commodity credits were corrected, there would be little improvement in the functioning of the present, narrow exchange market in 1984, a disappointing outcome. Indeed, as long as the system continued to include substantial surrender requirements and specific exchange entitlements, a genuine market in foreign exchange was unlikely to develop. He agreed with the staff that, if such a market did not clearly emerge in 1985, a fundamental re-examination of the existing system would be required.

Yugoslavia had used Fund resources under a series of programs since 1979, Mr. Dallara noted. The level of the Fund's holdings of Yugoslav dinars was high, and Yugoslavia was clearly an example of prolonged use of Fund resources. While there was some question about the sustainability of Yugoslavia's external position, there was no doubt that considerable additional internal domestic actions were needed. The convertible current account had been strengthened significantly, and in the not too distant future Yugoslavia's balance of payments need to use Fund resources might be in question. The data suggested a need for further debt rescheduling, and creditors might wish to have a Fund-supported program in place before accepting any rescheduling arrangements. Hence, as the Fund continued to support Yugoslavia's adjustment efforts in the coming period, its relationship with the country might well change somewhat.

The number of performance criteria under the present stand-by arrangement for Yugoslavia was surprisingly large, and presumably the staff would not suggest that such a large number should be the regular practice, Mr. Dallara said. However, in certain cases, the staff would correctly conclude that, in the light of the Fund's experience with the country concerned, a large number of performance criteria was important for the achievement of the program objectives. The staff should not be discouraged from using a large number of performance criteria when it was thought to be important for the success of a country's adjustment program.

In his opening statement, Mr. de Vries had mentioned that "the Yugoslav authorities are hoping to receive support from the Fund in their efforts at multiyear rescheduling as a basis for their further adjustment efforts and in view of the economic results already achieved," Mr. Dallara noted. While the Fund should facilitate debt rescheduling between debtor member countries and their creditors, it should continue to avoid becoming an advocate for a particular approach to rescheduling.

Mr. Lindø recalled that, when the present stand-by arrangement had been brought to the agenda of the Executive Board, his chair had expressed its appreciation of the close cooperation between, and the considerable flexibility shown by, Yugoslavia and the Fund. He was therefore pleased that, thus far in 1984, developments in the economy and the implementation of policies had been consistent with expectations. Indeed, in some areas, the authorities had gone further than required under the program.

The external current account had recorded substantial deficits in the early 1980s but had improved significantly in 1983 and was expected to strengthen further in 1984, Mr. Lindå commented. Moreover, thus far in 1984, the increase in external reserves had exceeded the target. Those developments were probably due largely to the real depreciation of the dinar, which had helped Yugoslavia to increase its share of export markets, and to the increase in domestic interest rates. However, the most recent data showed a weakening of export performance. The staff apparently had no details on that development and wondered whether the downward trend was merely a seasonal deviation from the recent trend of relatively rapid growth in the volume of exports. The authorities expected to record substantial balance of payments surpluses in the future. To that end, they would have to make a continued effort to achieve a more export-oriented production structure; moreover, exchange rate and interest rate policies would have to remain flexible.

There had been a marked increase in nominal interest rates under the adjustment program, Mr. Lindå noted. However, the rate of inflation in the coming period was expected to be higher than had been forecast, and he agreed with the staff that the rate of increase of nominal interest rates should be accelerated to exceed the rate called for under the agreed formula.

Structural weaknesses in the economy could be significantly reduced if prices were permitted to respond to market conditions to a greater extent, Mr. Lindå considered. He was therefore pleased that the 30-day advance notification requirement had been abolished and that the share of fully liberalized prices in total prices had increased somewhat. However, several measures had been introduced to provide some control over price developments. The authorities' concern about the rate of inflation was understandable, but he agreed with the staff that, at the present stage, it was more important to accept the inflationary consequences of liberalizing prices than to reduce the rate of inflation in the short run. At the same time, the authorities should have responded to the unexpectedly rapid rate of inflation.

The April 1984 law limiting personal income payments by unprofitable and illiquid enterprises had been stricter than had been called for in the letter of intent, Mr. Lindå noted. Although it was too soon to make a final assessment of the impact of the new law, the number of enterprises in arrears had apparently declined, and the growth of interenterprise credits seemed to have slowed.

The discussions between the staff and the authorities on the foreign exchange allocation system apparently had fostered important improvements in the system, and further measures were being considered, Mr. Lindå considered. However, given the importance of a smoother functioning of the system and the authorities' aim of moving toward a fully convertible dinar, he agreed with the staff that a more fundamental review of the system would be called for if an efficient market did not emerge as a result of the measures that had recently been adopted or were under consideration.

The present economic policy program was comprehensive, included a detailed list of performance criteria, and had required legislative approval of significant and sometimes controversial and painful measures, Mr. Lindå observed. Yugoslavia had been using Fund resources for several years, and although most of the performance criteria had been observed, economic performance--particularly the balance of payments--had begun to show signs of improvement only recently. Moreover, it was not clear whether the improvement was viable, and there were still substantial structural problems in the economy. Alleviating the impact of those problems was an enormous task that would require courage, innovation, and perseverance. While he agreed that, in some respects, economic adjustment in Yugoslavia could have been more rapid than it had actually been, the particular economic environment of the country should be borne in mind in any assessment of actual developments. Finally, the proposed decision was acceptable.

Mr. Fujino noted that the authorities had implemented difficult measures to tackle deep-rooted problems, and that economic developments had generally been consistent with expectations under the Fund-supported program. The external position had been significantly strengthened. The flexible exchange rate policy had apparently played an important role in improving the current account, particularly with the convertible currency area. In addition, there had been a large positive swing in the short-term capital account--one of the main program objectives--although much of the improvement seemed attributable to special factors, including an increase in advance payments received for construction work abroad, and accelerated repatriation of export receipts, and was therefore probably temporary. To consolidate the net gains of recent months, the authorities should carefully examine the possibility of accelerating the pace of interest rate adjustments. Making interest rates more positive in real terms might well in itself have a positive effect on capital flows; moreover, the internal and external stability desired by the authorities probably could not be fully achieved as long as real interest rates remained negative.

The adjustment program, including the exchange rate depreciation and price liberalization, entailed considerable inflationary pressure in the short run, Mr. Fujino commented. An important task was to contain the inevitable increases in costs and prices to the extent possible. In that connection, the authorities' cautious and prudent credit policy and their emphasis on further reducing public sector revenue and expenditure in real terms were welcome. Their success in reducing expenditure--a difficult task in any country--was particularly commendable. A further comment on the implications of the faster than expected cut in expenditure, and on the response of enterprises to the incentives provided by the authorities, would be helpful.

Real wages had fallen continuously--by about 30 percent--over the previous four years, Mr. Fujino observed. Caution would be needed to maintain the quality and morale of the work force, especially as many workers had taken second jobs. A further comment on the situation would be useful.

The process of sharply adjusting prices could cause distortions, such as excessive stockbuilding and unjustifiably large price increases, Mr. Fujino added. Such problems were difficult to solve; resort to price controls would obviously be inconsistent with the program objectives. Positive real interest rates could discourage unnecessary stockbuilding.

He agreed with Mr. Dallara, Mr. Fujino continued, that the possibility of multiyear rescheduling of the public debt should be approached with great caution.

The authorities' efforts to liberalize prices, adjust administered prices, reduce subsidies for unprofitable enterprises, control public sector revenue and expenditure, and improve the foreign exchange allocation system should increase the efficiency of the economy, Mr. Fujino commented. Those actions were part of the strong adjustment effort needed to solve the structural problems that had proved costly to the economy. The present policy orientation was in the right direction, and the proposed decision was acceptable.

Mr. Senior said that he agreed with the staff appraisal. The authorities' policies had been broadly consistent with the program objectives, and all the performance criteria except two--for which waivers had been granted--had been met, a significant accomplishment, given the relatively large number of criteria.

The progress had been particularly significant in the external economy, as reflected in the remarkable improvement in the convertible current account and the reversal of the deterioration in the short-term capital account, Mr. Senior commented. He fully agreed with the staff that exchange rate policy had played a major role in restoring external balance. The recovery of economic activity in partner countries had been important, but the exchange rate was an essential instrument for adjusting the competitiveness of an economy--even a planned economy--to that of its partner countries. There was no precise quantitative relationship between adjustments in the real exchange rate of the dinar and movements in Yugoslavia's external position, but the flexible approach to exchange rate management should certainly be continued.

He did not fully share the staff's view on the role of interest rate policy in Yugoslavia's external adjustment, Mr. Senior remarked. The increase in deposit rates might well have had a positive influence on the balance of payments, but he doubted whether the effect had been through the capital account, as the staff had suggested. In his view, the responsiveness of capital outflows to interest rate movements had been negligible. Accordingly, any positive effect on the balance of payments of increases in nominal interest rates must have occurred through the current account: the higher interest rates had probably encouraged workers' remittances and financial savings, thereby lowering consumption and imports.

The authorities' current efforts were important, but they were merely the initial steps in the adjustment process and would have to be supported by structural reforms to improve resource allocation, Mr. Senior considered. The Fund should continue to play a supportive role, and it could best do so by reducing the present large number of performance criteria. As many as 12 performance criteria might have been necessary in the initial stages of the adjustment effort, but a smaller number might well be warranted in the future. The fact that planned economies were significantly different from market economies was not an acceptable rationalization for imposing a relatively large number of performance criteria. He hoped that the scheduled Executive Board discussion on financial programming for planned economies would provide an opportunity to examine a simpler scheme of conditionality for planned economies that would be more closely akin to the scheme for market-oriented economies.

Mr. Kabbaj said that the external sector had performed particularly well, owing in part to the flexible exchange rate policy. In the first seven months of 1984, the convertible current account had recorded a surplus of $274 million, compared with a deficit of $126 million in the same period of 1983. It was important to note that the improvement had not been at the cost of a reduction in imports; rather, total exports had surged, with exports to developed countries rising by 30 percent, while exports to developing countries had fallen. The staff had cautioned that the drop in exports to developing countries had been due largely to factors that might persist throughout 1984, and the latest available data showed a weakening of exports to the convertible currency area in August and September. Nevertheless, for 1984 as a whole, total merchandise exports were expected to grow significantly.

The capital account had improved significantly thus far in 1984, Mr. Kabbaj noted. Outflows of short-term capital in the first seven months of 1984 had been just $15 million, compared with $700 million in the same period in 1983. The overall external outlook remained basically unchanged from the time of the adoption of the stand-by arrangement in April 1984. All the present medium-term scenarios included a significant decline in the debt service ratio.

The main unfavorable economic developments in recent months were the surge in inflation and the continuation of underlying inflationary expectations that, while not entirely unexpected, could undermine further progress in the coming period, Mr. Kabbaj remarked. Inflationary expectations had played a part in the speculative stockpiling and in the slow response of the public to the authorities' efforts to enhance savings. Indeed, a decline in the personal savings ratio, as well as in personal consumption, was expected in 1984. The rate of inflation had accelerated following the cancellation of the general price freeze, but the origin of the inflation was not clear to him; after all, final domestic demand had been more subdued than expected.

The authorities' pricing strategy was appropriately aimed at gradually attaining greater price flexibility, Mr. Kabbaj said. The price freeze had been lifted in May 1984, and the prior notice requirement in September. More extensive price liberalization would eventually help the authorities to achieve the critical objective of improving resource allocation while providing incentives needed to absorb idle funds.

Production had strengthened considerably in 1984 as a result of the significant decrease in supply bottlenecks, Mr. Kabbaj remarked. Industrial growth as a whole had exceeded the forecasts and, even more important, had been concentrated in export-oriented industries. The growth of agricultural output had been more moderate, and the authorities had expressed some concern about the protection against Yugoslavia's products. In the light of the significant fall in recent months in real income, consumption, savings, and investment, adjustment in the coming period should concentrate on the supply side, particularly on increasing the productive capacity. In that connection, an increase in market incentives would prove helpful. Finally, the proposed decision was acceptable.

Mr. de Maulde accepted the proposed decision.

The staff representative from the European Department commented that, although the current level of exports was no higher than in 1980, exports had been growing rapidly during the previous 12 months. Moreover, it was important to take the composition of exports into account in judging export performance. For instance, in the first seven months of 1984, there had been a large increase in exports to industrial countries, a positive development; the exchange rate adjustments had been expected to have their greatest effect on exports to those countries. At the same time, there had been large declines in exports to developing countries, but mainly as a result of conditions in those countries. In addition, there had been some problems with exports to specific countries--for instance, delays in the delivery of ships--that presumably would be solved over time. However, it was obviously important to keep a close watch on the evolution of exports, especially in the light of the weakening of exports evident in August and September 1984. Although additional data were needed to gain a full understanding of recent developments, the staff had not altered its forecast for the current account and was pleased that the compression of imports had apparently halted. Many of the imports in recent months had been inputs for export production, and the staff continued to hope that exports would pick up in the final quarter of 1984. The staff's present projections for the current account included room for a substantial increase in imports in the final quarter of 1984 compared with the same period in 1983.

As Mr. Wicks had suggested, the relationship shown in Chart 1 would be different if the entries in the upper right-hand corner were eliminated, the staff representative commented. However, those data points represented exports of ships, and of shoes and leather goods, which were expected to be highly responsive to changes in the exchange rate; it seemed inappropriate to exclude those points merely because they were the most striking examples of the relationship shown in Chart 1. Data points that might be appropriately eliminated were those on the far left-hand side of the chart, which represented sectors--such as electricity--that might not be very responsive to price incentives. The staff believed that the chart depicted a genuine relationship and provided evidence that the desired external adjustment had actually been occurring.

The staff agreed with Mr. Prowse's definition of "external balance with capacity growth," the staff representative remarked. In using that term, the staff had meant to bring to mind the experience of the late 1970s, when the volume of foreign borrowing and the inflow of foreign savings had been unsustainable. The staff wished to see the economy grow at near-full capacity, but the authorities intended to reduce the foreign debt in the long run, which would obviously require a current account surplus. The most appropriate current account situation for a country like Yugoslavia was debatable, but the staff had meant to say that, given the constraint on debt in the longer term, the economy should operate efficiently and at the highest possible capacity rate.

The uncertainty that the staff felt about the prospects for domestic adjustment in Yugoslavia was a reflection, in part, of the staff's incomplete mastery of the institutional makeup of the country, the staff representative said. Gaining a mastery of the differences between the institutional, social, and political systems of Yugoslavia and those of some other member countries was necessarily a slow process.

There were a number of macroeconomic indicators of the authorities' progress in making needed adjustments, the staff representative continued. For instance, exports had been increasing, and there had been a dramatic turnaround in the current account without a further compression of imports. Moreover, while investment had fallen sharply, the burden of adjustment had been borne by both the household and public sectors; there had been a steep decline in the share of public sector expenditures in the economy, from approximately 33 percent in 1979/80 to an estimated 26 percent in 1984. In addition, the exchange rate had been adjusted sharply, nominal interest rates had been increased significantly in keeping with the objective of reaching positive real rates, and other relative prices had been adjusted appropriately. Hence, there was evidence that the adjustment for which the staff had hoped was actually taking place. The references in the staff report to the uncertainties about the desired adjustment had to do more with the institutional aspects of adjustment than the macroeconomic quantitative indicators. Some of the important substantive measures had been introduced only recently, and their impact thus far had been limited. Most of them were meant to provide greater financial discipline and were aimed at the enterprise sector, such as the restrictions on personal income payments by unprofitable and illiquid enterprises and the restrictions on subsidies financed by the joint reserve funds. In some cases, the monitoring of the relevant performance criteria had begun only in the third quarter of 1984, and the available data provided only basic information showing that the adjustment program was being implemented as intended.

Progress on the adjustment front was also difficult to measure because the social system in Yugoslavia differed from that of many other member countries, the staff representative went on. Employment data for Yugoslavia were difficult to interpret, and there was some question whether employment was being shifted to the external sector and certain other sectors as a result of the adjustments in relative prices. Given the current social and political systems in Yugoslavia, there had probably been a shift in production rather than in employment, as individual enterprises tended not to reduce their work force even in difficult periods. The Yugoslav Government did not provide the social safety net typical of many industrial countries; that function was usually performed by individual enterprises. The staff did hope to see changes in the pattern of production of individual enterprises, and there was some anecdotal evidence that such changes were occurring. One important aspect of the domestic adjustment was the emergence of a different attitude toward financial discipline in the enterprise sector. Apparently, restrictions on personal income payments by illiquid enterprises had been welcomed in most of the republics and provinces as a source of necessary financial discipline and a means of reducing subsidies to enterprises.

It was misleading to state that there had been a surge in inflation in the first seven months of 1984, the staff representative said. In 1983, the rate of inflation had been very high; it had been running at about 80 percent when the price freeze had been imposed at the end of the year. The lifting of that freeze had released pressures that had inevitably built up since the imposition of the freeze, but the upward trend in the rate of inflation had been evident before the freeze. The staff was worried that what had actually been a series of price freezes had contributed to inflationary expectations.

The authorities had wished to contain the inevitable increase in prices following the relaxation of the price freeze, the staff representative went on. They were concerned that the relaxation of the latest freeze could be followed by a rise in the rate of inflation that would require further adjustment, including a large change in the exchange rate. The staff had been somewhat concerned about the method that the authorities had chosen to relax the freeze. Prices had risen rapidly in July 1984, and the staff had expected a further acceleration in September, with the relaxation of the 30-day notice requirement. In fact, however, the rate of increase in prices in September--5 percent--had been no higher than the rate in August. The staff hoped that destocking had begun following the relaxation of the 30-day notice requirement, which had brought the price regime fully into line with the provisions under the program. Considerable evidence of stockbuilding had led the staff to encourage the authorities to step up the pace of adjustment of interest rates to positive real levels. There was evidence that some initial large price increases--for instance, those for processed foods and fruit--had been rolled back, thereby helping to moderate inflation.

Given the uncertainty about the effect of the relaxation of the price freeze on inflationary expectations and stockbuilding, the staff had been cautious in estimating the rate of inflation for the rest of 1984, the staff representative continued. Moreover, the series of price freezes had made it difficult to draw firm conclusions on the sources of inflation. The staff had thought that price developments in September and October 1984 might suggest an inflation rate for 1984 higher than the authorities' projection of 50 percent. That annual rate would be possible if the monthly rate of price increases were to decelerate to 3-4 percent, something that might not occur, as the effects of the relaxation of the price freeze were still passing through the economy. However, with the unexpectedly low rate in September, the annual rate was unlikely to be much higher than 50 percent, and it was on the basis of that assumption that the monetary program had been left intact. Another factor in the staff's decision to adhere to the existing monetary program was that, during the most recent mission to Yugoslavia, the authorities had not been in a position to discuss their policy package for 1985. The present monetary program covered the period through December 1984; the adjustment program extended until mid-April 1985. The staff intended to examine the monetary program for the first quarter of 1985 with the authorities during the next mission, in the second half of November.

The staff had been concerned about some of the administrative measures that the authorities had described during the midterm review mission, the staff representative commented. However, the authorities had assured the staff that none of the measures would affect prices already liberalized. It was the staff's understanding that certain measures had been introduced specifically in response to excessively large price increases by some producers, but that the number involved was small. It further believed that some control over existing monopolistic elements in the economy might well be warranted.

The authorities had given no indication that they intended to request a change in the schedule of repurchases, the staff representative commented. They were interested in an ongoing relationship with the Fund and valued the discussions on policy, but they had not yet decided whether or not to request a follow-up stand-by arrangement. In that connection, the Finance Secretary had denied a news report that either he or any representative of the Government had stated that the authorities would refuse to sign any new letter of intent.

The staff had not played an advocacy role with respect to a multi-year approach to the rescheduling of Yugoslavia's foreign debt, the staff representative said. The staff had supported the authorities in their efforts to begin discussions with creditors on a multiyear arrangement, and, in that connection, it understood the restraints on the commercial banks and official lenders involved. The staff had not advocated a particular multiyear rescheduling arrangement.

The staff had believed that the stand-by arrangement for Yugoslavia should include a number of specific performance criteria as complements to the criteria usually employed in such arrangements, the staff representative added. Both the staff and the authorities wished to ensure that the desired effects on enterprise behavior of demand restraint and the shift in relative prices would in fact materialize. Accordingly, when designing the policy package for 1984, the authorities had stated their intention to introduce new, and occasionally complex, requirements for the enterprise sector. The staff had concluded that, because of the complexity and novelty of some of those measures, they should be reflected in performance criteria to ensure that no misunderstandings occurred and to support the authorities' efforts in those areas. All the performance criteria and understandings in the stand-by arrangement had been stipulated in the initial policy program presented by the authorities during the negotiations on the stand-by arrangement. Some of the novel elements--particularly the income restrictions on loss-making and illiquid enterprises, and the restrictions on payments from the joint reserve funds--had required new legislation that had been difficult to secure. The legislation had eventually been approved, and there were indications that some of the new measures had been particularly welcome in the republics and provinces and had been having the desired effect. The restriction on the payment of income by illiquid enterprises, for example, had resulted in the reduction in outstanding enterprise credit in the second quarter of 1984. If the kind of new measures covered by some of the present performance criteria became a regular part of the authorities' policy efforts, and if the financial discipline of enterprises increased, a follow-up stand-by arrangement could include a smaller number of performance criteria; a statement of intention by the authorities to continue the relevant policies might be sufficient to warrant the smaller number. The situation in 1984 had been unusual, particularly because of the novelty of some of the new policy measures, and there was no necessity to require the same conditions in subsequent arrangements.

The question had been raised, the staff representative recalled, whether enterprises had benefited from the cuts in government expenditure. There was some evidence that, as the authorities had hoped, a reduction in public sector revenue would be one means of alleviating the impact of increased interest payments in the enterprise sector. A performance criterion restricting revenue to the public sector had been included in the stand-by arrangement to ensure that the desired reduction--and the so-called "unburdening" of the enterprise sector--would occur on schedule. The staff had felt that, in an environment of increasing real interest rates, making the position of enterprises more viable by restraining public sector revenue growth was crucial.

It was true, the staff representative said, that some special factors had played a role in the turnaround in the capital account, but the staff and the authorities felt that the increase in domestic interest rates had made a contribution. The staff strongly hoped that the improved capital account would be sustainable once real interest rates reached positive levels, at some time in 1985. There was some evidence linking interest rates and capital flows; for instance, the acceleration of the repatriation of export earnings in 1984 had contributed to the turnaround in the short-term capital account. The continued improvement in the capital account in coming years projected by the staff was a reflection of the authorities' intention to run current account surpluses and reduce outstanding foreign debt.

The quality of the price indices in Yugoslavia was similar to that of other countries in the region, the staff representative commented. The staff had no great difficulty with the price indices that had been used to formulate some of the performance criteria and assess the authorities' adherence to them.

The main so-called disciplinary action against enterprises that were illiquid or suffering losses was the restriction on personal income payments, the staff representative commented. The relevant legislation was stricter than had been required under the terms of the stand-by arrangement, which had limited the increase in such payments to 67 percent. The authorities had in fact limited the increase to 50 percent. The authorities had also introduced some other so-called disciplinary measures. For instance, investment credit for the firms concerned was limited until they could provide what the authorities considered adequate working capital from their own funds.

A question had been raised, the staff representative from the European Department recalled, whether the authorities were bailing out troubled enterprises or were allowing them to go bankrupt. The joint reserve funds, financed by contributions from enterprises, helped to rehabilitate enterprises and were still in operation. The stand-by arrangement included a restriction on the amount of payments that could be made by the joint reserve funds, and the authorities had remained within the ceiling. Moreover, under a proposed law, the joint reserve funds would be substantially reduced forthwith and would eventually be eliminated. The authorities' actions were welcome, as the joint reserve funds had inhibited the desired shift of resources. Bankruptcy and liquidation of enterprises were uncommon in recent Yugoslav history. Still, three major enterprises were being liquidated; that development was additional evidence of the emergence of a new attitude toward financial discipline in the enterprise sector.

Mr. de Vries remarked that the idea of a nation of South Slavs had been alive as early as the 19th century, and, after an initial attempt in the interwar period, a "socialist" state in the Eastern European sense had been established after World War II. Over time, Yugoslavia's economic and social system had become significantly different from that of other Eastern European countries but had retained its socialist character. At the same time, the decentralization of power over the various republics had made it necessary for the central government authorities to rely relatively heavily on the price mechanism. The basic ambivalence in Yugoslav society between central and local decision making was reflected in the policies and implementation of the present adjustment program.

The continued tension between those two basic elements would not be eliminated in the near future and was at the heart of a number of Executive Directors' comments on the ambivalence of the Yugoslav authorities toward certain policy actions. Greater price flexibility was one of the authorities' goals, but they tended to maintain administered prices in some areas. Similarly, while encouraging a shift in productive resources in response to profit and other market incentives, they had not gone as far as some Executive Directors would wish, and, while the foreign exchange allocation system was to be made more efficient, it would not be eliminated.

The authorities had not decided whether to request a follow-up stand-by arrangement, Mr. de Vries said. They wished to complete the next round of discussions with the staff, in November 1984, before reaching a conclusion. In any event, the present stand-by arrangement still had six months to run.

It was his impression that the Yugoslav authorities and the public at large would have difficulty in accepting another stand-by arrangement with a large number of detailed performance criteria, Mr. de Vries said. The Government would not find it easy to gain domestic support for an adjustment program as detailed as the present one, and the recent statements about a program that had been wrongly attributed to the Finance Minister were an indication of that problem. On October 30, 1984, the Vice Prime Minister had stated in the Federal Assembly that Yugoslavia intended to continue cooperating with the Fund.

As Mr. Prowse had noted, one of the authorities' objectives was "capacity growth with external balance," Mr. de Vries remarked. In other words, the authorities wished to achieve external balance without introducing additional deflationary measures.

In conclusion, Mr. de Vries said, the following points seemed to have received particular emphasis. First, Executive Directors seemed to have felt that the authorities should follow up on their achievements in external adjustment. Second, Executive Directors had stressed that there had not been as much structural adjustment as they would have wished. Third, Executive Directors had been concerned about the degree of price flexibility and the high rate of inflation; and they had been worried that the improved export performance might not be as firmly established as they would have hoped.

The Chairman said that Executive Directors had also seemed to feel strongly that the pace of interest rate adjustment in Yugoslavia should be accelerated.

The Executive Board then took the following decision:

1. Yugoslavia has consulted with the Fund in accordance with Paragraph 4.e of the stand-by arrangement for Yugoslavia (EBS/84/65, Sup. 1, 4/19/84), and the letters from the Governor

of the National Bank of Yugoslavia and the Federal Secretary for Finance, annexed to the stand-by arrangement, dated March 20, 1984 and May 25, 1984, in order to reach understandings with the Fund regarding policies and measures which Yugoslavia will pursue through April 17, 1985.

2. The Fund finds that the contemplated review is completed, and that no additional understandings are necessary regarding circumstances in which purchases may be made by Yugoslavia under the stand-by arrangement.

3. The approval under Decision No. 7635-(84/27), adopted February 17, 1984, of Yugoslavia's restriction on the availability of foreign exchange for tourist travel is extended until the completion of the next Article IV consultation with Yugoslavia or until April 30, 1985, whichever is earlier.

4. Paragraph 4.f of the stand-by arrangement for Yugoslavia (EBS/84/65, Sup. 1) shall be amended to read as follows:

> "During the entire period of this stand-by arrangement, while Yugoslavia has any overdue financial obligation to the Fund, or if Yugoslavia...."

Decision No. 7830-(84/158), adopted
October 31, 1984

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/84/157 (10/26/84) and EBM/84/158 (10/31/84).

3. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/84/228 (10/26/84) is approved.

APPROVED: July 26, 1985

LEO VAN HOUTVEN
Secretary