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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 83/47

3:00 p.m., March 11, 1983

J. de Larosière, Chairman
W. B. Dale, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	W. B. Tshishimbi
	C. Taylor
	P. Péterfalvy, Temporary
	A. Le Lorier
	C. A. Salinas, Temporary
R. D. Erb	
M. Finaish	M. A. Janjua, Temporary
	I. R. Panday, Temporary
T. Hirao	T. Yamashita
	D. I. S. Shaw, Temporary
	J. R. N. Almeida, Temporary
G. Laske	
	C. P. Caranicas
	A. S. Jayawardena
	J. E. Suraisry
	T. de Vries
	K. G. Morrell
G. Salehkhou	O. Kabbaj
	M. Camara, Temporary
	S. E. Conrado, Temporary
J. Tvedt	
Zhang Z.	Wang E.

J. W. Lang, Jr., Acting Secretary
K. S. Friedman, Assistant

Also Present

R. Sapunxhiu, Alternate Executive Director, IBRD. Asian Department: S. P. O. Itam, F. Le Gall. European Department: L. A. Whittome, Counsellor and Director; B. Christensen, H. B. Junz, W. E. Lewis, D. Ripley. Exchange and Trade Relations Department: S. Mookerjee, Deputy Director; S. Kanesa-Thasan, N. Kirmani, A. B. Petersen. External Relations Department: N. K. Humphreys, G. Newman. Legal Department: J. G. Evans, Jr., Deputy General Counsel; W. E. Holder. Middle Eastern Department: H. Jakubiak. Research Department: T. Gudac. Treasurer's Department: D. Williams, Deputy Treasurer; K. Boese, W. L. Coats, D. S. Cutler, L. E. Escobar, D. Gupta, A. F. Moustapha, M. Sami, T. M. Tran. Bureau of Statistics: M. J. Brimble. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: S. El-Khouri, L. Ionescu, H.-S. Lee, P. D. Péroz. Assistants to Executive Directors: H. Alaoui-Abdallaoui, J. Bulloch, L. E. J. Coene, T. A. Connors, I. Fridriksson, G. Gomel, M. Hull, M. J. Kooymans, P. Leeahtam, W. Moerke, V. K. S. Nair, K. Okma, J. K. Orleans-Lindsay, G. W. K. Pickering, H. Suzuki, M. Toro, A. Yasseri, Zhang X.

1. YUGOSLAVIA - 1982 ARTICLE IV CONSULTATION, AND REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors continued from the previous meeting (EBM/83/46, 3/11/83) their consideration of the staff report for the 1982 Article IV consultation with Yugoslavia and a review under the stand-by arrangement (EBS/83/46, 2/24/83; Sup. 1, 3/10/83; and Cor. 1, 3/10/83). They also had before them a report on recent economic developments in Yugoslavia (SM/83/40, 2/28/83).

Mr. Tvedt stated that he agreed with the staff's conclusions. The economic situation in Yugoslavia was serious, and strong action by the authorities was clearly required, together with a fair amount of good luck. The present difficulties were particularly disappointing because Yugoslavia was in the third year of an arrangement with the Fund. Still, he fully supported the program; the Fund had played an effective and useful role in coordinating the external financing for Yugoslavia.

The proposed targets seemed somewhat ambitious, Mr. Tvedt considered, particularly in view of the precarious external position and the excessively optimistic assumptions on which the program was based. If the targets were to be achieved, the authorities would have to adopt even harsher measures; there was no room for any slippages. Incomes policy would play an important role in the adjustment effort, but the authorities must also maintain an exchange rate policy aimed at preserving the competitiveness of the economy and an interest rate policy designed both to stimulate domestic financial savings and to promote improvement in the external current account balance.

Exports were expected to rise rapidly in 1983, Mr. Tvedt noted, despite the projected increase in import demand in Yugoslavia's main markets of only about 1 per cent. The staff apparently expected strong growth in Yugoslavia's export market shares which, in turn, had to be seen in the context of the adjustment efforts in other countries. He wondered whether the simultaneous adjustment efforts in a group of countries would not prove to be mutually offsetting. In that event, a reorientation of policy in those countries in favor of expansionary measures would become all the more urgent.

He was satisfied that the program and the authorities' strong commitment to it would move the economy in the desired direction and would eventually take Yugoslavia off the list of members whose economies faced critical problems, Mr. Tvedt remarked. He was glad that the authorities intended to negotiate further programs with the Fund following the conclusion of the present one.

Mr. Zhang said that he fully accepted the proposed decisions. The Government's determination to avoid any further recourse to debt rescheduling was welcome and courageous. Stronger efforts than hitherto would have to be made to accelerate the adjustment process, which would undoubtedly involve a continuing decline in output and income.

The authorities had observed the performance criteria for both the first and second quarters of 1982, Mr. Zhang stated, and unfavorable developments in the second half of the year had basically been limited to the external sector. The improvement in the current account with the convertible currency area for 1982 as a whole had been considerably below target, and capital outflows had been recorded. The several exchange rate devaluations of recent years had done little to stimulate exports but had contributed to the rise in domestic prices. Any evaluation of the results of the implementation of the program for the second year of the stand-by arrangement and of the prospects for the third year must make full allowance for the unfavorable international economic environment.

The measures under the 1983 program were much more stringent than those under the 1982 program, Mr. Zhang considered, and their implementation would involve even greater sacrifices by the Yugoslav people. That outcome was perhaps necessary and unavoidable if the authorities were to deal successfully with the debt repayment problems. To some extent, the new program reflected the intention of the authorities to consolidate, sustain, and improve upon the results that had already been achieved.

The main policy target under the 1983 program, as well as under the previous programs, was a large improvement in the current account balance with the convertible currency area, Mr. Zhang remarked. The program provided for a 20 per cent increase in the volume of merchandise exports in 1983, a further large decline in the volume of imports, and a substantial recovery in the balance on invisibles. The export target should be seen in the context of the continued sluggishness in world export markets, the heavy concentration of Yugoslav exports in products that were subject to cyclical fluctuations in demand, and the growing proportion of Yugoslav exports that were affected by trade barriers in other countries. Because of those factors, the staff had recognized that the export target would be difficult to achieve. He wondered whether the expected unfavorable developments could be reversed by the further devaluations that were planned under the program. On the other hand, imports from the convertible currency area had fallen significantly in the previous three years as a result of the continued decline in real income--as measured by the level of real wages--of more than 15 per cent. The projected decline in real wages and personal income in 1983 would certainly prevent the demand for imports of consumer goods from increasing, but he doubted whether the imports of some essential raw materials that were available only in the convertible currency area could be further curtailed without a serious adverse impact on domestic production. The development of the external sector under the program would depend to a large extent on conditions in the world economy, which were beyond the control of the Yugoslav Government. If the unfavorable international climate continued in 1983 and the important targets for the external sector could not be achieved, what was likely to happen to the program as a whole?

All the targets and performance criteria in nominal terms were calculated on the basis of a 20 per cent increase in prices in 1983, Mr. Zhang noted, but the staff had mentioned that the rate of price increase was expected to be much larger than had originally been anticipated. How realistic were the nominal targets under the proposed program? If inflation was greater than had originally been expected, would actual rates in excess of the nominal targets be seen as a failure by the authorities to implement the program? Would the present measures have to be reinforced, or would new measures have to be introduced? It would be useful to have a comment on the staff's conclusion on page 30 (EBS/83/46) that "performance criteria for the final year of the stand-by arrangement include...the reaching of agreement at the time of the midyear review on policies for the remainder of the stand-by period." Was that a general practice of the Fund, or could it be interpreted as a tightening of the conditionality?

In formulating the present program, Mr. Zhang remarked, the Government had increased its control of a number of major policy variables and had decided to use its legal power to enforce certain mechanisms, when necessary, thereby facilitating the implementation of the program. The staff clearly recognized the difficulties in designing and implementing policy in a federal state like Yugoslavia. Without abandoning its fundamental principle of self-management, the Government had initiated a complex process of structural adjustment that would take time to complete. There were bound to be successes in some areas and failures in others.

Mr. Erb said that basically he agreed with the staff appraisal and supported the proposed decisions. As Mr. Polak had stressed, "success will depend on full implementation by Yugoslavia of the measures announced, and on early reinforcement of any measures that prove not to be fully adequate to bring about the intended results." He took that statement to mean that the authorities would adopt the necessary reinforcing measures if the proposed actions proved to be inadequate.

The performance of the balance of payments in 1982 had been much more unfavorable than had been expected, Mr. Erb remarked, partly because the external environment had been unfavorable, and partly because the authorities had been too slow in making the needed changes in economic policy. Yugoslavia's external position had become critical, and the authorities must make extraordinary efforts to improve it. There was no room for any delay in policy implementation.

The authorities had been unable to contain sufficiently the growth in nominal incomes and thereby to bring inflation down to the target rate, Mr. Erb commented. They intended to limit the growth in personal income to that of current, rather than prospective, net enterprise income. Did they expect that, in so doing, they would achieve the necessary reduction in the growth of nominal wages? Given the structural adjustments that were needed, it seemed best to tie wage adjustments more closely to productivity increases. The Federal Government was prepared to intervene if nominal wage increases grew too rapidly, and it would be useful to know when the wage data for the fourth quarter would be available. The availability of timely data was important, as it enabled the authorities to act quickly, when necessary.

The authorities had made progress in introducing corrective price changes, Mr. Erb remarked, but he doubted whether the changes were sufficiently large and he was worried that distortions in relative prices might still exist. Was the staff satisfied with the structure of relative prices? Would the pricing procedures ensure that appropriate changes in prices would be made over time in the face of changing economic conditions, and particularly in response to changes in the rate of inflation?

Fiscal policy would have to remain tight in the coming period, Mr. Erb considered. The authorities were taking important steps to control expenditure, and he agreed with the staff that special significance should be attached to their commitment to freeze revenues in excess of planned expenditure levels in a blocked account at the National Bank.

He was pleased that the authorities had taken steps to deal with the excessive credit expansion by controlling inter-enterprise credit, Mr. Erb said. However, he was puzzled by the conclusion in the staff appraisal that, at the time of the midyear review, the staff would be prepared to suggest measures that could help strengthen the enforcement mechanism if insufficient progress had been made in controlling inter-enterprise credit. Given the severity of the problem, the recommendations should be taken into account in the immediate future, rather than only at the time of the review.

The interest rate structure in Yugoslavia was clearly inadequate, Mr. Erb remarked. Interest rates on the majority of deposits were a mere fraction of the expected rate of inflation and, in the area of interest rate adjustments, he fully agreed with the staff that considerable further progress should be evident on the occasion of the midyear review.

The new law on foreign exchange allocation was complex and confusing, Mr. Erb commented. Allocating foreign exchange on the basis of the payments position of individual republics or sectors seemed to be an inefficient method and it raised some doubt whether resources would be used for the most productive investments. Foreign exchange resources would be used more efficiently if they were allocated through the pricing mechanism. He wondered how the Government intended to ensure that the exchange allocated to various sectors would be used productively to produce substitutes for goods that could no longer be imported, to encourage potential export growth, and to provide some of the fundamental needs of the economy.

Commenting on the exchange rate policy, Mr. Erb said that Yugoslavia must continue to ensure that its goods were competitive in international markets. Given the large magnitude of the external imbalances, he wondered why the real effective exchange rate had been permitted to appreciate significantly in mid-1982. The authorities should monitor the exchange rate carefully and stand ready to take the steps needed to achieve their external targets, particularly through the continued flexible adjustment of the exchange rate.

The authorities would have to implement the proposed policies fully, Mr. Erb considered, and they would undoubtedly have to take additional steps to achieve the desired degree of adjustment. The staff reports gave him the uneasy feeling that the authorities were delaying taking needed steps in the hope that conditions would improve by the time of the midyear review. Yugoslavia was not in a position to introduce adjustment measures at a leisurely pace.

Commenting on Yugoslavia's external financing prospects for 1983, Mr. Erb said that he, like other Executive Directors, supported the Fund's efforts to make it clear to all the various creditors that financial flows were a necessary part of the country's adjustment effort. It was of vital importance that the bank credits that had been assumed to be available under the proposed program were actually committed and made available for disbursement on or before May 27, 1983. It was his understanding that the banks were in the process of requesting their governments to roll over the debt payment guarantees in the original support package. The U.S. Government was prepared to take such a step if other governments followed suit and the relative share of the United States in the package was unchanged. It was his understanding that a number of governments had not yet clearly decided to provide the additional guarantees, thereby raising questions about the speed at which the bank commitments could be made. Staff and management might well be able to serve as a catalyst in encouraging finance ministers in the major governments involved to decide quickly to provide the rollover guarantees.

Mr. Jayawardena stated that the Fund's involvement in Yugoslavia--a socialist country with a centrally planned economy--was a welcome test of the efficacy and universality of the Fund's basic policies and enhanced the institution's image as a genuinely international organization. The Fund was assisting a centrally planned economy that had continuously and courageously experimented with economic reforms in a highly practical manner.

The authorities had clearly been making a serious effort to adjust in difficult circumstances, Mr. Jayawardena remarked. Their growth-oriented policies in the early 1970s had been financed largely by costly credit. In recent years, Yugoslavia, like many other members, had had to contend with the oil shocks and large debt service at a time of growing recession and protectionism in its trading partners. At the same time, commercial banks had tended to restrain the availability of credit, and there had been a sharp decline in real investments and incomes.

The fundamental problem facing the Yugoslav economy was its inadequate competitiveness, Mr. Jayawardena considered. That conclusion seemed somewhat surprising, as Yugoslavia was one of the few socialist countries that had continuously implemented economic reforms designed specifically to improve competitiveness. However, neither the complex system for rationing foreign exchange nor the exchange rate policy had significantly helped the competitiveness of exports. There were more efficient ways of allocating credit than maintaining differential interest rates. The Fund-supported programs in Yugoslavia would have been more successful if they had been oriented more clearly toward achieving the necessary structural reforms in the economy, thereby improving the competitive position. The Fund's expertise in creating appropriate programs in an economy like Yugoslavia's needed to be further improved and, to that end, the experience with Yugoslavia should make a significant contribution. Above all, the Fund needed to understand the main objectives of a socialist society.

Given the constraints of the stand-by arrangement worked out two years previously, the proposed program for the third year was appropriate, Mr. Jayawardena remarked. Fiscal policy was to be tight, with expenditure declining in real terms, and a more active use of interest rate policy was to be made, while the rapid growth of inter-enterprise credit was to be constrained. The authorities' determination to achieve its external objectives in a more orderly manner than hitherto was most welcome. He was pleased that they intended to use the system for controlling foreign exchange in a rather liberal manner, and the planned income policy seemed to be clearly needed. The authorities were obviously determined to face squarely the problems plaguing the economy, and the proposed decisions were fully acceptable.

Mr. Salehkhou said that he welcomed the flexible approach that management and staff had taken in conducting the review under the stand-by arrangement. The proposed waivers for the accumulation of arrears and the small breach in the domestic credit ceiling for December 1982 were acceptable, and he hoped that the same flexibility would be shown to other members that were clearly determined to make a serious effort to implement their adjustment programs. The flexibility encouraged members to implement the additional measures needed to ensure the successful implementation of adjustment programs.

In addition to the number of domestic and structural distortions in the economy, Mr. Salehkhou continued, the most difficult problem facing Yugoslavia was the same one that had existed at the time of the implementation of the three-year stand-by arrangement: the need to improve the external current account to compensate for the deterioration in the capital account. The improvement had in fact been very slow, despite the introduction of a number of courageous measures, partly because of the domestic rigidities and partly because of the protectionist barriers in some developed countries. In 1982 the authorities had also faced increasing difficulty in rolling over short-term credits, in negotiating new credits, and in dealing with the effects of the unfavorable maturities on the heavy borrowing that had been contracted after the mid-1970s. He was therefore pleased that the 1983 program stressed the need to accelerate the adjustment process by reducing the various distortions in the economy, although the effort would initially have an unfavorable effect on the rate of inflation, which was already very high. The proposed measures were comprehensive and should provide new incentives to increase productivity and to improve the allocation of resources. The various fiscal, monetary, pricing, and exchange rate policies were aimed at a substantial reduction in investment and domestic consumption in the short run, and at achieving a sustainable balance of payments position in the medium term.

He agreed with the staff, Mr. Salehkhou commented, that the effort to prevent another surge in personal income was crucial to the success of the 1983 program. In that connection, the decision to limit the growth in personal income to that of current net enterprise income was particularly welcome, as it should help to achieve the target of reducing real personal income per worker below the 1982 level. In addition, the price policy, which was designed to bring domestic prices broadly in line with international ones while providing new incentives for increasing exports, should considerably reduce the price distortions in the economy.

The fiscal and monetary policies would also play an important role in achieving the program objectives, Mr. Salehkhou remarked. The authorities had taken the courageous decision to reduce substantially real public sector expenditure and its share in the gross social product, and they were prepared to take appropriate steps to handle any excess revenues. The program included a significant tightening of credit policy and, more important, an upward adjustment in interest rates that should progressively reduce the subsidization of the cost of credit, despite the political sensitivity of credit subsidies in Yugoslavia and their major role in promoting investment in the less developed regions of the country.

On the external front, Mr. Salehkhou said, the authorities' decision not to seek any rescheduling of the foreign debt and to give priority to debt repayments, despite the severe stress on the country's international reserves, was particularly welcome. The Government had appropriately decided to give the exchange rate policy a more active role in the economy and, as a result, the dinar should move toward a market-clearing rate and provide a significant incentive for the sustained expansion of export production. The 1983 program should benefit from the amendments to the law governing foreign exchange operations, which increased the responsibility of the commercial banks in the allocative system and emphasized the need for efficient sectoral distribution.

The 1983 program seemed comprehensive: it should result in a significant improvement in Yugoslavia's external position and in a substantial correction of domestic economic distortions, Mr. Salehkhou commented. However, the outcome would depend on the authorities' determination as much as on the availability of foreign assistance. The proposed decisions should be approved.

Mr. Janjua said that he broadly agreed with the thrust of the staff appraisal and had no difficulty in supporting the program for 1983. The authorities had clearly demonstrated the willingness to keep the program on track and to make progress toward achieving a viable external position, but during 1982 important policy weaknesses together with exogenous factors--such as the sluggishness of world markets and the cautious policy of commercial banks--had adversely affected the economy. The 1983 program was comprehensive and ambitious. It involved important changes on several policy fronts simultaneously, including tight monetary and fiscal policies, the maintenance of a competitive exchange rate, and a decline in the standard of living.

An important aspect of the 1983 program, Mr. Janjua continued, was the authorities' decision not to reschedule any debt during the year. The program also included measures designed to deal with two structural problems that had undermined program implementation in the past: wage determination, and credit expansion in the nonbanking sector. The proposed measures should have a positive impact on both the internal and external imbalances over the coming several years. The seriousness of the authorities' intentions was reflected in their plans to continue the adjustment effort under another stand-by arrangement in 1984. The 1983 program was ambitious, and in the light of the staff's comments on the prospects for the economy the occurrence of slippages could not be ruled out.

Commenting on demand management in Yugoslavia, Mr. Janjua noted that the authorities had had difficulty in implementing the tight monetary policy in the recent past. Although the relevant performance criteria had essentially been observed, the monetary controls had not been effective. A stringent monetary policy was to be maintained in 1983, partly in response to the experience of the recent past. However, the credit control mechanism was elaborate and might limit the flexibility that would be needed in the implementation of monetary policy. On page 2 of the report the staff had also noted that "credit extended for carrying of agricultural inventories is exempted from the ceilings imposed by the National Bank on domestic credit." A further comment on that practice would be helpful. In general, it was worth noting that commodity financing was an important part of credit expansion in a number of countries, and it would be useful to know whether that component of credit was treated uniformly in establishing credit ceilings for members.

The progress on the external front in 1982 had not been fully satisfactory, Mr. Janjua remarked. The policy measures and financing arrangements with the Government and the banks should help to reduce the current account deficit. The decline in imports in recent years had affected production and exports, and imports were projected to decline in 1983, while exports were expected to increase substantially. A further comment on those trends would be useful. The additional real depreciation of the exchange rate that had been agreed between the authorities and the staff might well have implications for the effort to contain inflation and to maintain discipline in the pricing behavior of enterprises.

In describing the adjustment in the exchange rate that was to be a performance criterion, Mr. Janjua noted, the staff had said that there was to be "a monthly depreciation of the real effective exchange rate of the dinar." That statement implied that Yugoslavia would have to devalue every month in order to meet the performance criterion even if the currencies of the country's trade partners and competitors were appreciating. A similar performance criterion in the recent case of Turkey had been stated more appropriately in the words, "the maintenance of a competitive exchange rate."

The Director of the European Department commented that there were two crucial constraints on any practical approach to the problems facing the Yugoslav economy: the absolute priority that the authorities gave to the self-management principle, and the powerful position of individual republics in the Yugoslav federal system. In difficult times, republican nationalism tended to grow, and that trend had perhaps been one of the motivations behind the recent changes in the exchange restrictions.

The staff felt that the 1983 program was not a static one, the Director said. Further action would most probably have to be taken in a number of areas, such as interest rates. The staff fully agreed with Executive Directors' comments on interest rate policy in Yugoslavia. It was true, as Mr. Casey had suggested, that there was a certain ambivalence within the country on the part of the authorities with respect to interest rates, and the staff expected to take up the subject of the need for further interest rate adjustments during the next scheduled review. It was easier for the authorities to make occasional adjustments in the rates, rather than a single large change. Further progress on the interest rate front would help the authorities to improve the control over inter-enterprise credit. Meanwhile, the authorities would have to continue to rely on administrative controls to limit bank credit, and there was of course no certainty that the controls would be fully effective. Positive real interest rates on dinar-denominated financial assets probably would not encourage the movement from foreign exchange accounts to dinar-denominated deposits, at least for some time. The uncertainties of the foreign exchange position would probably lead Yugoslav residents to keep their foreign exchange accounts as long as they were able to do so. Agricultural credit was not included under the authorities' own ceiling for the National Bank, however, it was specifically included under the ceilings that had been set by the Fund.

The staff expected the exchange rate adjustment to help to improve export performance, the Director remarked. The staff felt strongly that exporting should be at least as profitable as sales in the domestic market. As Executive Directors had mentioned, a number of additional important steps should be taken, such as improvements in the design of exports and in marketing, and the staff hoped that increased profitability would provide an incentive to make those changes.

The staff's statements on the appropriate exchange rate policy for the coming period, the Director commented, were meant to say that there should be a minor real adjustment of the rate at least once a month. The staff's description of the authorities' commitment in the exchange rate policy area had been more specific than in the case of Turkey, but less specific than in the case of Brazil. In that connection, much depended upon the attitude of the member country itself. In the case of Turkey, the staff had been less specific because the Turkish authorities had been most unwilling to have anything said that might cause changes in the leads and lags. The Yugoslav authorities had been more relaxed about that particular concern, although leads and lags were possible in that country as well, especially with respect to remittances. The staff and the

Yugoslav authorities had felt that the exchange rate policy commitment should be fairly specific but should not contain the full details that other governments had sometimes wished to include.

There seemed to be some doubt among Executive Directors whether the staff balance of payments projections for the nonconvertible currency area were realistic, since a number of member countries of the Council for Mutual Economic Assistance (CMEA) were also attempting to make adjustments, the Director said. The two CMEA countries that were also members of the Fund--Hungary and Romania--together with Yugoslavia, assumed that their current account position would move from a surplus of about $1.25 billion in 1982 to a deficit of some $0.5 billion in 1983; indeed, a sharp turnaround. That those countries would simultaneously be in deficit was not inconceivable; they had combined deficits in 1979 and 1980 of about the magnitude expected for 1983. The difficulty in accepting the forecast figures was that the expected current account position would represent a very sharp turnaround. Much would depend upon the attitude of the U.S.S.R. and on developments in Poland, whose deficit was running at about $2 billion. The CMEA countries and Yugoslavia seemed to assume that the U.S.S.R. would be prepared to run a substantial surplus, but there was of course no certainty that it would in fact do so. The combined hopes and ambitions of Hungary, Romania, and Yugoslavia for their external accounts were certainly ambitious.

In stating that the balance of payments risk in the case of Yugoslavia was positive, the Director explained, the staff had meant to say that it was reasonably confident that the external position would improve in 1983. That was not to say that the staff was convinced that all the targets would be achieved. Indeed, the targeted improvement in the current account with the convertible currency area was ambitious. Exports to the convertible currency area had basically been flat during the previous three years, when Yugoslavia had experienced a decline in market shares, and the staff was now projecting an improvement in the country's market shares. Hence, the staff hoped for a return to the position that had prevailed in the fairly recent past. In that sense, the external targets, while still ambitious, seemed to be reasonably sound. Unfortunately, Yugoslavia would probably gain less than many other countries from the recent decline in the international price of oil. At least half of Yugoslavia's oil was imported from the U.S.S.R., and it was difficult to know the price of those particular imports. In addition, Yugoslavia imported oil from other oil producers under long-term contracts, some of which included provisions for the oil exporters to import Yugoslav goods.

It was clear, the Director of the European Department said, that Yugoslavia would gain from the decline in international interest rates. However, because the restructuring of its debt had increased interest costs, there would probably be no net gain in 1983. Speakers had wondered whether there were important differences between debt restructuring and rescheduling. The differences between the two lay partly in the eye of the beholder but were not unimportant for that reason. There were also technical differences concerning grace periods and the extension of credit, but, in the final analysis in the case of Yugoslavia the differences in 1983 were primarily presentational.

The staff representative from the European Department commented that it was useful to note that, in many respects, incomes policy, the inter-enterprise credit situation, the fiscal position, and the system for allocating foreign exchange were interrelated matters that clearly had a bearing on the adequacy of the 1983 program and on the question of the pace of adjustment in Yugoslavia. Ideally, a number of the measures should have been implemented some time ago, and in the coming period the authorities should proceed with the adjustment effort as quickly as was politically feasible. Substantial adjustment was still needed, and the staff believed that a nearly continuous dialogue with the authorities would be necessary in the coming period. Hence, the authorities' determination to negotiate additional arrangements with the Fund in 1984 and 1985 was certainly welcome.

Controlling inter-enterprise credit was particularly important, the staff representative continued, because it was one of the factors in the excessive expansion of consumption. The authorities intended to speed up the approval of the legislation needed to improve inter-enterprise credit control and were convinced that the new law would be in place by the end of May 1983. The staff wished to assess the actual operation of the new legislation for at least two months before passing judgment on its effectiveness. However, the staff had already begun to explore with the authorities the type of mechanism that might be needed to strengthen the control process. In that connection, the authorities were considering two moves. First, if the reduction in unsecured outstanding inter-enterprise credit was disappointingly small, such excess amounts could be excluded from the computation of income, thereby immediately restraining the enterprises' ability to pay wages, as net income would be less than would have been the case otherwise. Second, a penalty--equal to the interest rates on new credits yielding a positive rate of return--could be levied on creditors. The penalty mechanism would ensure that creditors levied and collected a positive real rate of return on debts, something that was not happening at present, and would encourage the creditors to be more prudent than hitherto about agreeing not to collect payments due. If such mechanisms could be designed, they would probably be implemented fairly quickly should the new legislation prove to be inadequate.

Commenting on the appropriate treatment of budget revenues in excess of current estimates, the staff representative said that the authorities were not empowered to introduce a freezing mechanism, although they might wish to be given the authority if the return of revenues to the population at large was insufficient. Given the fiscal proposals and the authorities' determination to restrain the growth of incomes, it would certainly be preferable to constrain expenditures through continuous rate cuts than to build up an overhang of surplus revenues in the hands of the authorities that might be released at inopportune times. However, the legal framework for the freezing mechanism should at least be approved in case the incomes restraint proved to be inadequate.

Ideally, the staff representative continued, wage increases should be tied more closely to productivity than to net income streams of enterprises. However, under the existing self-management system, the main organizing rule was that incomes that were generated by each enterprise should be shared among the employees. The preliminary data suggested that a wage freeze in the first quarter of 1983 would involve about a 9 per cent decline in real wages compared with the first quarter of 1982, an outcome that, in the light of the seasonally low first quarter, would be more or less consistent with the 7.5 per cent year-on-year goal that the authorities had set.

The staff description of the system for allocating foreign exchange was not totally clear because the system itself had not been fully worked out, the staff representative explained. The authorities had established the framework, and the system was clearly meant to give the banking system a significantly larger role in the overall allocation of foreign exchange. The general goals of the new system seemed appropriate. An important objective of the next staff visit under the stand-by arrangement would be to assess the effectiveness of the allocation system. The move to a pricing mechanism for foreign exchange allocation was unlikely to occur for some time. The feeling that the devaluation of the dinar was being overdone clearly suggested that a move to a full pricing mechanism could not be made at the present stage.

The question had been asked, the staff representative recalled, whether the present price freeze would permit the pass-through of the effects of the devaluation to domestic prices. The staff had been told by the authorities that, on the basis of recent surveys, there was still a relatively large gap between the profitability of exports and that of domestic sales, and for that reason alone steps should be taken to close the gap. It was important to ensure that the export sector would grow, particularly in areas in which Yugoslavia enjoyed a comparative advantage and could make market gains in the convertible currency area. In that connection, the staff would not be very concerned if the effects of the devaluation were not passed on to domestic prices and were instead absorbed by enterprises in their costs and profits. To some extent, enterprises had been rather wasteful in their use of imports largely because it had been so easy to pass costs through to the domestic economy. At the same time, it was important to improve the profitability of Yugoslav exporters, many of whom were price takers and did not have much opportunity to reduce prices in the wake of the devaluation.

The present stand-by arrangement was somewhat shorter than the previous one, the staff representative noted. The difference was not important in terms of Yugoslavia's relations with the Fund. After all, the authorities had already expressed a wish eventually to negotiate additional stand-by arrangements for 1984 and 1985. In addition, they clearly had a wish to have a flexible attitude toward the performance criteria.

The incomes policy could legally be applied to both the enterprise and social sectors, the staff representative from the European Department explained. The authorities expected incomes in the so-called noneconomic sector to decline more sharply than those in the enterprise sector.

The Deputy Director of the Exchange and Trade Relations Department recalled that Yugoslavia had had no payments arrears when the stand-by arrangement had been concluded in 1981. The arrears had arisen fairly recently and, as exchange restrictions, they violated the general performance criterion related to the introduction of such restrictions. By waiving the performance criterion on arrears until August 14, 1983, the Fund was in principle waiving the arrears that existed at present and any possible increase in them until August 14. However, the staff expected that, when the financial package for Yugoslavia was in place, the Government would be able to eliminate the arrears at the latest by August 14 and, conceivably, well before then.

The inclusion of understandings at the time of the coming midyear review among the performance criteria listed on page 30 of the staff report was not a new practice, the Deputy Director of the Exchange and Trade Relations Department explained. It was quite common to make further drawings conditional upon the reaching of understandings at a midterm review. In most cases, the understandings had to do with credit ceilings for the remainder of the period of the arrangement, and with changes in certain macroeconomic policies deemed to be necessary as a result of the review.

Mr. de Vries noted that in negotiating the successive stand-by arrangements for Yugoslavia the authorities, the staff, and the Executive Board had continuously been overoptimistic. As the staff had said, the effectiveness of the price mechanism in Yugoslavia had been overestimated, and the degree of regulation had been underestimated.

Executive Directors seemed to feel that the external current account had not responded as much as had been hoped to the measures that the authorities had introduced, Mr. de Vries commented. Some Executive Directors felt that demand had been excessive and needed to be further reduced, while some others, noting that real incomes had been declining significantly, had stated that the demand restraint had been severe. He himself tended to agree with the second view. The staff reports showed that there had been a fall in final domestic demand in real terms between 1980 and 1982 of 7 per cent, and the staff expected a further decline of some 4 per cent in 1983. Indeed, in the nearly three years to October 1982 there had been a 15 per cent decline in real wages. Those figures suggested that there had been a considerable retrenchment, but it had not produced the results that had been hoped for. There had not been a boost in exports to the convertible area. Instead, there had been a decline in activity and an increase in exports to the nonconvertible area. As the staff had concluded, the price mechanism in Yugoslavia worked less effectively than had been expected, mainly because regulation was still pervasive.

The staff seemed to agree with Mr. Casey that the authorities' attitude to market forces was ambivalent, Mr. de Vries commented. In fact, however, the authorities would feel very uncomfortable with that conclusion, as they continued to believe firmly in regulation. Yugoslavia was after all a socialist republic, and the authorities were convinced that a great deal of regulation was appropriate. They were attempting to incorporate the elements of a market economy within their socialist economy, and, in so doing, they had to make difficult trade-offs, for instance, between a market orientation and socialism, and between decentralization and regulation--objectives that were difficult to combine. The Fund had an opportunity to be of assistance as the authorities struggled with those trade-offs.

The staff had suggested that the Fund had made mistakes in judging the situation in Yugoslavia, Mr. de Vries continued, but the staff itself did not seem to have drawn the full lessons to be learned from the Yugoslav experience, and considerable attention should still be paid to that matter. For the moment, the staff's attitude was a very practical one, as it had concluded that, given present structures, the only pragmatic approach was to reduce wages and incomes as much as was necessary to reach a sustainable situation. That approach, however, avoided dealing with the fundamental problems facing the economy, namely, the trade-offs to be made, including the extent to which efficiency would be sacrificed to the need to satisfy fundamental political and social objectives.

There was a widespread feeling among Executive Directors that interest rates should become more nearly positive in real terms, Mr. de Vries remarked. In a purely economic context, that move would considerably increase efficiency, but it was also important to note the staff's remarks that negative real interest rates had produced a hidden transfer from the richer republics to the poorer ones. In times of economic difficulties, when the republics tended to emphasize local interests more, such a hidden transfer mechanism was important. On the other hand, it was true that in a period of rapid inflation those transfers tended to become disproportionately large.

The authorities felt strongly that they should not resort to debt rescheduling in 1983, Mr. de Vries noted, and the Government and the banks had been willing to find another way to deal with the debt situation. The authorities were very appreciative of the banks' attitude and of the staff's contribution in that area.

It had been suggested by Mr. de Maulde that, instead of accumulating excess budgetary receipts in a blocked account, the authorities should reduce taxation, Mr. de Vries recalled. The intention of the authorities was precisely the opposite. They would rather have a simple system under which they could achieve a surplus in the budgetary accounts. However, the present system, which had been devised with the help of the staff, was an ingenious one and seemed capable of achieving the same end.

To understand why wages were related to the income stream of an enterprise, one had to understand Yugoslavia's system of self-management, Mr. de Vries commented. The workers themselves managed the enterprises, and if there was an increase in the income stream of the enterprise, there was more money to share among themselves. The problem was that the income shares were based on estimated future income. If instead wages would be based on current income streams, an important adjustment would have been made that would fit in well with the system of self-management.

The Chairman made the following summing up:

Directors noted the importance placed by the Yugoslav authorities on meeting external payments obligations in an orderly manner and welcomed the stabilization plan for 1983, which is intended to promote internal and external balance in both the short and medium term. The need for wide-ranging adjustment measures had become more urgent in late 1982 and early 1983 as a result of the smaller than expected improvement in the current account balance with the convertible currency area and the adverse swing in the capital account. Although these developments partly reflected adverse developments abroad, they were also indicative of the urgent need for structural adjustment of the Yugoslav economy.

Directors noted the disappointing economic situation of Yugoslavia after two years of the program with the Fund. They emphasized the inadequacy of adjustment measures of the past years in the face of more difficult external conditions. They welcomed the fact that the real problems seemed to be addressed at last in the present program.

Directors thought it essential to implement restrictive demand management policies. Many considered the official targets for the curtailment of domestic demand to be ambitious but argued that this policy thrust was essential. Given the magnitude of the external debt and the scarcity of available foreign resources, the authorities had no other choice. It was imperative to ensure appropriate allocation of these scarce resources to help achieve external balance in the short term and to bring domestic inflationary pressures under control.

Directors welcomed the emphasis that the program for 1983 placed on the reduction of fundamental distortions, overt and implicit, on both the consumption and investment side, as this was a sine qua non for the achievement of sustainable balance in the economy. Directors noted the important steps already taken by the authorities to bring domestic prices in line with world market prices to improve the efficiency of resource allocation. But a number of Directors, while noting the intention of the authorities to prevent new price distortions from arising, wondered whether this action was sufficient and whether the date by which the authorities hoped to bring about full harmonization--by the end of 1984--was not too far away. Several Directors suggested that the administrative regulations that pervade the pricing mechanism in Yugoslavia might be excessively heavy and could hamper economic incentives.

A number of Directors stressed the policy weakness stemming, in their view, from the negative interest rate structure in Yugoslavia. They doubted whether new controls on inter-enterprise credit would be effective as long as bank deposits continued to be underremunerated. Directors considered it essential that positive real interest rates be established, and viewed the mid-year review as a key opportunity to assess the appropriateness of interest rates.

A number of Directors stressed that the net effect of the new foreign exchange system on export incentives was unclear as the system was overly complex; some suggested that it would be preferable to promote improved integration of the foreign exchange market. If the exchange rate was to be an effective instrument, as was required, an active exchange rate policy would need to be supported by a more market-oriented mechanism for allocating foreign exchange. Some Directors queried whether exchange rate developments foreseen for a number of program countries in this geographical area were fully consistent with one another, and some of them considered that a continuous depreciation would not by itself make up for structural inadequacies.

Directors noted that incomes policy had traditionally been expected to play a central role in the Yugoslav policy strategy but had seldom proved as effective as expected. Recent steps taken to improve the control over the growth of incomes were important but might still prove to be inadequate, in which event it would be essential that more effective instruments of control be developed and implemented rapidly. Therefore, they welcomed the intentions of the Yugoslav authorities to take the necessary steps to tighten controls should the outturn for the first quarter prove unsatisfactory.

Directors noted the prospective tightening of fiscal policy. Although fiscal policy had not usually played a large role in Yugoslav stabilization strategies, a more active use could add to the flexibility of demand management policies and enhance the effectiveness of incomes and credit policy. The limits set on the growth of net domestic assets, which incorporate a substantial rise in velocity, in combination with steps to attempt to control the volume of inter-enterprise credit, should contribute to the constraining of inflationary pressures. These policies, coupled with changes in the structure of interest rates, represented important structural improvements in the Yugoslav financial system and should enhance financial discipline. Directors urged the authorities to pass quickly the necessary but overdue legislation relating to inter-enterprise credit.

Several Directors stressed the pressing need for an improvement in the flow of economic information. This was essential for the authorities themselves if they were going to act as desired and as promptly as required. It was necessary also for those who had to make judgments on the adequacy of policies in Yugoslavia.

Directors expressed satisfaction at the efforts of the international banking community and of cooperating governments to arrange external financing supplemental to the Fund's resources. This would permit adjustment policies to be carried out more efficiently than would have been possible if a further significant compression of imports would be required. They stressed the need to put these elements of the financing package in place speedily and effectively.

In general, Directors considered the external financing plan for Yugoslavia to be tight. They thought that it would be crucial for the Yugoslav authorities to pursue their adjustment strategy with determination, and that they should be prepared to strengthen policies during 1983. The need for continuing the current adjustment efforts was pressing, given the medium-term nature of the Yugoslav economic problems and the immediate external constraints. In that respect, Directors welcomed the intentions of the Yugoslav authorities to seek a continuous monitoring of their arrangements with the Fund.

Mr. Zhang noted that various calculations for the stand-by arrangement had been based on a projected rate of inflation of 20 per cent. Would a larger increase in the rate than the projected rate entail a further severe deflation of the Yugoslav economy in the coming period?

The staff representative from the European Department replied that the performance criteria had been based on the staff's assessment of the economic prospects. The criteria, and the estimated increase in velocity, had been based in part on the interest rate changes which, the staff had felt, would encourage a shift from M-1 to M-2, a reversal of the trend in 1982. The staff had not suggested performance criteria for the second half of 1983 because it had wished to guard against mistaken forecasts of developments in the Yugoslav economy. The authorities' estimates of both expenditures and revenues were based on a projected rate of inflation of 20 per cent. At present, the projection was 25 per cent. The staff believed that the rate of inflation would be considerably higher than the original projection, and that actual revenues would outstrip projected revenues. Accordingly, the staff had asked the authorities either to act quickly to redistribute the excess revenues to the economy, or to freeze excess revenues at the National Bank, or both.

The Director of the European Department added that, as Mr. Zhang had suggested, if the rate of inflation was 30 per cent, or even higher, as was quite likely, the program would become much more stringent than it was at present. The staff had made some allowance for a higher rate of inflation, but the program would still have to become more stringent than it was if the actual inflation rate greatly exceeded the projected rate. The situation would of course be carefully examined during the June 1983 review.

The Chairman remarked that he had wished to wait until the completion of the present discussion on Yugoslavia before approaching the governments concerned about the guarantees they provided on loans to Yugoslavia. The intention was for the Fund to play a catalytic role in encouraging governments to extend the agreed guarantees.

The Executive Board then took the following decisions:

Decision Concluding 1982 Article XIV Consultation

1. The Fund takes this decision in relation to Yugoslavia's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1982 Article XIV consultation with Yugoslavia in the light of the 1982 Article IV consultation with Yugoslavia conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Yugoslavia continues to maintain the restriction on the availability of foreign exchange for travel as described in EBS/83/46 (2/24/83). In the circumstances of Yugoslavia, the Fund grants approval for the retention of this exchange restriction until the completion of the next Article IV consultation or February 28, 1984, whichever is earlier. The Fund notes the existence of external payments arrears and the intention of the authorities to eliminate them at an early date. In the circumstances, the Fund grants approval of maintenance of external payments arrears until August 14, 1983.

Decision No. 7362-(83/47), adopted
March 11, 1983

Review Under Stand-By Arrangement

1. The Government of Yugoslavia has consulted in accordance with paragraph 3(b) of the stand-by arrangement for Yugoslavia (EBS/81/5, Sup. 2, 2/2/81) in order to establish performance criteria subject to which purchases may be made by Yugoslavia during the third year of the stand-by arrangement.

2. The letter from the Governor of the National Bank of Yugoslavia and the Federal Secretary for Finance of Yugoslavia, dated December 30, 1982, and the Supplement to that letter dated February 18, 1983, setting forth the policies and measures which the authorities of Yugoslavia will pursue for the third year of the stand-by arrangement, shall be annexed to the stand-by arrangement for Yugoslavia, and the letter of January 15, 1981, annexed to the stand-by arrangement, as supplemented by the letter of January 25, 1982, shall be read as supplemented by the letter of December 30, 1982 and the Supplement dated February 18, 1983.

3. Yugoslavia will not make any purchase under the stand-by arrangement that would increase the Fund's holdings of its currency in the credit tranches to more than 25 per cent of quota or increase the Fund's holdings of its currency resulting from purchases of supplementary financing to more than 12.5 per cent of quota

a. during any period in which:

(i) the intention as regards the exchange rate expressed in the last sentence of paragraph 3 of the annexed letter and in Section II of the Supplement dated February 18, 1983, is not being carried out;

(ii) the intentions as regards interest rates expressed in paragraph 8, sentences 1 through 4, and paragraph 9, sentences 2 through 4, of the annexed letter have not been carried out; or

b. during any period in which:

(i) the data for the preceding period indicate that the limit on outstanding net domestic assets of the banking system described in sentence 4 of paragraph 6 of the annexed letter and as specified in the attached Memorandum of Understanding, Annex 2, as amended by Section I of the Supplement, has been exceeded; or

(ii) there has been an increase in credit by the National Bank of Yugoslavia to the budget of the Federation, as referred to in sentence 8 of paragraph 6 of the annexed letter; or

(iii) the limit on foreign debt mentioned in paragraph 10, sentences 5 through 7, of the annexed letter and described in the attached Memorandum of Understanding, Annex 4, is not being observed;

(iv) the intentions relating to public sector expenditures stated in sentences 3, 4, and 5 in the first paragraph of Section III of the Supplement are not being observed; or

c. After May 14, 1983, if the progress toward the provision of external bank financing for Yugoslavia, as regards amount and timing, is not sufficient; or

d. After August 14, 1983, if suitable performance criteria have not been established in consultation with the Fund as contemplated in paragraph 12 of the annexed letter or while such criteria, having been established, are not being observed.

4. Purchases under this stand-by arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 1,283 million until May 15, 1983, the equivalent of SDR 1,433 million until August 15, 1983, and the equivalent of SDR 1,533 million until November 15, 1983.

5. The Fund waives the application of the performance criterion in the first subparagraph of paragraph 3 of Decision No. 7058-(82/23) (Review and Consultation Under Stand-By Arrangement, adopted February 22, 1982) and waives until August 14, 1983 the application of the performance criterion in paragraph 3(c)(i) of the stand-by arrangement in EBS/81/5, Supplement 2 (February 2, 1981) in respect of the arrears existing during 1983.

6. In paragraph 1 of the stand-by arrangement for Yugoslavia (EBS/81/5, Sup. 2, 2/2/81), the phrase "For a period of three years from January 30, 1981" shall be replaced by "For the period from January 30, 1981 to December 31, 1983."

Decision No. 7363-(83/47), adopted
March 11, 1983

2. DESIGNATION PLAN AND OPERATIONAL BUDGET FOR MARCH-MAY 1983

The Executive Directors continued from the previous meeting (EBM/83/46, 3/11/83) their consideration of the proposed designation plan for March-May 1983 (EBS/83/48, 2/28/83; and Sup. 1, 3/10/83) together with the proposed operational budget for March-May 1983 (EBS/83/49, 2/28/83; and Sup. 1, 3/10/83).

Mr. de Vries said that he attached importance to maintaining the practice of holding a full discussion on the proposed designation plan and operational budget in order to keep them running smoothly. The proposed decisions, as amended, were fully acceptable. On the present occasion the staff had understandably had little time to prepare the papers, and the Executive Directors had therefore had relatively little time to examine them.

The staff representative from the Treasurer's Department remarked that Australia's reserves had fallen by more than SDR 2 billion. The staff had no information suggesting that a reflow of funds had occurred. It was true, as Mr. Grosche had mentioned, that some of the countries listed in the appendix to the designation plan provided no data to the Fund and others were providing data on a basis that was not particularly timely. Indeed, the data provided by some of the countries was becoming gradually less timely, and the Bureau of Statistics was quite concerned about the matter and had been pressing, in concert with the area departments, for provision of more timely data.

At the time the proposed designation plan and operational budget had been drawn up, the staff representative from the Treasurer's Department explained, the staff had felt that the balance of payments and gross reserve position of Bahrain had met the criterion for inclusion. It was of course possible that the situation had changed since then, and the decision to exclude or include Bahrain was in the hands of the Executive Board.

Mr. Finaish stated that his authorities hoped that the Executive Board would exclude Bahrain from the proposed designation plan and operational budget because of the adverse impact of oil price developments on Bahrain's revenues and reserves. Bahrain had been included in each of the three previous designation plans and operational budgets, and the proposed amounts for Bahrain in the new designation plan and operational budget were small.

The staff representative from the Treasurer's Department said that the situation of oil exporters like Bahrain had changed substantially since the drawing up of the proposed designation plan and operational budget. It might be best to agree to exclude Bahrain, and to review the situation carefully on the occasion of the discussion on the next designation plan and operational budget. The amount for Bahrain in the proposed designation plan and operational budget could be deleted, thereby reducing the totals for each by the corresponding amount.

Mr. Morrell remarked that there had been a substantial increase in reserves in Australia since the latest devaluation. However, the level of reserves was still substantially less than it had been at end-January 1983, which was the level on which the proposals were based.

The Executive Directors then turned to the proposed decisions as amended, which they approved.

The decisions were:

Designation Plan

The Executive Board approves the designation plan for the quarterly period beginning March 11, 1983 as set out in EBS/83/48, Supplement 2.

Decision No. 7364-(83/47) S, adopted
March 11, 1983

Operational Budget

The Executive Board approves the list of members considered sufficiently strong as set out in EBS/83/49, Supplement 2, page 3, footnote 1, and the operational budget for the quarterly period beginning March 11, 1983, as set out in EBS/83/49, Supplement 2.

Decision No. 7365-(83/47), adopted
March 11, 1983

APPROVED: August 17, 1983

ALAN WRIGHT
Acting Secretary