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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 83/90

10:00 a.m., June 24, 1983

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

Executive Directors	Alternate Executive Directors
	W. B. Tshishimbi
J. de Groote	H. G. Schneider
	A. Le Lorier
	P. D. Péroz, Temporary
	M. Teijeiro
R. D. Erb	
M. Finaish	T. Alhaimus
	S. R. Abiad, Temporary
	Jaafar A.
	T. Yamashita
R. K. Joyce	M. Casey
	C. Robalino
G. Laske	
G. Lovato	C. P. Caranicas
	A. S. Jayawardena
	J. E. Suraisry
J. J. Polak	
	K. G. Morrell
G. Salehkhou	O. Kabbaj
	E. I. M. Mtei
	E. Portas, Temporary
J. Tvedt	
N. Wicks	C. Taylor
Zhang Z.	Wang E.

L. Van Houtven, Secretary
R. S. Franklin, Assistant

Also Present

Asian Department: E. Gurgen, G. Szapary. European Department: L. A. Whittome, Counsellor and Director; L. Alexander, P. B. de Fontenay, L. Hansen, P. C. Hole, H. B. Junz, M. Z. Khan, B. J. Nivollet, J. K. Salop, J. Somogyi, G. Tyler. Exchange and Trade Relations Department: M. Allen, G. Belanger, H. W. Gerhard, S. Kanesa-Thasan, N. Kirmani. External Relations Department: A. M. Abushadi, P. B. de Fontnouvelle. Fiscal Affairs Department: M. Z. Yucelik. IMF Institute: H. Auth, C. Dizdar, F. Öztrak, I. Szalkai, Participants. Legal Department: W. E. Holder. Research Department: R. Saracoglu. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: J. Delgadillo, S. El-Khouri, L. Ionescu, P. Kohnert, H.-S. Lee, P. Pêterfalvy. Assistants to Executive Directors: E. M. Ainley, H. Arias, L. Barbone, J. Bulloch, M. Camara, M. B. Chatah, L. E. J. Coene, T. A. Connors, M. K. Diallo, G. Ercel, C. Flamant, I. Fridriksson, M. Hull, H. Kobayashi, M. J. Kooymans, P. Leeahtam, V. K. S. Nair, Y. Okubo, J. K. Orleans-Lindsay, G. W. K. Pickering, C. A. Salinas, J. Schuijer, Shao Z., D. I. S. Shaw, M. Toro, Wang C. Y., A. Yasseri, Zhang X.

1. TURKEY - 1983 ARTICLE IV CONSULTATION, AND STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1983 Article IV consultation with Turkey together with a request for a one-year stand-by arrangement equivalent to SDR 225 million (EBS/83/98, 5/20/83; and Cor. 1, 5/25/83). They also had before them a report on recent economic developments in Turkey (SM/83/114, 6/6/83).

The staff representative from the European Department made a brief oral statement regarding Turkey's exchange rate policy and certain performance criteria under the program.

Mr. de Groote made the following statement:

The stand-by arrangement proposed today for your approval is of great importance for Turkey and for the Fund: by asking for a new stand-by arrangement after the successful implementation of a three-year program, Turkey shows its confidence in the adjustment policies supported by Fund resources. The previous three-year stand-by arrangement achieved several remarkable results in spite of the world recession, deteriorating terms of trade for Turkey, problems in the international capital markets, and a generalized world trend toward protectionism. The Turkish Government wishes to maintain uninterrupted its successful stabilization efforts, including the further implementation of structural reform, and also to continue the close relationship with the Fund that made this progress possible. The proposed program thus has aspects that go beyond the limits of the purely financial sphere.

The unflagging and determined efforts of the Turkish authorities in implementing the program of stabilization and structural reform launched in 1980 have yielded considerable progress in the fundamental restructuring of the Turkish economy, while at the same time controlling inflation and restoring external equilibrium. The annual inflation rate, based on the wholesale price index, fell from 107.2 percent in 1980 to 36.9 percent in 1981 to 25.2 percent in 1982, and is not expected to exceed 20 percent in 1983. The performance of external accounts over the past three years has also been impressive. The current account deficit was reduced from 6.3 percent of GNP in 1980 to 2.2 percent in 1982; it will probably amount to 1.3 percent of GNP in 1983. Continuous restraint in the fiscal and monetary spheres, together with the introduction of a flexible exchange rate, positive real interest rates, and wage restraints in both the public and private sectors have contributed to these achievements. Other objectives of the program, which will require more time to be fully realized, were to redirect the economy toward a development path placing more reliance on market forces in order to improve resources allocation, and to adopt a more externally oriented strategy overall.

The improvement in the external account is based on a marked expansion of exports, the containment of imports, and favorable developments with respect to invisible receipts and capital flows. Exports increased in value by 29 percent in 1980, by 62 percent in 1981, and by 22 percent in 1982. The performance of exports is the more remarkable in that the increase was distributed across the board as regards both product groups and geographical areas. The sectoral distribution of exported goods suggests that the industrial sector was the main contributor to the export boom of 1981 and 1982. During these two years the value of manufactured exports increased by 119 percent and 50 percent, respectively. This growth in manufactured exports was realized mostly through the penetration of new markets in reaction to protectionist trends in the EC, as is shown by the geographical distribution, which reflects important progress in the Middle Eastern markets. The Turkish authorities believe that this is not an isolated development, but expect further export growth: total exports still amount only to about 11 percent of GNP--about $120 per capita--and Turkey's share in the imports of its four main Middle Eastern trading partners is minimal at about 2 percent. After a small increase in 1981, import value actually decreased in 1982, mainly as a result of a decrease in import prices in response to the drop in oil prices and to the elimination of a premium previously paid by Turkish importers. Import volumes were kept low mainly through reduction in stocks. The current account was further improved by the continuous inflow of invisible receipts. Thus, despite the fact that neither financial assistance from the banks nor special assistance under OECD arrangements was as large as had been expected, capital continued to flow in, and the overall balance registered a surplus of US$0.3 billion in 1982. This favorable balance of payments trend helped greatly to increase external confidence, and by the end of 1982, Turkey saw, for the first time since 1979, an increase, even though a relatively modest one, in its medium-term syndicated commercial borrowing. This is an important step forward, since Turkey intends to rely more on commercial borrowing, and will approach the international financial markets to finance its development efforts. The improvement in the balance of payments also permitted a reversal in the real growth trend from a decline in 1979 and 1980 to an increase of 4.2 percent in 1981 and 4.4 percent in 1982, an extraordinary performance in the face of the demand policies then being pursued.

In order to restrain domestic demand, a tight monetary policy was maintained; at the same time, interest rates were deregulated to reflect market conditions and thereby encourage private savings. Certain unforeseen developments in 1982, including the dramatic improvement of the balance of payments position and a faster than expected increase in the reserve money multiplier, led the Government to restrain the rate of monetary expansion and improve the efficiency of monetary policy. Tight monetary conditions will be maintained in 1983 to reduce inflation and to achieve external aims; monetary targets have been established consistent with a 1983 inflation target of 20 percent and a 1983 growth rate of 4.8 percent of GDP. In order to reduce the cost of borrowing, which has been excessively high, interest rates on time deposits have been lowered by 5 percentage points, and lending rates will be lowered by 4 percentage points effective July 1, 1983. Even with these reductions, interest rates will remain positive in real terms.

As to public finances, various factors have made it possible to reduce public sector borrowing requirements from 14.5 percent of GNP in 1980 to 5.5 percent in 1982. This dramatic turnaround was achieved by the implementation of the tax reforms of 1981, the more effective control of expenditures to match actual revenue trends, and a more effective performance of the State Economic Enterprises (SEEs). The tax reform resulted in a significant increase in budgetary revenues for 1981, followed by a performance in 1982 that fell below expectations owing mainly to a gradual reduction of personal income tax rates, delayed tax payments by companies because of the tightening of financial conditions in that year, and the decline in the inflation rate. For 1983, a number of measures have already been taken to improve tax collection, strengthen tax administration, and link income taxes of the self-employed more closely to the taxpayers' wealth. The authorities have also strengthened the financial performance of the SEEs by making them more responsive to market forces, thus reducing their need for transfers.

Since the previous program succeeded in bringing domestic demand into line with balance of payments requirements, the present program can focus more on structural improvements to the economy: this will primarily involve expanding the reforms initiated under the previous program, such as the reorientation of the economy toward exports, the reform of the financial system, and the reform of the SEEs.

The export orientation of the Turkish economy will be further enhanced through the application of a flexible exchange rate policy, further liberalization of imports, and the easing of exchange restrictions, with the expected result that exports will increase further as a percentage of GDP.

The importance of the financial sector to the overall structural adjustment process is reflected in the implementation of several measures aimed at improving the efficiency of credit allocation, introducing more competition into the financial sector, and reducing the cost of credit. Institutions will be strengthened, a deposit insurance scheme set up, and the functioning of the capital markets improved. A new banking law empowering the Government to issue decrees affecting these main areas will soon be enacted. This is in addition to the several laws and decrees already implemented in 1982 to improve conditions in the capital markets and to enable firms to revalue their fixed assets and strengthen their financial positions, which had been eroded by the devaluation of those assets during the period of high inflation.

The new strategy for the SEEs was carried further in May 1983. The principles and guidelines embodies in the decree promulgated at that time are explained in the staff papers. Because of the great importance of SEE reform for the achievement of the program's medium-term objectives, the Government will continue to seek further improvements which will necessarily be gradual, since they will require an overhaul of the managerial approach of the SEEs. The World Bank's structural adjustment loan specifically aims at reinforcing and monitoring the difficult process of financial and managerial reform in the SEEs.

The need to promote a better sectoral distribution of economic activity has led the Government to adopt measures for improving agricultural productivity and increasing agricultural exports, and to give the highest priority to the energy sector.

The dramatic improvement in resource allocation has not yet affected the high level of unemployment, which stands out as the major problem still awaiting solution. The unemployment rate increased from 13 percent in 1975 to about 18 percent in 1982. The authorities believe that, in the medium term, structural improvements in the economy will optimize the relationships among growth, employment, and the balance of payments, and provide some relief or partial solution of this problem. Appendix IV of the staff report adequately illustrates that this optimization depends crucially on a greater export reorientation of the Turkish economy. The higher the level of exports, the more reliance can be placed on external borrowing, which means that higher level of income growth can be obtained while maintaining the same debt service ratio which would accompany a more deflationary approach to the Turkish adjustment problem. The perception has been growing in Turkey that an outward-looking orientation of the economy is the only way out of the present situation, and this perception renders the process of export reorientation irreversible. It is therefore imperative for the present policies to generate an increase in income large enough to provide an even broader base for that perception.

The staff paper clearly demonstrates how the new stand-by is basically an extension of the previous three-year stand-by just completed. Through this new arrangement, the Government intends to continue the policies pursued during the previous stand-by arrangement in order to make further needed progress in reducing the current account deficit, lowering the inflation rate, continuing wage restraint, and strengthening public finances through a mix of demand and structural measures. The new stand-by arrangement is intended to enhance confidence in the international banking community during the time when the Turkish economy is in a state of transition toward a more sustainable export-oriented development path. In this, the stand-by arrangement is fully in accord with the catalytic role the Fund is supposed to play in these unsettled times, and is therefore in my view fully justified. I therefore ask the Board to give its approval to the proposed arrangement.

Mr. Laske stated that he could warmly support Turkey's request for a one-year stand-by arrangement. Remarkable progress had been made under the previous arrangement in controlling the rates of inflation and monetary expansion and improving the external current account and the fiscal performance. Still, the adjustment of the economy and the correction of major distortions had not yet been completed; while monetary and fiscal policy had been put on a sounder and more appropriate footing over the previous three years, progress in improving important structural adjustments had been slow.

Monetary policy seemed particularly deserving of close attention by the authorities if the gains already achieved were to be preserved, Mr. Laske continued. The collapse of an important financial institution in 1982 had exposed structural shortcomings in Turkey's banking system. The new banking law recently passed by Parliament should provide the authorities with an opportunity to introduce structural and operational improvements in the system while facilitating the conduct of monetary policy. The authorities had been attempting to control credit expansion mainly through quantitative restrictions, and the freeing of interest rates from government direction had been expected to induce more price-oriented elements into the allocation of credit. Unfortunately, the process had not developed as expected; the reformed arrangements had led to an interest-rate cartel, which was dominated by the largest banks and tolerated by the Central Bank. It was to be hoped that the new mechanism for setting interest rates--which, in his view, was a second-best solution--would not lead to renewed distortions in the structure of interest rates and would not inhibit timely adjustment of rates to changed circumstances.

The overshooting of the projections for the monetary aggregates in 1982 and early 1983 had been attributed, inter alia, to the liquidity effect of money inflows through the balance of payments and to the nonobservance of the reserve requirements by the banks, which had occurred in the wake of the previous year's difficulties in the banking system, Mr. Laske went on. He wondered why the sterilization of the foreign exchange inflows had proved to be less effective than desirable. In any event, he welcomed the fact that increased attention would be paid under the proposed stand-by arrangement to the nonobservance of reserve requirements, with the avoidance of new reserve deficiencies having been made a performance criterion.

The monetary aggregates had expanded more strongly than anticipated in the first quarter of 1983, and reserve money growth was estimated to reach a rate of 42.5 percent in the first five months of the year, Mr. Laske commented. To achieve the target of a 24.5 percent increase for the year as a whole would require a sharp decline in the growth of reserve money in the remainder of the year, and he wondered whether the current stance of monetary policy in Turkey would allow for such a decline.

Turning to the fiscal situation, Mr. Laske recalled that one of the disturbing elements in the public sector finances had been the poor performance of the State Economic Enterprises. He was pleased to note that there had been strong improvement in the financial situation of those enterprises as a result of more cost-oriented pricing policies; however, further improvements were needed in management, control of investment, and the size of the work force. He hoped that the new law covering the State Economic Enterprises would facilitate the implementation of those reforms. In that respect, he was pleased that the established limits for budget transfers to the State Economic Enterprises had been made a performance criterion of the stand-by program.

The recorded improvement in the external accounts--particularly the strong increase in the export of manufactured goods--had to a large extent been due to the flexible application of exchange rate policy in Turkey, Mr. Laske continued. Restoration of the external competitiveness of Turkish exports had been an essential element in the gain in market shares and the diversification of exportable goods. Because prospects for further market gains in certain regions were currently less bright than they had been in recent years, the authorities should continue with a flexible exchange rate policy, particularly given the still rather high rate of inflation in Turkey.

Good export performance would also be a necessity in future because Turkey was entering a period in which the capital account was likely to register declining surpluses, as was signaled by the projections for 1983, which showed a further slowing of official balance of payments assistance and a rise in repayment obligations, Mr. Laske said. It was obvious that Turkey would continue to need capital inflows--which would have to be obtained mainly from the private markets--meaning that foreign creditors would have to have confidence in the effectiveness and credibility of Turkey's economic policy. It should be possible to engender such confidence if the authorities continued to demonstrate the same determination and capacity to address problems that they had shown over the previous three years.

Finally, Mr. Laske noted from Table 4 of EBS/83/98 that, without taking account of the potential use of Fund resources, Turkey's net official reserves were projected to increase in 1983 by just under $500 million, following a similar increase in 1982. Turkey's international reserves were not excessively high; nor were the forecast increases exorbitant. However, if the actual reserve increases surpassed the projections by a significant amount, the Turkish authorities might wish to consider not drawing on the resources to be made available under the proposed stand-by arrangement.

Mr. Péroz stated that he also was in agreement with the staff appraisal and could support the proposed decisions. On the occasion of the review of the previous stand-by arrangement, it had been clear that Turkey had, on the whole, been successful in implementing its adjustment program. Still, progress had been somewhat uneven, particularly in certain areas of needed structural reform, and the proposed stand-by arrangement was therefore warranted. Moreover, although the Turkish economy appeared able to function at a lower level of official assistance than in the past, Turkish creditworthiness had still to be completely restored; he hoped that the new stand-by arrangement would help toward that end.

It was encouraging to note that the authorities remained committed to further progress in the area of structural reform, Mr. Péroz continued. Laws recently introduced should provide for a framework within which public and State Economic Enterprises would be able to function more effectively. As a consequence, the World Bank had released the second tranche of the third structural adjustment loan to Turkey, and had offered technical assistance in improving the efficiency of the State Economic Enterprises.

The real test of the success of the authorities' efforts would be in the response of the financial markets, Mr. Péroz considered. During 1982, Turkey had regained some access to international capital markets, at the cost of a small decline in the overall exposure of foreign banks. It was to be hoped that the economy's progress throughout 1982 and 1983 would lead the banks shortly to resume net lending on a significant scale and on broadly acceptable terms. The fact that the debt service ratio on foreign debt was expected to decline further in 1983 and 1984 should add to the confidence of the banks, but the improvement would be possible only through continued progress on the export side, a development that was dependent upon two conditions: first, the maintenance of adequately restrictive demand management policies; second, the pursuit of an appropriate exchange rate policy. Fiscal policy was already well restrained, particularly on the expenditure side, although it was not certain whether revenue projections would be fully realized, and the authorities should remain prepared to make further expenditure cuts if revenues did not measure up to expectations. With regard to the exchange rate, it was clear that the flexibility observed in the past had been an essential factor in the remarkable performance of the export sector. However, given the risk that some of Turkey's most important export markets might not expand as rapidly as they had previously, continued exchange rate flexibility was in order. In that regard, he had no difficulty with the approach to be adopted under the proposed stand-by arrangement.

Mr. Casey remarked that the Turkish authorities should be commended for their achievements under the previous stand-by arrangement, which could serve as a good example for countries currently experiencing severe debt servicing problems. It was clear from Turkey's performance under the previous arrangement that a country need not forgo real economic growth in order to attain a sustainable external position. The improvements that had been made possible by the previous arrangement had helped Turkey through the crisis of the late 1970s and had laid the foundation for a viable balance of payments position in future. He could therefore support the new stand-by arrangement, which should help the authorities to consolidate the gains made thus far and to make further progress with needed structural adjustment. However, he noted that Turkey's overall balance of payments for 1983 was projected to be in considerable surplus; while recognizing that the stand-by arrangement would bring a measure of confidence to Turkey's creditors, he agreed with Mr. Laske that the authorities should be encouraged not to draw the full amount under the stand-by arrangement if at all possible.

A fundamental goal of the proposed program was to increase Turkey's access to commercial capital markets as a replacement for concessional lending and Fund assistance, Mr. Casey observed. Clearly, the caution generally being shown by banks could limit Turkey's ability to raise the necessary capital, although there had recently been some increase in medium-term syndicated commercial borrowing. He noted, in passing, that the authorities were beginning to improve their debt recording system, and he wondered whether technical assistance from the Fund in that area might be helpful.

It would be necessary under the program to continue the fight against inflation, Mr. Casey considered. Although the Turkish authorities should be commended for the progress made thus far in reducing inflation, it remained high by international standards. Consideration should be given to a further tightening on the monetary side, especially in light of recent increases in velocity and in the reserve money multiplier. It was not clear that a tighter monetary stance would adversely affect domestic objectives such as growth and employment; besides, monetary policy should be more concerned with external rather than with domestic objectives in a relatively open economy. On a further point related to monetary policy, he was somewhat concerned that the procedure chosen for the setting of interest rates might lead to an accommodating monetary policy. In the circumstances, developments in monetary policy should be monitored closely.

Increased emphasis should be given to structural adjustment in Turkey, Mr. Casey said. One important element of such adjustment would be an improvement in the efficiency of the State Economic Enterprises. In that regard, he noted that the freezing of transfers to those enterprises and the measures already taken to improve their management had helped to produce some surpluses. On a related matter, while the establishment of a new category of government-owned organizations--the public economic enterprises--might help to increase the managerial flexibility of the State Economic Enterprises, organizations in the new category should also be run efficiently, and efforts should therefore be made to ensure that prices in the new category were allowed to reflect market forces. Finally, it would have been helpful if the staff had provided more information on the specific improvements to be made in the State Economic Enterprises and on how the new laws governing those enterprises were likely to work in practice.

In other areas of fiscal policy, Mr. Casey considered that the authorities should be encouraged to improve tax collections as soon as possible, especially since reductions had been made in several tax rates. A continued effort should also be made toward trade liberalization; in that respect, he welcomed the decision to eliminate import guarantee deposits by June 1984, and he hoped that the authorities would proceed rapidly in moving away from restricted import licenses.

On exchange rate policy, Mr. Casey noted that the flexibility exercised in the past had led to a depreciation of the real effective exchange rate, which meant that competitiveness had been improving. In that connection, he wondered how far the Turkish lira was from its equilibrium rate.

Mr. Salehkhou remarked that, with the successful completion of the three-year adjustment program, the Turkish authorities had demonstrated their determination to take serious measures in the face of a partly adverse external environment. The previous rate of growth in Turkey's export markets in the Middle East and neighboring countries would probably not last, and the authorities should prepare for a time when competition would be intense.

Except in a few areas, almost all the objectives of the previous three-year adjustment program had been achieved, Mr. Salehkhou continued. Inflation had subsided significantly; the current account deficit had been reduced; the budget deficit and wage claims had been cut back; and creditable economic growth had been restored. The economy had also witnessed rapid improvement in trade liberalization and in the elimination of payments arrears, and the exchange rate policy had been managed flexibly. Moreover, the performance criteria under the adjustment program had all been fulfilled. As for the areas in which progress had been less rapid, unemployment had continued to be a major problem, but all indications were that, over time, the significant GNP growth rates that had been achieved would create greater employment opportunities. Another potential problem area was the monetary sector, where a fine balance must be struck between the growth potential of the economy--necessitating easier credits--and the urgent need for a further reduction in the rate of inflation. The Government had embarked on a series of reform measures aimed at strengthening the management of the banks and streamlining their financial operations, although more needed to be done to restore confidence fully in the financial sector following the difficulties that had been experienced in 1982.

In general, there was a need to pursue structural reform in all sectors of the economy, Mr. Salehkhou commented. For example, further improvements in the State Economic Enterprises were needed, and it was important to continue the reform measures already undertaken. In that connection, he welcomed the recently passed law that, inter alia, would require the State Economic Enterprises to comply with annual investment and financing programs and determine prices in light of market forces.

The proposed stand-by arrangement was a reflection of the previous arrangement and continued many of its objectives, Mr. Salehkhou noted. GNP was to be increased by 5.3 percent in 1984, and the program contemplated other measures aimed at further reducing the current account deficit. However, he had hoped that the new program would place greater weight on such crucial areas as the reform of the monetary system, the State Economic Enterprises, and government revenues and taxation; at first glance, it seemed that a longer program would be required to achieve the progress needed in those areas, although the proposed one-year program should go some way toward strengthening the economy. Hence, he could support the proposed decisions.

Mr. Wicks stated that, like others, he could support the staff appraisal and proposed decisions. The Turkish authorities were to be commended for having completed the previous three-year program on target; their success should prove to others that positive and determined efforts could yield good results quite quickly. Nonetheless, it was clear that progress in the area of structural reform had fallen somewhat short of expectations, and he therefore welcomed the assurances of the staff and the Turkish authorities that the follow-on program would come to grips with the underlying structural problems in the economy, particularly the need for further trade liberalization and a radical improvement in the finances of the State Economic Enterprises. In that regard, it was worth noting that, because of the heavy use that had already been made of Fund resources, drawings under the proposed stand-by arrangement would push Turkey close to the 600 percent of quota limit on cumulative access. If, after mid-1984, Turkey wished to make further use of Fund credit, any subsequent arrangement could be of only modest size, even taking into account the quota increase under the Eighth Review. In the circumstances, he agreed with the suggestion by Mr. Laske and Mr. Casey that, where possible, the Turkish authorities should make an effort to manage without drawing on the full amounts available under the stand-by arrangement.

The lack of a fully effective monetary policy in Turkey continued to be cause for concern, Mr. Wicks remarked. The 1982 banking crisis and other developments had underlined the need for structural reforms in the banking system and for a general strengthening of the financial sector. He therefore welcomed the prospective implementation of the measures contained in the new banking law passed by Parliament in April 1983; it was encouraging to note that the authorities were continuing to explore alternative methods of monetary control. In general, the accommodating nature of monetary policy had in the past allowed high levels of inflation to persist in Turkey, and he therefore endorsed the staff's view that the achievement of the inflation target and the aims on the external side would require somewhat greater restraint in credit expansion than had seemed necessary only a few months previously.

On the fiscal side, the significant decline in the public sector borrowing requirement (PSBR) as a proportion of GNP since 1980 was a welcome improvement and the product of some considerable effort on the part of the authorities, Mr. Wicks continued. He wondered whether the staff believed that the new financing requirements recently introduced by the Treasury would make life easier for the authorities; indeed, it would be interesting to know the extent to which the requirements had facilitated the elimination of budgetary arrears, which might otherwise have undermined the public sector credit ceiling of the central bank. Further progress in reducing the PSBR would be necessary if the financial targets for 1983 and 1984--which assumed a further increase in the productivity of public and State Economic Enterprises--were to be met. In that regard, he hoped that the recent improvements in financial performance were a reflection of increased efficiency as well as price increases. It was also to be hoped that the enactment of the decree governing reform in the State Economic Enterprises would allow market forces a greater role in the determination of manpower levels and prices. Vigorous implementation of the law should ensure that the demands of the public and State Economic Enterprises on public resources would continue to decline; the provision of technical assistance by the World Bank at the enterprise level should be of help in that regard.

The adoption of a more flexible exchange rate policy had been a major factor in the improved current account balance in Turkey, Mr. Wicks observed. He shared the staff's commendation of the authorities' intention to continue with existing exchange rate policies, because export competitiveness would be essential to a stable external position. There remained a few indications that the exchange rate adjustment accomplished thus far might not be fully adequate. One sign was a slowdown in export growth; another was the suggestion of a possible revival of a parallel exchange market. He would welcome comments from either Mr. de Groote or the staff on those matters.

Further progress toward trade liberalization was also important, Mr. Wicks said. In that regard, he noted that the staff was not recommending approval of the one remaining bilateral payments arrangement. He agreed with the staff that "protection by way of a rationalized tariff regime at an appropriate exchange rate will greatly benefit the economy in the longer run."

The importance of a sustained reduction in the current account deficit could not be overstated, especially since the banks remained wary about their exposure in Turkey, Mr. Wicks remarked. There were some disturbing signs that the improvement in the current account might be faltering: exports had grown at an annual rate of only about 4 percent in the first quarter of 1983 as against a target of 15 percent for the year; moreover, remittances from workers abroad had declined steeply. He noted that the staff felt that the official forecast of \$0.6 billion for the 1983 current account deficit, which was lower than the previous estimate, was optimistic in the light of the adverse effect of lower oil prices on the demand for exports in the Middle East. He invited the staff's comments on the likelihood of achieving the forecast for the year in the light of the first quarter's results.

Mr. Jaafar agreed with others that the Turkish authorities had made remarkable progress toward stabilization and structural adjustment under the previous three-year program. Inflation, which had reached a peak in 1980, had dropped sharply to 26.5 percent in 1982 and was targeted to fall to 20 percent in 1983 and to 17 percent in 1984. Those targets should be within reach if the authorities resolutely continued to implement stabilization policies. He was also encouraged to note the positive overall growth of the economy, particularly the good export performance. However, further improvements were needed, especially in the financial and fiscal areas. The interest rate structure should be simplified, public finances required further rationalization, and revenues--which had remained sluggish in 1982--would need to be bolstered.

External debt had in the past been a cause for concern, Mr. Jaafar went on, and he was therefore encouraged by the continued improvement in the area of external debt in recent years. Still, the debt servicing level--which had stood at 27 percent in 1982 and was projected to be at 25 percent in 1983--remained on the high side. Perhaps the debt servicing burden would be eased by a further improvement in the current account position.

More rapid capital inflows than had been achieved in the past three years were essential for Turkey's development, Mr. Jaafar considered. In that respect, the authorities should, inter alia, further improve and encourage direct foreign investment and participation in Turkish development. There had been some success of late in raising loans in the private international capital markets, but further improvements in the balance of payments position would be necessary to encourage additional foreign lending to Turkey.

The comments by Mr. de Groote on the unemployment situation in Turkey touched on an important issue regarding the country's economic development, Mr. Jaafar commented. The current 18 percent level of unemployment was high by any standard and should be a cause for serious concern; yet, he had seen little detailed coverage of unemployment in the staff report. Appendix IV of the staff paper showed different scenarios for medium-term development in Turkey and gave some sense of the enormity of the unemployment problem. However, it was apparent from those scenarios that external stability was considered more important. The trade-off between external stability and unemployment would of course depend crucially on assumptions about export and import performance.

Export growth in Turkey in the previous three years had been spectacular, especially given the global economic recession and the protectionist measures adopted by EC countries against Turkish exports, Mr. Jaafar observed. The main factor in that success had been the increase in Turkey's export shares in Middle Eastern markets. While he supported the efforts to continue to expand market shares in those countries and elsewhere, he was doubtful about the potential for further expansion in the Middle East because of recent adverse developments on the oil front. Hence, the authorities should also be making an effort to increase Turkey's share in its traditional markets, where the scope for growth might be greater. In that regard, he could support the proposed one-year program, which aimed at promoting the competitiveness of Turkish exports through a realistic and flexible exchange rate policy.

The scope for containing imports was far more limited, unless Turkey was able to reduce its dependence on imported energy, Mr. Jaafar said. In that respect, he would appreciate further elaboration by the staff on Turkey's domestic energy potential. Finally, like others, he could agree with the staff appraisal and support the proposed decisions.

Mr. Lovato stated that he too could support the staff's appraisal and proposed decisions. Turkey had recorded impressive performance on the external payments and inflation fronts, where program targets had been overshot. The sizable current account adjustment and the deceleration in inflation had taken place without any declines in real output, which had proved resilient in 1981 and 1982. However, the growth projections for 1983 and 1984 seemed to be on the high side, particularly if judged against the background of sluggish world economic activity. The stimulus to output growth in 1983 and 1984 would stem mainly from domestic demand, since both consumption and fixed capital formation were forecast to increase at remarkably high rates. In that regard, he detected some inconsistency in the staff's discussion of near-term prospects and policy choices. On pages 2 and 6 of its report, the staff had suggested that domestic demand restraint would be maintained by an appropriate mix of financial policies; yet domestic demand was projected in Table 2 to grow briskly in both 1983 and 1984. Nonetheless, the framework of the proposed stand-by arrangement appeared reasonable.

With regard to monetary policy, Mr. Lovato observed that both reserve money and money supply aggregates had overshot the 1982 targets. Despite the interest rate reform that had provided the authorities with an important policy instrument for supplementing conventional central bank credit ceilings, monetary control had been undercut by two events: the failure of the authorities to sterilize unforeseen inflows through the balance of payments, which had led to a sizable rise in reserve money; and an unexpected increase in the money multiplier, due to both the noncompliance by banks with their legal reserve requirements and the switch from currency to deposit holdings elicited by financial innovations and higher interest rates on bank deposits. Some of those problems were nonrecurrent and not particularly troubling; others were cause for concern. He would appreciate elaboration by the staff on the techniques of monetary control in Turkey and on the degree of confidence that could be placed in the targets of the proposed monetary program.

Another question concerned the lagged effects on inflation of a higher than targeted monetary expansion, Mr. Lovato noted. Inflation appeared thus far not to have been affected by the high rates of increase in the money supply in 1982, mainly because of the upward jump in money demand prompted by higher interest rates. However, some liquidity overhang might have emerged since the end of 1982 and, as suggested by the staff, velocity might increase, albeit slightly, in the course of 1983. In the circumstances, it was likely that some price response to past excessive rates of money creation would occur in the near term. On a related matter, he had found little factual evidence or analysis in the staff paper on wage dynamics and incomes policies. He presumed that Turkey had had some experience with incomes policy, which, incidentally, might have had a significant dampening effect on inflation.

On the external side, it was clear from the staff papers and from Mr. de Groote's statement that, in 1981, exports had grown substantially, reflecting important progress in the Middle Eastern markets, Mr. Lovato said. However, if total exports in 1981 had actually been equivalent to $5,703 million--rather than the $4,703 million reported in Table 36 of SM/83/114--then there appeared to have been no increase at all in exports in 1982, and he wondered whether it was possible to make any more progress with exports toward Middle Eastern countries.

Short-run projections were encouraging, Mr. Lovato considered; a halved current account deficit was to be financed mostly by a capital account surplus, relying more on commercial and less on official sources of external financing, leading to some buildup of net international reserves in 1983. However, in the medium term, external debt outstanding and debt service obligations loomed large and left no room for complacency. The simulation exercise in Appendix IV of EBS/83/98 with its medium-term scenarios for debt and balance of payments was instructive in the exploration of trade-offs between growth and a viable external position. The large degree of uncertainty surrounding many of the assumptions involved in the simulations made the numerical results largely illustrative. Still, the logical framework of the exercise was helpful and should be adopted in reports on other countries and as background material for the discussion of Fund-supported programs. Despite the obvious limits of the exercise, some implications could be drawn from it as broad guidelines for policy formulation. Priority would have to be given in the medium run to export promotion aiming at further gains of market shares and to supply-side measures that would reduce the import content of domestic output. In that respect, he hoped that the proposed stand-by program would focus more on structural improvements to the economy.

Mr. Polak observed that, over the previous three years, Turkey had faithfully implemented the program agreed with the Fund. Through restrictive budgetary and monetary policies, combined with exchange rate flexibility, most of the substantive objectives of the program had been achieved: growth had been restored and inflation had been brought under control.

For the future, Mr. Polak said, cautious demand management policies and exchange rate flexibility would continue to be necessary but would not, by themselves, suffice. Also important was competition and enterprise, both in the State Economic Enterprises and in the private sector; at present, the economy remained overregulated. Deregulation, commercialization, and efficient management of the State Economic Enterprises was the only way for Turkey to move toward sustainable growth and to deal with its severe problem of unemployment. It was true that the losses of the State Economic Enterprises had been eliminated, but profits had remained negligible during the three-year period of the previous arrangement. In addition, the trend of budget transfers to those enterprises had not declined significantly. While central bank financing of investment by the State Economic Enterprises had been almost totally eliminated, the change had been accomplished before the beginning of the previous extended arrangement. The State Economic Enterprises thus remained inefficient and ill-managed, and, together with excessive government regulation, they tended to smother the development of initiative in the private sector.

Turkey had evolved successfully under Fund guidance to its present position, Mr. Polak observed, and it was now up to other organizations--such as the World Bank--to help the Turkish authorities carry out the slow process of basic structural adjustment and necessary modernization. It was clear from Appendix IV of the staff paper that the medium-term external debt and balance of payments scenarios were really an exercise in development economics rather than the traditional short- or medium-term analysis contained in Fund documents.

Although further development of the Turkish economy should be the task of institutions other than the Fund, he could support the proposed stand-by arrangement under which the Fund would continue to provide technical assistance and financial support to further the efforts of the Turkish authorities, Mr. Polak remarked. In that regard, he tended to agree with Mr. Laske that, while Turkey clearly had a balance of payments need that qualified for use of Fund resources, the authorities should be encouraged not to draw the full amount under the stand-by arrangement if at all possible. As noted by others, Turkey was close to the overall limit on access to the Fund's resources, and drawing the full amount proposed under the stand-by arrangement would leave Turkey with only a low level of access if it were to encounter more serious difficulties in future. Moreover, the choice not to draw the full amount might be interpreted by the financial markets as evidence of a stronger Turkish economy and might encourage those markets to increase the lending that would be needed in future.

Mr. Suraisry commented that, since the beginning of the three-year stand-by arrangement in 1980, the Turkish authorities had been able to reverse the unfavorable economic trend of the 1970s. Remarkable results had been achieved on almost all fronts, and he commended the authorities for the determination that they had shown in correcting the imbalances in the economy. Following three years of austerity and unfavorable world economic conditions, it was no surprise that there was currently some pressure to relax economic policies in Turkey, particularly given the high rate of unemployment. He encouraged the authorities to resist that pressure. Further structural measures would be needed before the economy could be put back on the right track, and unemployment could only be overcome if the underlying economic problems were corrected. Relaxing economic policy too early would jeopardize that aim.

He noted with satisfaction the measures taken by the authorities to liberalize the exchange and trade system in Turkey, and he encouraged them to continue their effort to restore the competitiveness of the economy, Mr. Suraisry remarked. The authorities had also indicated a willingness to continue to follow cautious policies with regard to external debt, which should help to increase Turkey's access to international capital markets on favorable terms. The recent improvement in debt monitoring was a welcome step, as was the authorities' request for technical assistance from the Fund and the World Bank to computerize debt statistics.

The efforts made to reform the banking system and the State Economic Enterprises in Turkey were commendable, Mr. Suraisry continued. Following the implementation of the 1981 tax reforms, substantial improvements in those two areas would have an important impact on both monetary and fiscal policies and, consequently, on the overall performance of the economy. Finally, he was in general agreement with the staff appraisal and could support the proposed decisions. In particular, the request for a new stand-by arrangement was fully justified, given the remarkable progress that the Turkish authorities had made over the previous three years. The proposed one-year stand-by arrangement should serve to ensure the continuation of that progress.

Mr. Portas said that he too could support Turkey's request for a new stand-by arrangement. As others had mentioned, impressive results had been achieved under the program adopted by the Turkish authorities in 1980. Despite the restrictive conditions prevailing in the world economy, the current account deficit and the rate of inflation had been significantly reduced, and real GDP had grown at remarkable rates. The Turkish authorities should be commended for their decisive action in implementing the appropriate monetary, fiscal, and external policies.

Unfortunately, Mr. Portas continued, the deterioration in employment had not yet been arrested. In spite of the evolution of real GDP growth, the rate of unemployment had grown by 0.5 percent in 1982, and total unemployment had risen to 18 percent. Obviously, there remained some rigidities on the supply side of the labor market that would take time to correct; and the current circumstances of the world economy meant that higher rates of economic growth permitting lower rates of unemployment would be difficult to achieve. However, it was to be hoped that, with growth rates of about 5-6 percent a year, the rate of unemployment would at least be held at its current level. Then, with an improved external position and a continued effort toward structural change over the medium term, a gradual reduction in the unemployment rate would be possible. The new stand-by program correctly emphasized the need to continue structural reform while maintaining aggregate demand at levels consistent with balance of payments needs. Such an effort would be followed by an appropriate mix of structural and demand policies within the framework of an outward-looking economic strategy.

On the external side, Mr. Portas remarked, the continuation of a flexible exchange rate policy would be necessary to further stimulate exports in the coming year. He agreed with the staff that export competitiveness should be maintained; at the same time, protective measures by Turkey's trading partners should be reduced. While in the past the share of nontraditional and processed agricultural products in the country's total exports had increased significantly, the growth of traditional agricultural exports had been impaired by a slow growth in OECD markets and the protectionist policies in several countries. Finally, with regard to external commercial credit flows to Turkey, it seemed likely that it would take some time for the country to regain regular access to financial markets, despite the substantial improvement in the current account. Apparently, the banks still did not have sufficient incentive to commit new funds on a larger scale.

Mr. Erb agreed with others that Turkey had made great progress under its previous program with the Fund and that the Turkish authorities were acting prudently in adopting policies aimed at further improvements in the economic and financial performance of the economy while consolidating the gains already made. In the circumstances, he could support the proposed decisions.

Turning to the requested stand-by arrangement, Mr. Erb considered that the authorities should continue with an exchange rate policy that would maintain competitiveness, especially since they were wisely moving toward greater liberalization in the external sector. It seemed clear from the staff analysis that the authorities needed to pay particular attention to monetary policy because inflation remained high and monetary developments were subject to a large degree of uncertainty. The staff and the authorities should stay in close contact to ensure fundamental agreement on the interpretation of monetary developments as they unfolded.

Further progress was also necessary in reforming the State Economic Enterprises, particularly now that their financial position had improved, Mr. Erb continued. He was encouraged by the recently enacted law regarding those enterprises and hoped that its implementation would improve their functioning.

He had noted in the letter of intent the authorities' indication that their desire for a continuing relationship with the Fund was not based solely on financial considerations, Mr. Erb remarked. His own view was that a continuation of the relationship between Turkey and the Fund under the proposed stand-by arrangement would give the authorities an incentive to continue with the current thrust of policy and would help to generate the confidence of the international financial markets in the Turkish economy. The Fund's financial role in Turkey would necessarily be limited, since Turkey's use of Fund resources was nearing the 600 percent of quota limit; it should be recalled in that connection that Turkey had had Fund-supported stabilization programs since 1978. In the circumstances, he would welcome an effort by the authorities not to make actual use of the purchases available under the proposed stand-by arrangement unless external flows turned out to be far less favorable than expected. As shown in the Appendix on medium-term scenarios for external debt and the balance of payments, Turkey's external position was likely to continue to be tight in future; hence, he agreed with the staff and some of his colleagues that, unless there was greater access to capital flows on market terms, the authorities' view of what was a sustainable balance of payments position might need to be revised and further adjustment might become necessary.

Turkey's future growth potential would depend importantly on further structural adjustments, Mr. Erb continued. In that respect, he agreed with Mr. Polak that the World Bank should continue to play an active role in the Turkish economy, which could be supported by development assistance flows or medium-term borrowing from official and commercial sources. He agreed with Mr. Polak that it would not be desirable for the Fund to commit resources for that purpose.

Mr. Abiad agreed with others that, since 1980, the Turkish authorities had made impressive progress in reducing the external and domestic imbalances in the economy. The current account deficit had declined sharply with a rapid growth in exports and some decline in imports. In addition, reflecting the systematic pursuit of restrained demand-management policies, public finances had been strengthened: the cash deficit of the budget, transfers to the State Economic Enterprises, the level of investments of those enterprises, and the public sector borrowing requirement had all declined relative to GNP. The tight incomes policy had been a major factor contributing to the reduction of cost-push pressures from labor and to the significant deceleration of the rate of inflation. Also noteworthy had been the marked improvement in Turkey's foreign debt position and the gradual restoration of domestic and foreign confidence in the Turkish economy. The achievement of those results was all the more remarkable given the prolonged world recession, rising protectionist pressures in some EC countries, and international capital market developments over the period.

Unfortunately, Mr. Abiad continued, the successes had been accompanied by high and rising levels of unemployment. Beyond the growth in the labor force, other factors contributing to the problem had been the side effects associated with the reform of the State Economic Enterprises and the slowdown in their investments, and the insufficient acceleration in the rate of economic growth. Those problems could in part be traced to the slow resumption of private sector investment in labor-intensive activities. Another element of the problem that might have been analyzed in the papers was that relating to the supply-side structural difficulties in the labor markets in such areas as professional skills, training, and geographical mobility.

Despite the commendable adjustment efforts of the authorities during the previous three years, progress in solving the structural problems of the economy had been less rapid than the successes achieved with short-term demand management, Mr. Abiad remarked. Most of the problems were institutional and, hence, structural in nature, and their solution needed to be viewed in an appropriate time perspective. Indeed, the Turkish authorities themselves acknowledged that much remained to be done in the area of structural reform. In their letter of intent requesting a new stand-by arrangement, they had clearly expressed their awareness of the need for sustained efforts and persistence with respect to structural policies in order to achieve further progress in adjustment.

Turning to the proposed stand-by arrangement itself, Mr. Abiad noted that, in the area of monetary policy, the 1983 targets had been reduced significantly in relation to those proposed earlier, reflecting the need for greater restraint in central bank credit expansion following the recent changes in monetary indicators. While the downward revision was consistent with the inflation and balance of payments objectives, it would adversely affect an already serious unemployment situation. In that regard, it appeared from the illustrative medium-term scenarios presented in Appendix IV of EBS/83/98 that the growth rate that would be most compatible with a sustainable balance of payments and foreign debt position would hardly be sufficient to stem the increase in unemployment. The simulations prepared by the staff thus suggested that, in the near future, the authorities would face difficult choices in balancing potential trade-offs between output growth and employment on the one hand and the viability of the balance of payments and foreign debt situations on the other, unless adequate domestic resources and private foreign capital could be mobilized to encourage productive investment on an appropriate scale.

The estimate of export volume growth in 1983 had also been revised downward slightly from earlier projections and was considerably below the growth rates achieved in the previous three years, Mr. Abiad observed. It was regrettable that Turkey's successful efforts to expand its export markets in one region were being accompanied by a decline in the share of its traditional markets in the European Community. As explained in Appendix III of EBS/83/98, the decline was attributable not only to depressed demand conditions in EC countries but, more important, to protectionism in those markets. A reduction in the trade barriers against Turkish products would contribute significantly to the success of the country's adjustment efforts.

Regarding the resources to be made available under the proposed arrangement, Mr. Abiad remarked that the amount involved represented 75 percent of Turkey's quota and seemed to have been constrained by the cumulative total Fund holdings of Turkish currency as a percentage of present quota. Table 1 of the main paper showed that those cumulative holdings had also been calculated as a percentage of Turkey's proposed quota; in that regard, it would be helpful if the staff could elaborate further on the assumptions underlying the relationship between the latter calculations and future access limits. Finally, since the Turkish authorities had made a determined effort to adjust the economy and had established a good record of cooperation with the Fund, he could fully support the proposed decisions.

Mr. Morrell stated that he too could support the proposed stand-by arrangement that would allow Turkey to continue implementing its stabilization program and structural reforms. The remarkable progress achieved by Turkey under the previous program in the face of world recession, deteriorating terms of trade, an unfavorable international capital market situation, and trade barriers was commendable. He welcomed the authorities' firm commitment to a continuation of the flexible exchange rate policy, particularly since export competitiveness would be crucial in sustaining export growth and strengthening the balance of payments position. In that regard, he found it ironic that import liberalization measures were being taken by many of the developing countries while a general growth in protectionism was occurring in the industrial countries. In particular, the Turkish authorities had indicated their concern about the difficulties of access to their traditional markets in the European Community.

Like others, Mr. Morrell continued, he had been interested in the medium-term scenarios incorporated in Appendix IV of EBS/83/98. He wondered whether the Fund had the resources to develop models that could be used for all Fund programs or whether the staff had used models developed in the particular countries concerned. Depending on the complexity of the models used and the cost of producing them, it might be difficult for the Fund to commit itself to providing such analyses for a large number of members.

Of particular interest were the staff conclusions concerning the "growth" scenario, which the staff had suggested would not be sustainable, Mr. Morrell commented. The debt service ratio appeared to be continually declining in that scenario because of the high rate of growth of GDP. Bearing in mind Mr. Jaafar's comments on the high rate of unemployment in Turkey, care should be taken in interpreting the conclusions that were drawn from the growth scenario. He would be interested in staff comment on that matter and in how it might be regarded in future debt analyses.

The staff representative from the European Department indicated that the Turkish authorities were not happy about the unemployment situation in Turkey but had felt the need, over the previous year, to give priority to the balance of payments. They hoped that, with an improved balance of payments arising from a strong growth in exports, it would be possible to achieve higher rates of growth in future. Indeed, they were aiming at an average rate of growth of 5.5 percent over the coming five years, which should help the unemployment situation. It was inevitable in current circumstances that the balance of payments would remain a real constraint in the period ahead, and the authorities would be obliged to monitor progress on that front carefully in dealing with the domestic economy.

Regarding questions on the domestic energy potential in Turkey, the staff representative noted that imported energy had met 40 percent of the economy's requirements in 1982. By 1990, the authorities hoped to reduce the share of imported energy to 33.5 percent, mainly through an increase in hydroelectric power and the use of lignite. Also, Turkey was an oil producer and was endeavoring to increase domestic production; in that regard, the authorities had recently taken steps to attract foreign partners to assist them in their efforts.

Monetary policy had proved to be one of the most difficult issues for discussion between the staff and the Turkish authorities, the staff representative continued. One of the problems had been to determine targets that would be adequate to sustain domestic growth without further aggravating the unemployment situation while permitting a further decrease in the rate of inflation. In that regard, a technical problem had arisen. In most countries, it was possible to work on the basis of net domestic assets of the banking system as a whole; however, if the staff had worked along that line in Turkey, the data necessary to monitor programs would not have been available until some months after the test date had passed. Hence, the staff had been obliged to deal with reserve money. However, the impact on reserve money of liquidity flows through the balance of payments was unpredictable. Moreover, the reserve money multiplier had been affected by the structural changes that had been occurring in the banking system in Turkey, which had had a substantial influence on the willingness of the population to place their cash holdings in bank deposits.

In reviewing the projections for reserve money, both the staff and the Turkish authorities had recognized the need to reduce the targets for central bank credit to the economy from the levels that had been thought appropriate in the December discussions, the staff representative said. Thus far, the reserve money target had been adhered to because of the actions of the Central Bank and because the staff's assumptions about the balance of payments impact had been reasonably accurate. Unfortunately, the reserve money multiplier had been higher than earlier expected. The staff and the Turkish authorities would need to discuss that matter in depth during the mission that was scheduled to visit Turkey within the next two months.

Taking up questions on fiscal policy, the staff representative observed that available evidence suggested that the treasury paper issued to the public had been well received. On the matter of tax revenue, the staff agreed that some difficulty had been experienced in the efficiency of revenue collection; the authorities had since made some changes, which they hoped would have a substantial impact over the medium term, and they had indicated that an improvement in the efficiency of revenue collection was a priority matter.

The Fund and the World Bank had focused on different problems affecting the State Economic Enterprises in Turkey, the staff representative noted. In general, the Fund staff had tended to concentrate on the overall financial performance of those enterprises, while the World Bank had concentrated more on the operational efficiency of individual enterprises and of the system as a whole. A request for a structural adjustment loan relating, inter alia, to that matter had been presented to the

World Bank on June 23, and it was his understanding that the Turkish authorities would cooperate closely with the World Bank, which would provide technical assistance down to the individual enterprise level.

The new law affecting the State Economic Enterprises was encouraging, the staff representative considered, as it provided the framework for specific action to deal with the problems of those enterprises. In passing, he noted that the authorities had been tentatively speaking in terms of fairly significant reductions in transfers from the budget to the State Economic Enterprises in 1984.

With regard to the external sector, Executive Directors had welcomed the flexible exchange rate policy that had been followed thus far, the staff representative observed. A judgment about when sufficient competitiveness would be achieved was difficult. However, over the most recent period, the flexible exchange rate policy had permitted a rapid rate of growth in exports. It was relevant to note, however, that Turkey was about to effect a change in its import policy, to be implemented over a five-year period, in which the restrictive import licensing and other measures would be replaced by a set of rational tariffs at an appropriate exchange rate. In the circumstances, the authorities would have to maintain a great deal of flexibility in exchange rate policy so as not to run the risk of flooding the country with imports against which efficient domestic production could not compete.

In the first three months of 1983 there had been a decline in the growth of exports, which gave some cause for concern, the staff representative commented. In looking at the available data, however, the staff had been struck by the fact that exports to the EC in the first quarter had been 44 percent higher than they had been in the first quarter of 1982, which suggested that competitiveness was good. The slow growth in exports overall had been caused by two main factors: first, agricultural export prices had been particularly adverse and, for certain important commodities, volume had been poor; second, there had been a very sharp drop of more than $200 million in exports to Iraq. The first element was presumed to be temporary, and the staff wanted to view prices and volume over a longer period than three months to get a more accurate picture. The decline in exports to Iraq had perhaps been affected by the delay in trade discussions between Iraq and Turkey; those discussions had since been concluded and, according to the Turkish authorities, they had gone well. Finally, it should be noted that total exports for the month of April had in fact grown by 20 percent in value by comparison with the corresponding month the year previously. The sharp discontinuity between developments in the first three months of the year and developments in April had led the staff to be cautious about making export projections for the year as a whole, until it could be determined whether the April figures represented a sustained reversal in the trend.

Commenting on the capital account, the staff representative agreed with those who felt that the balance of payments in Turkey had still not fully recovered. It was clear that the capital account would have to handle substantial gross repayments of past borrowings, including rescheduled debt, from 1985 onward, when the grace periods had expired. Those large repayments could probably not be financed by the sort of concessional lending that had taken place in the past, and they would therefore have to be covered by borrowing from the markets. In that respect, the prospects for commercial bank lending in Turkey were reasonably good. In fact, Turkey could, if it wished, borrow a great deal on short term; however, the authorities had learned from past experience and had indicated an unwillingness to have recourse to short-term borrowing. Recently, negotiations had been completed for a $200 million financial consortium loan for a period of five years, with a three-year grace period, which would be taken up by banks in the United States, Europe, and Japan.

While Turkey was not able at the moment to make very large calls upon the markets, the signs were encouraging, the staff representative considered. The staff had obtained the impression that a good deal of medium and long-term financing was available in the markets if Turkey could come up with satisfactory projects; the staff and others had been emphasizing to the authorities that it was in their interest to identify projects that would be welcomed by the banks and to put them forward in order to gain access to project borrowing in addition to financial credits. Inevitably, financial credits would be necessary in larger amounts than had been made available thus far in 1983, and to acquire them would require a restoration of confidence in the Turkish economy. Turkey had made good progress in the previous three years toward improving the viability of the economy and erasing the poor reputation it had had a number of years previously. If the authorities continued with the policies that had produced those good results, it was possible that the banking community would begin to recognize that the country had the ability to service new gross borrowing, which would mainly be used to make payments falling due to the same lenders; in net terms, the financial community would not be asked to provide a great deal.

With regard to questions on the prospects for exports to Middle East markets, the staff representative agreed with those who felt that it would be imprudent to assume that growth would be as rapid as it had been in the past. Still, the authorities had made a number of relevant points in arguing their case for continued growth. They had noted that past progress had been due in part to their ability to deal easily with the Middle East regions, which were geographically close to Turkey. Also, many of the Turkish exports to the Middle East countries were necessities, which were not likely to be cut back. Finally, despite the gains made by Turkey in the Middle East markets, its share in those markets was still quite small. Of course, the authorities had admitted that the gains in future would not be as great as they might have been in view of the recent income reductions in many of the Middle East countries.

In response to those Directors who had suggested that it would be useful for the Turkish authorities to improve the debt recording and projection process, the staff representative noted that Turkey had accepted technical assistance toward that end from both the Fund and the World Bank.

Two experts would be going to Turkey in a few weeks, and he hoped that, within a year, a substantial improvement would be made in the debt recording system and in the ability of the authorities to use the improved system to implement foreign debt management policy.

Finally, with regard to the simulations provided in Appendix IV of EBS/83/98, the staff representative from the European Department observed that a relatively simple model had been used. Based on future debt payments for debt existing at the end of 1982, the staff had been able to plug into the computer program whatever assumptions it wished about rates of growth, forms of borrowing, grace periods, interest rates, and so on. It should of course be remembered that, while the simulations might be helpful to draw policy conclusions for the future, they were no more accurate than the assumptions on which they were based.

Mr. de Groote observed that performance under the previous three-year stand-by arrangement had validated the Fund's judgment about what changes had been necessary in Turkey. At present, the country was in the midst of fundamental political change, and it was important for the authorities to indicate the desirability of continuing a dialogue with the Fund so that the forthcoming elections would not signal different policies from those that had been so successful in the recent past.

Expanding on a point mentioned by several speakers, Mr. de Groote noted that the simulations in Appendix IV had been particularly useful in clarifying for the main characters on the political scene in Turkey the implications of future policy development. It was clear from the staff's presentation that certain policies would need to be maintained if a further improvement was to be registered in the balance on current account, and in real income and employment. The scenarios had been far more effective than simple logic in showing that the Fund had been justified in recommending strong adjustment in the short term. In the relatively short period of three years, Turkey had been able to reach a stage in which improvements in real income and employment would clearly coincide with further improvements in the balance of payments on current account. In some respects, that guidance by the Fund had been as important as the financial resources that had been placed at Turkey's disposal over the period. He was certain that the Turkish authorities would continue to behave with the caution that had characterized their implementation of the previous arrangement; they were cognizant of the fact that a decision not to use all the resources available under the proposed stand-by arrangement would be regarded by the markets as evidence of strength in the economy. In the circumstances, he was certain that the authorities would consider the amounts that might be granted under the proposed arrangement as a "second line of defense."

The signs of progress in the Turkish economy were not primarily the result of external circumstances but had come about mainly through the implementation of appropriate adjustment policies, Mr. de Groote continued. The transfer of resources in the balance of payments had been extraordinary, with movement from a current account deficit of 8-10 percent of GDP to a deficit of only 1 percent of GDP over the previous three years. Also, the financial markets had been largely deregulated, and laws recently enacted would enable the authorities to move even further toward full deregulation. He recognized of course that the present system of fixing interest rates was somewhat inconsistent with that goal; however, in time, a fully deregulated financial system would be established.

Another positive element of the adjustment policies was the effort to eliminate import restrictions, Mr. de Groote remarked. While the five-year phase out period might seem long to some, it had to be remembered that the Turkish economy in the past had been greatly protected from outside influences, with the ratio of imports to GDP at only 6 percent, which was low by world standards. The steps toward import liberalization had already begun to produce results--imports had reached some 12 percent of GDP.

A fourth important element in the adjustment process was the fundamental reduction in the public sector borrowing requirement, which was currently within manageable proportions, Mr. de Groote commented. A fifth element was the progress that had been made in the area of the State Economic Enterprises; recently enacted legislation should make it possible for those enterprises to reach a stage at which they could reap profits. Of course, the establishment of competitive management and recruitment in the enterprises was not an easy matter, since it was difficult to replace a fully centralized system by a market mechanism simply by enacting legislation; however, the changes were among the priorities of the Turkish authorities. A final positive element of adjustment was the reduction of the debt ratio to manageable proportions through the realization of a better balance of payments position and a higher level of exports.

The factors he had mentioned showed clearly that the current situation in Turkey was a result of a systematic and appropriately directed policy that had been helped in part by favorable external factors, including the situation in neighboring countries in the Middle East, Mr. de Groote observed. According to the very latest data, the year-to-year percentage change for exports from January to April showed an increase of 8 percent, while the increase in imports had been at about 10 percent for the same period. That margin was somewhat smaller than had been implied by the data in the staff papers and might alleviate some of the concerns of his colleagues. In that regard, he would be interested in further discussion of a point raised by Mr. Jaafar and Mr. Horrell concerning the fact that Turkey's access to traditional markets had been hindered by the protectionist attitudes of some regional groups of countries in the industrial world. He took satisfaction in observing that there had recently been an improvement in the export performance in those traditional markets, which indicated that the competitiveness of Turkish exports was being established. He could confirm the intention of his Turkish authorities to continue to follow a flexible exchange rate policy. It was of course difficult to know at what point the equilibrium rate for the Turkish lira would be reached; however, the authorities were committed to continuing to adjust the rate in the light of circumstances in order to maintain a competitive position for exports without giving an undue competitive advantage.

He tended to agree with Mr. Polak on the need for further progress in liberalizing trade, making prices more flexible, and encouraging competition within the domestic economy, Mr. de Groote said. Turkey was currently in a transition period, and it was necessary to maintain a close dialogue with the Fund and the World Bank to show the authorities who would be in power in future that the results of following recommended policies would be favorable, particularly in the critical area of employment. Although the unemployment situation could not be easily corrected, because progress had been marked by the industrialization of agriculture and the consequent movement of unemployed people toward the urban areas, it was safe to assume--on the basis of recent information provided by the World Bank on the effects of an expansion in foreign trade and the new laws that had been adopted--that the State Economic Enterprises would soon begin to have an employment effect. If so, developments in Turkey would provide a clear indication that the attainment of balance of payments and public finance objectives were the precondition for sound development policies and an improved employment situation.

The Chairman made the following summing up:

Executive Directors highly commended the Turkish authorities for the substantial economic improvement achieved since the introduction of the 1980 stabilization program. The determination with which the program had been implemented had resulted not only in a significant reduction in the rate of inflation and the current account deficit but also in a revival of economic growth, albeit not to the extent that an increase in the high rate of unemployment had been prevented. Directors noted the key roles in the economic improvement that had been played by a flexible exchange rate policy and by greater reliance on market forces. They observed, however, that the results achieved had been more impressive in short-term demand management than with respect to structural changes.

Directors felt that the program which the authorities intend to pursue in the year ahead was adequate in view of the medium-term outlook and deserved the support of the Fund. They urged the authorities to implement the program forcefully. While stressing the continued need for tight demand management policies, in view of the still difficult medium-term outlook for the balance of payments, they urged the authorities, in addition, promptly to implement the structural changes currently envisaged for the financial sector and the State Economic Enterprises, to move decisively to reduce excessive regulation of the economy, so as to stimulate domestic competition, and to take further steps to open up the economy to foreign competition.

Given the forecast reduction in concessional capital inflows and the sharp increase in debt repayments over the next few years, Directors considered it crucial for the authorities to continue to reduce the current account deficit. In that respect, they said, the most recent trend in the growth of imports and exports should be cautiously watched. They stressed that sustained export growth was essential to achieve a manageable external situation in the medium term, and they welcomed the undertaking of the authorities to continue with a flexible exchange rate policy.

Directors found the recent return of Turkey as a borrower on the medium-term commercial market to be encouraging but they emphasized the need to keep such borrowing, as well as short-term borrowing, at reasonable levels to avoid a recurrence of debt-servicing problems. The authorities' intention to improve the debt-recording system with the help of Fund and World Bank technical assistance was considered an important element in future debt management. Given Turkey's balance of payments prospects, and taking into account that its indebtedness to the Fund was close to the present access limits, a number of Directors encouraged the authorities to be cautious in their use of Fund resources and, if possible, not to draw the full amount authorized under the new stand-by arrangement.

Directors expressed satisfaction with the considerable improvement in public finances. Some concern was indicated with regard to the slow growth of budget revenue, and, although it was noted that matching expenditure reductions had been effected, Directors stressed the importance of strengthening the tax administration to help achieve the further reduction in the budget deficit programmed for 1983 and 1984. They also noted the significantly improved financial performance of the State Economic Enterprises (SEEs), which had been brought about by flexible pricing policies and a significant reduction in investment programs, and which had permitted a decline in real budgetary transfers to the SEEs. Directors stressed, however, the need for productivity and management improvements in the state enterprise sector and urged the authorities to implement the new structural reform measures vigorously; the World Bank's contribution in that area was welcomed.

A number of Directors viewed with concern the lack of a fully effective monetary policy in Turkey. The inability of the authorities to sterilize money creation through the balance of payments, and the nonobservance of reserve requirements by banks were noted in particular. The change in monetary mechanisms made it difficult to forecast monetary developments, and Directors thus urged the authorities to monitor the situation closely and to stand ready to take action should the assumptions embodied in the current program not be realized. Several Directors stressed the need for greater restraint in credit expansion than had been recently observed, and they welcomed the measures to simplify and to make more effective the reserve requirement system. While Directors supported the effort of the authorities to reduce the high real interest rates on deposits and nonconcessional credits, a number of them indicated a preference for more market-oriented measures to ensure the reduction. Directors stressed the importance of keeping interest rate policy flexible and maintaining or establishing positive real interest rates for deposits and credits.

Directors noted with satisfaction the gradual liberalization of import controls and the elimination of multiple currency practices. They particularly welcomed the intention to phase out restrictive import licensing, although some wondered whether the proposed five-year period for the phase-out might be too long. The progress already made in, and the prospects for, reducing import guarantee deposits was noted; at the same time, the protectionist measures taken, against Turkish goods, in particular by the EC, were much regretted. Finally, it is expected that the next Article IV consultation with Turkey will be held on the standard 12-month cycle.

The Executive Board then adopted the following decisions:

Decision Concluding 1983 Article XIV Consultation

1. The Fund takes this decision relating to Turkey's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1983 Article XIV consultation with Turkey, in the light of the 1983 Article IV consultation with Turkey conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund welcomes the steps taken by Turkey to liberalize the exchange and trade system as described in EBS/83/98. The Fund urges Turkey to terminate the remaining bilateral payments arrangement with a Fund member as soon as possible.

Decision No. 7442-(83/90), adopted
June 24, 1983

Stand-By Arrangement

1. The Government of Turkey has requested a stand-by arrangement for the period of one year beginning June 24, 1983 for an amount equivalent to SDR 225 million.

2. The Fund approves the stand-by arrangement attached to EBS/83/98, Supplement 1.

3. The Fund waives the limitation in Article V, Section 3(b)(iii).

Decision No. 7443-(83/90), adopted
June 24, 1983

2. HUNGARIAN PEOPLE'S REPUBLIC - STAND-BY ARRANGEMENT - MID-TERM REVIEW

The Executive Directors considered a staff paper on the mid-term review under the stand-by arrangement with the Hungarian People's Republic (EBS/83/110, 5/27/83).

Mr. de Groote stated that the paper on the mid-term review under the stand-by arrangement for Hungary clearly demonstrated that all performance criteria had been met and that the short-term goals of the program had been achieved. It was clear that the first year of cooperation between the Fund and its newest member had been fruitful and the assistance provided by the institution had been helpful to Hungary, whose liquidity situation had been strained by a number of adverse developments in the world economy.

Hungary's current account in convertible currencies had been improving steadily, Mr. de Groote continued. In 1981, a deficit of some \$730 million had been registered; by 1982, the deficit had been reduced to \$150 million, and it was expected that 1983 would show a current account surplus of about \$500-600 million. Demand management for the year as a whole appeared to be going smoothly, with domestic consumption and investments developing as intended and fiscal and monetary policies in line with performance criteria. The authorities were determined to maintain full cooperation with the Fund by continuing to adjust and to follow appropriate policies in light of circumstances in order to adhere as closely as possible to targets, with the usual safety margin that the authorities liked to maintain. The new letter of intent, together with the measures described in the staff paper, were a reflection of that determination. The authorities' intentions had found immediate expression in the recent decision to adjust the exchange rate by a further 3 percent, effective the first week in July.

It was important to look at the efforts of the authorities in the context of the global economic environment with all its adverse effects on the Hungarian economy, Mr. de Groote considered. Export prices had further decreased, the climate in the international capital markets had deteriorated, and the overall political relationships between East and West had tended to create some difficulties. The necessary measures adopted by the authorities to curtail domestic consumption and investment had required political skill and courage even in Hungary, where the atmosphere on such matters was traditionally more relaxed. His Hungarian authorities continued to feel that there was no other way to overcome the current difficulties than by seeking further integration into the world economy and by moving forward with the economic adjustment program. That view had already been solidified in a fundamental decision that had been taken by the legislative body of the Party--the Central Committee--and was in the process of being enacted by the Political Committee, the executive body of the Party. Moreover, the Prime Minister had on June 23 made an important address to Parliament, which had afterward given its approval to a number of fundamental ideas.

The Prime Minister had indicated that, in present circumstances, it was necessary to slow down the growth of the economy, which would not, however, mean stagnation in the attainment of the social and economic objectives of the country, Mr. de Groote said. The authorities were determined to find new solutions to problems, even if those solutions might occasionally create conflicts between some social groups. The Prime Minister had stressed that he had always searched for economic solutions and had used administrative measures only when no other avenues were open. He had indicated that, in order to speed up the development of the Hungarian economy, the country should move toward a coordinated and comprehensive development of the main elements of the economic management system, including changes in both the planning and the regulatory systems, particularly with respect to the monitoring of prices, incomes, taxes, and market movements. The Prime Minister had stated that, in conjunction with an improvement in the efficiency of the central state economic management system, there was a need to continue to take all necessary measures to increase the economic independence of enterprises. The intention was to propose further steps toward the democratization of the economy, so that individuals in the economic units would be able to take a more active part in the decision-making procedure, to express an opinion on the work of the managers, and to have a say in their selection.

With regard to Hungary's future relations with the Fund, Mr. de Groote considered it important that there should be a full evaluation of the performance under the first stand-by arrangement. The Hungarian authorities had the political will to move forward with an economic reform program that should free the economy of many of the restraints of the past by introducing changes in prices, income taxes, and capital allocations that were compatible with the economy's integration into the world economy. The authorities hoped that the continued implementation of the reform program, along the lines indicated in the Prime Minister's statement to Parliament, would place them in a position to maintain a cooperative dialogue with the Fund.

Mr. Zhang observed that the mid-term review by the staff showed that all performance criteria in the current stand-by arrangement with Hungary had thus far been met, that the short-term objectives had been achieved, and that prospects for a successful implementation of the 1983 program as a whole were good. It had been clear from the outset that the achievement of the main objective of the program, which aimed at realizing a surplus of $600 million in the Hungarian convertible currency account, would depend not only upon the implementation of a vigorous demand management program for domestic activities but, more important, upon a favorable international economic environment. Thus far, domestic demand had developed broadly in line with the pattern envisaged in the program, and the policy measures in the fields of price, income, credit, and government finance had been successfully implemented. When consumption and investment had begun to develop more strongly than targeted during the early months of 1983, the authorities had, without hesitation, taken immediate corrective action to ensure that future developments were brought back into line with the original targets. The quick and determined response by the authorities to the situation was highly commendable.

A more worrisome factor in the current situation was the effect on the Hungarian economy of the continuing deterioration of the external economic environment, Mr. Zhang remarked. The economies of Hungary's main trading partners in the convertible currency area had remained stagnant, and protectionism against imports from Hungary had continued. Export prices had been weaker than anticipated and, as a result, the good export performance of the Hungarian economy in volume terms had not been matched by equal increases in export receipts. Moreover, there had been a renewed outflow of capital resulting from the reversal of the temporary financing obtained in late 1982 and an additional drain from other short-term deposits by some foreign banks. Gross international reserves in convertible currencies had declined considerably during the second quarter of 1983. Since the Hungarian authorities had already adopted new measures to restrain domestic consumption and, hence, demand for imports, the achievement of the target of a current account surplus in convertible currencies of $600 million for 1983 as a whole would inevitably depend upon the development of exports to the convertible currency area for the remainder of the year. He fully appreciated the determination of the Hungarian authorities to improve their external financial position by relying upon appropriate policy instruments that combined planning with market mechanisms, and he believed that the adjustment program would be successful, despite the difficulties he had mentioned. In the circumstances, he could fully support the draft decision.

Turning to more technical matters, Mr. Zhang noted from the staff report that, as a result of strong growth in activity in the private sector and a bumper crop in 1982, household income had risen significantly beyond the anticipated level and had led to a corresponding unexpected increase in personal consumption. That development seemed to be a classic case in which supply created its own demand, and he wondered why the staff was advocating a return to the targeted path; he could accept the staff's argument if the intention was to curtail consumption in order to increase the supply for export, and he wondered what direct methods the staff was intending to use to fulfill its purpose. Assuming the supply of commodities available for export was increased, how could it be guaranteed that exports would necessarily increase? The staff seemed to be suggesting that exports could be increased through further devaluations; if so, the magnitude of the elasticities of demand for Hungarian exports in the major trading partner markets would be a crucial factor, although, as indicated in the report, the staff seemed to be implying that the magnitude of the elasticities of demand had been less than expected, as evidenced by the statement that the increase in exports had not led to a corresponding increase in the value of exports.

Another question was related to the term "household disposable income," which the staff had defined as income net of the effects of price increases, of the rise in the propensity to save, and of the depreciation of the currency, Mr. Zhang said. That definition was quite different from the conventionally accepted one and was rather confusing. He would appreciate further elaboration by the staff on its use of the term.

Miss Le Lorier considered that the Hungarian authorities had achieved positive results under the stand-by arrangement, despite adverse external conditions. There were very few other countries that could match Hungary's achievement of a growth of 10.7 percent in export volume together with a real growth in GDP of 2.5 percent in the face of an unfavorable world economic environment. A strong demand management policy, rapid results on the supply side, and a flexible exchange rate policy had all contributed to the positive performance. Of course, household consumption had been higher than expected, although it had been far less than might have been allowed by the increase in supply in the absence of demand restraint. In the circumstances, the authorities should be warmly commended for having moved so quickly to rein in domestic demand as warranted.

The efforts of the authorities had been all the more painful because of the sharp fall in world market prices for Hungarian products, Miss Le Lorier continued. As noted by the staff, the export revenues in convertible currencies, despite substantial gains in market shares, had not increased in 1982 beyond the level of the previous year. Another adverse external development--and one far less understandable on economic grounds--had been the behavior of the international banking community. It was unclear why a country that was making obvious and sustainable progress toward adjustment should be penalized by net outflows of capital; indeed, it was a paradox that a country that was adjusting so well should be asked to continue its efforts under the additional handicap of a reduction in exposure of the banking system while other countries that were less successful in their endeavors had, perhaps because of their lack of success, had the benefit of an increase in bank exposure. In her view, the Fund should strongly disassociate itself from the assessment of the Hungarian program that had apparently been made by the banking community.

Turning to the program for the remainder of the stand-by arrangement, Miss Le Lorier said that she could broadly support the staff's recommendations. The next Article IV consultation with Hungary would provide an opportunity for Executive Directors to study in greater depth the economic reform program currently under active consideration by the authorities. For the time being, she would limit her remarks to those policy areas and tools reviewed by the staff in its paper. On the external side, it appeared that the authorities had been successful in promoting an outward-oriented growth and a restructuring of relative prices in the economy. Of course, the slowdown in the rise of foreign prices had somewhat alleviated the threat of a significant upsurge in domestic inflation, but it should not be forgotten that Hungary's experience with a flexible exchange rate policy was limited, and Directors should refrain from prejudging the potential effects of that policy without the benefit of hindsight. In the circumstances, she would not advocate any change in the course of action followed by the authorities thus far, and she was confident that the exchange rate would continue to be managed in a pragmatic and flexible manner.

On the matter of import restrictions, Miss Le Lorier regretted that it had not been possible to remove the restrictions according to the previously agreed deadline; however, she acknowledged that the authorities' room for maneuver was limited, given the tight foreign exchange situation. Besides, the restrictions did not appear to have prevented a more efficient use of imported inputs. It was even possible that the restrictions might help in promoting a more import-saving attitude by economic units that had previously operated with some waste. The real worry was that a "gray" market or exchange transactions outside Hungary at a discounted rate might develop during the year, and she would appreciate hearing the staff's assessment of such a risk. The analysis of the authorities themselves--who were fully aware of the potential drawbacks of prolonged import restrictions--seemed to suggest that a phased relaxation of restrictions would take place before the new deadline in 1984.

Demand restraint would apparently continue to be stringent, which might be unfortunate, given the forecast bunching of external debt payments in 1984/85, Miss Le Lorier said. With respect to monetary policy, the measures implemented appeared severe by the standards for market economies: an increase in interest rates--not only on new loans but also on the outstanding stock of credit--was a unique decision; and the other measures taken to freeze or curtail various categories of enterprises' deposits seemed harsh. In that regard, the tools employed by the authorities might be the only ones readily available; however, applied on a continuous basis, they could have severe perverse effects. It might be assumed that the enterprises that had accumulated a substantial amount of deposits were the most price-efficient; if so, it might be better for the authorities to consider other means to freeze and eventually recycle more liquid assets. The first steps had already been taken to develop a financial market and avoid the risk of disintermediation outside the banking system. She hoped those steps could be supplemented by the issuance of new savings instruments for both households and enterprises; for example, it might be helpful to use instruments designed to finance the budget deficits in order to avoid continued reliance on the potentially disruptive measures taken thus far.

In the area of fiscal policy, Miss Le Lorier remarked that she could share the authorities' view that, from the standpoint of the fiscal balance per se, it was the difference between the level of consumer subsidies and the level of turnover taxes--rather than the gross level of subsidies--that was the relevant indicator of the degree of demand restraint. However, consumer price subsidies affected the relative price pattern and could distort supply and demand balances; hence, the efficiency of those subsidies in relation to the objectives pursued needed to be carefully reviewed. If that were done, it might appear that other means could better fulfill the same purposes with less undesirable effects on the structure of prices. In making those comments, she had intended only to underscore the priority that should be attached to structural and short-term adjustment measures in line with the medium-term goals, particularly with respect to investment. There was no intention to minimize in any way the success achieved thus far by the authorities or the adequacy of the program.

On more technical matters relating to the performance criteria, Miss Le Lorier commented that she was puzzled by the decision to retain the ceiling on net foreign liabilities in convertible currencies of the specialized institutions. The purpose of such a criterion was to prevent an undesired buildup in external liabilities and to safeguard the working of the program by closing a potential loophole for evading the constraints imposed by other criteria. In practice, she found it difficult to be concerned that such a form of external indebtedness could develop; the real fear was that the external liabilities might decrease too sharply. After all, a decrease in the level of gross reserves was forecast, despite the improvements in the current balance attributable to continued net capital outflows.

A similar reasoning could be developed with respect to the limit on the contracting of new foreign debt in convertible currencies by the nonbanking sector, Miss Le Lorier remarked. That limit amounted to $50 million; however, thus far, enterprises had been able to borrow only minimal amounts. Ideally, a target for a reasonable amount to be borrowed would appear much more suitable than a ceiling that was likely to have no binding effect. In general, she found it difficult to explain the significance of the two performance criteria against the backdrop of a reduction in net foreign bank exposure; unless there were strong legal reasons for maintaining those criteria, she would advocate their deletion.

Mr. Laske considered that the Hungarian authorities had made a valiant effort to keep the adjustment of their economy on track. Their task had been made all the more difficult by a shortage of foreign exchange, owing to renewed withdrawals of bank funds in convertible currencies. As a consequence, the original projections for the current and capital accounts for 1983 had had to be revised; the latest expectation was for a smaller current account surplus and for a larger net outflow of capital. Through a strong effort to increase exports, the Hungarian authorities had managed to limit the prospective reduction in the current surplus to a relatively modest amount. In contrast to some other countries that were also pursuing strong adjustment efforts, Hungary had concentrated more on stepping up exports than on restraining imports, a particularly welcome feature. The vigorous expansion of export volumes in both 1982 and early 1983 to a large extent reflected gains in market shares and had been achieved in spite of weak markets. Unfortunately, such good performance would probably not be repeated, and the authorities should turn their attention to retaining the markets recently won by accepting, inter alia, sacrifices in terms of prices.

A noteworthy element in Hungary's foreign trade experience and prospects was the exchange rate, Mr. Laske stated. In 1982, Hungary had depreciated the forint by 11 percent, which had served to cut in half the real appreciation that had occurred previously. The competitive position of exports had undoubtedly been strengthened by the depreciation, although probably not restored to its previous level. In the circumstances, he wondered whether it might not be advisable for the authorities to conduct exchange rate policy in a more flexible manner than was intended at present; he had been pleased by Mr. de Groote's indication that the authorities were willing to act in that way.

The failure of the authorities fully to pass on the price effect of the depreciation in 1982 might help to explain the overshooting of the targets for domestic demand, Mr. Laske commented; hence, he attached great importance to the decision to make a full passthrough of all future exchange rate adjustments.

The withdrawal of banking funds had begun again in the second half of 1982, Mr. Laske observed. During the recent discussion of international capital markets, two possible motives for such withdrawals--in the case of Hungary and elsewhere--had been mentioned. The first was the so-called "regionalization syndrome" and the other was a more general reluctance by banks to maintain their international exposure. It would be interesting to know which of the two motives might have carried more weight in the Hungarian case, although he was uncertain whether a clearer understanding of the motives of individual banks would have affected the country's policy stance.

The adjustment in Hungary aimed at reducing final domestic demand, with heavy reliance on cuts in investment expenditure, Mr. Laske remarked. Given the magnitude of the adjustment needed, it would be impossible to spare investment; however, over the longer run, the restraint in investment expenditure might lead to a deterioration in the quality of the capital stock and could thus have a negative impact on the growth potential of the economy. The major brunt of the reduction in domestic demand should therefore be borne by consumption, both private and public. The measures intended or already taken to achieve that end were impressive, although they might need to be reinforced later on in a way that gave greater weight to an even more market-determined allocation of resources.

As a consequence of the wage and price policies established in 1983, real disposable income was expected to decline by almost 2 percent, Mr. Laske observed. At the same time, the authorities wished to avoid a decline in financial savings; hence, the interest rate on such savings was to be increased. But the increase would place the interest rate on financial savings only marginally higher than in 1982, and it would continue to be negative in real terms. He was therefore somewhat pessimistic about the prospects for maintaining the level of financial savings in Hungary.

On a technical matter, Mr. Laske welcomed the fact that the import restrictions imposed in 1982 had been partly relaxed in early 1983. The original intention had been to remove those restrictions entirely during the course of 1983; however, following the deterioration in the balance of payments prospects, the authorities had decided to postpone their full elimination for one year. While recognizing the reasons for the authorities' decision, he was disappointed in the delay, which was bound to have a negative impact on the adjustment process. Finally, he could warmly support the draft decision.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/83/89 (6/22/83) and EBM/83/90 (6/24/83).

3. APPROVAL OF MINUTES

The minutes of Meetings 83/10 through 83/12 and 83/14 are approved. (EBD/83/170, 6/16/83)

Adopted June 22, 1983

4. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/83/161 (6/21/83) and EBAP/83/162 (6/22/83) is approved.

5. STAFF TRAVEL

Travel by the Managing Director as set forth in EBAP/83/165 (6/23/83) is approved.

APPROVED: November 23, 1983

LEO VAN HOUTVEN
Secretary