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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 83/113

10:00 a.m., July 29, 1983

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

Executive Directors	Alternate Executive Directors
	J. K. Orleans-Lindsay, Temporary
J. de Groote	H. G. Schneider
B. de Maulde	
	M. Teijeiro
R. D. Erb	
M. Finaish	T. Alhaimus
T. Hirao	T. Yamashita
J. E. Ismael	Jaafar A.
R. K. Joyce	M. Casey
	C. Robalino
G. Laske	G. Grosche
	C. P. Caranicas
	L. Barbone, Temporary
R. N. Malhotra	A. S. Jayawardena
Y. A. Nimatallah	J. E. Suraisry
J. J. Polak	
A. R. G. Prowse	K. G. Morrell
G. Salehkhou	O. Kabbaj
	M. Camara, Temporary
M. A. Senior	
J. Tvedt	
	C. Taylor
	Wang E.

L. Van Houtven, Secretary
L. Collier, Assistant

Also Present

Asian Department: Tun Thin, Director; J. T. Boorman, H. O. Roden, G. Szapary, M. Zavadjil. European Department: L. A. Whittome, Director; L. Hansen, W. E. Lewis, L. G. Manison, P. Mentré de Loye, D. M. Ripley, H. O. Schmitt. Exchange and Trade Relations Department: S. Mookerjee, Deputy Director; D. K. Palmer, Deputy Director; M. Guitian, A. B. Petersen. External Relations Department: A. M. Abushadi. IMF Institute: P. Putu Raka, Participant. Legal Department: G. P. Nicoletopoulos, Director; W. E. Holder, Ph. Lachman. Middle Eastern Department: B. A. Karamali, S. von Post. Research Department: W. C. Hood, Economic Counsellor and Director; R. R. Rhomberg, Deputy Director; K.-Y. Chu, T. K. Morrison, A. Muttardy, B. E. Rourke, A. Salehizadeh. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: S. R. Abiad, C. J. Batliwalla, J. Delgadillo, S. El-Khouri, L. Ionescu, P. Kohnert, I. R. Panday, P. D. Péroz, P. Péterfalvy. Assistants to Executive Directors: H. Arias, J. Bulloch, M. B. Chatah, T. A. Connors, G. Ercel, I. Fridriksson, M. Hull, H. Kobayashi, P. Leeahtam, W. Moerke, Y. Okubo, G. W. K. Pickering, E. Portas, M. Z. M. Qureshi, J. Reddy, J. Schuijer, P. S. Tjokronegoro, Wang X., A. Yasseri.

1. INDONESIA - PURCHASE TRANSACTION - COMPENSATORY FINANCING FACILITY

The Executive Directors considered a request by Indonesia for a purchase equivalent to SDR 360 million under the compensatory financing facility (EBS/83/145, 7/12/83; and Sup. 1, 7/26/83).

Mr. Ismael stated that on July 22, his Indonesian authorities had submitted a formal request to purchase SDR 360 million--50 percent of quota--from the Fund under the compensatory financing facility. In that connection, the staff had prepared an excellent and comprehensive paper for discussion by the Executive Board. To summarize the current position of the Indonesian economy, it would be reasonable to say that, like many other countries, it was trapped in the trough of the world economic downturn; it faced performance gaps of considerable magnitude in respect to growth and investment, balance of payments, and government budget operations. Fortunately, thanks to its cautious fiscal and monetary policies, Indonesia had not been plagued by domestic inflation.

The Indonesian authorities were not only aware of the existence of the performance gaps, Mr. Ismael continued, but they were also determined to take strong adjustment measures to cope with the new circumstances. It was with that awareness and determination that the Indonesian authorities had made difficult decisions to implement budget austerity, devaluation, investment expenditure cuts through project rephasing, and radical changes in monetary policy that fell just short of monetary reform. Those adjustments, however, could not be completed immediately, and sufficient external financing to tide the country over the transitional period would have to be obtained. The Indonesian authorities believed that further drawdowns of international reserves should be avoided as far as possible, as they wished to preserve a margin of external liquidity as a protection against any unforeseen liquidity squeeze.

Finally, he reiterated the staff's conclusion that all the necessary requirements for the purchase requested by his Indonesian authorities had been fully met, Mr. Ismael said. He therefore asked the Board to give its favorable consideration to the request.

Mr. Nimatallah commented that he welcomed the opportunity to discuss a request by an oil exporting country for a purchase under the compensatory financing facility. He strongly supported Indonesia's request; the balance of payments need was clearly established in the staff paper. The balance of payments had come under intense pressure in 1982/83, as oil export earnings were estimated to have declined by about SDR 2 billion. The Government had adopted various adjustment measures and had tapped available sources of commercial borrowing. Nevertheless, the balance of payments was estimated to have recorded an overall deficit of SDR 2.7 billion in 1982/83, and official reserves had declined by about SDR 2 billion. For 1983/84, oil export earnings were projected to decline further. Imports were also expected to decline in response to the strong adjustment efforts of the authorities, yet the current account deficit was projected to be SDR 6 billion, equivalent to 8 percent of GDP.

The staff paper had devoted considerable attention to the subject of Indonesia's cooperation with the Fund, Mr. Nimatallah remarked. During the Board's discussion in January of the Article IV consultation with Indonesia (EBM/83/6), Executive Directors had noted the strong fiscal adjustment measures taken by the authorities in response to the decline in oil earnings. Those measures had been strengthened by the scaling down of the public sector investment program, the comprehensive reforms of credit policies, and the 28 percent devaluation of the rupiah. He commended the authorities on taking those courageous actions despite the possible adverse effects on growth over the medium term. Indonesia's adjustment efforts went far beyond the requirement of cooperation for a drawing below 50 percent of quota under the compensatory financing facility.

Regarding the shortfall calculations, he had noted the relatively extensive discussion of Indonesia's oil policies and oil earnings, Mr. Nimatallah observed. More specifically, the calculations showed an "excess" rather than a "shortfall" in oil export earnings during the selected shortfall year although oil export earnings had declined. The results of the calculations for any commodity depended to a large extent on two things: first, the choice of the shortfall year, and second, the assumptions made for the two postshortfall years. In the present case, the year ended March 1983 was the shortfall year, but the decline in Indonesia's official oil prices had occurred toward the end of that period. Given the decline in oil prices from March onward, he wondered whether the calculations would have shown a shortfall, instead of an excess, had the year ended June 1983 been chosen as the shortfall year.

He noted the assumptions made by the staff regarding the price and export volume of oil in the two postshortfall years, Mr. Nimatallah continued: first, that the price would remain at $29.70 per barrel, which was 15 percent below the price in the shortfall year, and second, that the volume of oil exports would increase at only 4 percent a year. He realized that export volume projections involved considerable uncertainty and a great deal of judgment. However, given the likely strength of the world economic recovery in 1984 and the necessity of building up oil inventories, the staff assumptions about the demand for oil in general, and Indonesia's export volume in particular, seemed to be on the conservative side. The assumptions were critical because the results of the calculations were very sensitive to them. For example, according to his calculations, if export volumes had been assumed to increase by 1 percentage point more than 4-5 percent a year in each of the two postshortfall years, oil export earnings would have shown a shortfall rather than an excess in the shortfall year. But time would tell whether the assumptions made by the staff were too conservative. He could therefore go along with the assumptions and the results of the calculations made by the staff in the present case. He reiterated his support for Indonesia's request and endorsed the proposed decision.

Mr. Prowse said that, like Mr. Nimatallah, he had noted the extensive treatment of oil income in the staff report; however, he was satisfied that the subject had been treated thoroughly, yet on a conservative basis, in accordance with the Board's request. The proposal met all the criteria for a drawing under the compensatory financing facility, and he supported it. With regard to the balance of payments need, the current account deficit had widened from SDR 2.6 billion in 1981/82 to SDR 6.3 billion in 1982/83, and was projected to be SDR 6 billion in 1983/84. Forty percent of the deficit had been financed by a reduction in foreign assets, which was evidence of the proper use of the reserves that Indonesia had built up during its previous periods of surplus.

Indonesia presented a good example of cooperation with the Fund, Mr. Prowse commented. The decline in oil prices and other developments in the balance of payments had been a catalyst for a series of rapid and decisive actions by the Indonesian policymakers, which included a 28 percent devaluation of the rupiah, a major revision of investment projects involving expenditure savings of up to $3 billion in 1983/84, a substantial reform of interest rate and credit policy, and an ongoing review of tax policy. The staff had concluded that the measures taken by the Indonesian authorities were an adequate response to the recent deterioration in the external position. He therefore agreed with Mr. Nimatallah that, in the matter of cooperation, the actions taken by the Indonesian Government would have justified a purchase above 50 percent of quota under the compensatory financing facility.

Mr. de Groote said that he supported Indonesia's request for a purchase equivalent to SDR 360 million under the compensatory financing facility. Indonesia's estimated shortfall was both temporary and beyond the control of the authorities, except for that portion that was due to the Government's restrictions on unprocessed timber. He would make a few general observations on the situation and policies of Indonesia in conformity with the Board's decision to view financing under the compensatory financing facility in relation to the willingness of the country to pursue appropriate policies and to cooperate with the Fund.

Following a period of relatively rapid growth and reasonable inflation rates, Indonesia, the world's ninth largest exporter of crude oil and fifth largest exporter of natural gas, had encountered severe external imbalances of mostly exogenous origin, Mr. de Groote remarked. Substantial decreases in export earnings beginning in 1981 had reversed the trend of the current account from a surplus to a deficit of 7 percent of GDP by 1982/83. During the earlier period, the dependence of the economy on oil, rather than on other sectors such as agriculture, mining, and manufacturing, and conditions in the world oil market had combined to mask the need for structural adjustment of the economy. As a result, no positive contribution from those sectors had been forthcoming as the external situation worsened in 1981-83.

The sharp reduction in oil revenues, a large part of which contributed to budget revenue, and widespread tax evasion throughout the economy had inevitably had a negative effect on public finances, Mr. de Groote observed. He was pleased to note that the balanced budget approach and the possibility of a small surplus in the current year's budget could contribute to resolving the balance of payments difficulties. The most critical factor in the attainment of a satisfactory overall balance of payments performance and in achieving the required economic adjustment both, at present and in the future, would be the choice of the public sector investment strategy. Even after the authorities' decision to postpone a number of investment projects, thereby reducing external expenditures by $10 billion, the remaining projects might still exert pressure on the external accounts over the next several years. Also, owing to foreign exchange constraints, delays in the remaining projects would add increased costs to the budget, thus absorbing foreign exchange receipts. Careful implementation and close supervision of those projects were therefore of vital importance.

The efforts of the authorities with respect to exchange rate policy, and the substantial reform of interest rate and credit policies had been very helpful, Mr. de Groote commented. The 28 percent devaluation of the rupiah in March and the present flexibility of the exchange rate under a managed float system should help restore competitiveness, especially in the non-oil sectors, as well as improve resource allocation in the economy as a whole. On the other hand, considering the present structure of the Indonesian economy, the measures should have some effect on the flight of speculative capital and on inflation, two areas of major concern to the authorities. He asked the staff for further comment on the possible effects of those measures.

During the Article IV consultation with Indonesia in January, Mr. de Groote recalled, the staff had stated that despite the clear need for an increase in savings and for reasonably high interest rates, the possibility for improving private savings was limited because an increase in savings would have to come mainly from the public sector. Under those circumstances, would the freeing of interest rates on deposits and loans early in June be helpful in boosting private sector savings, as suggested by the staff?

The prospects for the achievement of sustainable growth by the Indonesian economy depended to a great extent on the structural changes that could be made, Mr. de Groote remarked. If the economy continued to depend on the development of one or two primary commodities, the result could be further unexpected imbalances. He was therefore glad that the Indonesian authorities were following a development path that could lead to better balance among the various productive sectors. In conclusion, the policies followed by the authorities were in the appropriate direction and satisfied the requirement of cooperation with the Fund.

Mr. Robalino said that he supported Indonesia's request for compensatory financing. Indeed, the authorities would have been justified in requesting a drawing in excess of 50 percent of quota. Indonesia had a balance of payments need; its current account deficit, despite energetic corrective measures, was high; and its reserves, in terms of non-oil imports, were falling. Stringent adjustment policies on the part of Indonesia were not required by the decision on the compensatory financing facility. The authorities had not only promised that they would cooperate with the Fund in trying to solve the country's balance of payments problems to the extent necessary, but had actually been cooperating with the Fund.

The requested drawing was well below the estimated shortfall, Mr. Robalino observed. Therefore, in addition to Indonesia's representations, there was further security against overcompensation. The staff had presented convincing arguments that the shortfall was outside Indonesia's control. The analysis of the commodities making up Indonesia's exports indicated that Indonesia's share in world oil exports in the shortfall year had exceeded its average share in the four preceding years. Even if exports had been lower than in 1982, there was no reason to assume that a different oil pricing policy would have led to higher receipts from oil. Projections of an export recovery were adequate to assure that the shortfall was temporary.

Mr. Caranicas said that he supported the proposed draft decision for a purchase by Indonesia of an amount equivalent to SDR 360 million under the compensatory financing facility. Since January, when the Executive Board had considered the Article IV consultation report and had approved the request for purchases under the buffer stock financing facility, Indonesia's external balance had deteriorated further. The current account deficit had risen to about 7 percent of GDP, mainly owing to a decline in exports. Over 40 percent of the 1982/83 current account deficit had been financed by a decline in the net foreign assets of the monetary system, mainly reflecting a fall in official reserves.

Table 1 of the staff report indicated that the preliminary 1982/83 figure for gross foreign assets represented 6.8 months of imports, Mr. Caranicas remarked, which was a reduction of almost one half in the country's international reserves registered in 1980/81. However, reserves were slightly above the level of 1978/79, when they had stood at 6.4 months of imports. He did not object to a developing country like Indonesia, which was subject to large price flucuations in its exports of primary products, having comfortable reserves. But, prima facie, the balance of payments need, particularly in comparison with other Fund members whose reserves had practically disappeared, was not obvious. In addition, Indonesia's borrowing capacity had remained unimpaired. Under the present conditions of tight Fund liquidity and a possible commitment gap, perhaps a more evenhanded approach in considering the level of reserves of its members should be taken when assistance was requested for balance of payments difficulties.

Indonesia's cooperation with the Fund had been proved many times in the past, Mr. Caranicas recalled. The staff's assessment that the shortfall of SDR 553 million in export earnings was temporary in character was beyond doubt, particularly in view of the expected recovery in exports in the second postshortfall year. Indonesia's request for a purchase equivalent to SDR 360 million met all the requirements of the compensatory financing facility decision. The shortfall was approximately one and one half times as large as the proposed purchase; in addition, the Government of Indonesia had stated in its request that it would make a prompt repurchase of the excess if the amount of purchase was more than the actual shortfall.

As the present case was the first instance of a request for compensation that involved exports of oil, Mr. Caranicas continued, he wished to comment on the staff's methodology. Although there had been an excess rather than a shortfall, the calculation remained important for the determination of the overall shortfall. In that sense, the staff's cautiousness in its oil export projections was appropriate, although it was well known that the lack of confidence in oil export forecasts vitiated any calculation based on them. However, he was uneasy about the argument put forth by the staff to explain the loss in market share during the shortfall year. According to the description of the causes of the shortfall and export prospects on page 13 of the staff report, Indonesia had a pricing strategy that placed its oil price above the world average to a greater extent than previously. Therefore, one had the impression that Indonesia could not avoid part of the blame for its loss of market share and consequent reduction in oil exports. The staff argument that a more flexible pricing policy might have caused a further reduction in earnings was based on speculation and contrasted with the actual pricing and output experience in the shortfall period.

Finally, Mr. Caranicas pointed out that Table 3 in the staff report illustrated a paradox. The calculated shortfall was the sum of a shortfall and an excess. However, by virtue of the power of geometric averages, the final shortfall after an adjustment for the excess was greater than the shortfall without adjustment. Although immaterial in the present case, given the amount of requested compensation, that paradox warranted discussion about a possible change in methodology when the issue of the compensatory financing facility formula came before the Executive Board.

Mr. Joyce said that he supported the request, but with some concerns and reservations. His support was based on the staff's conclusions that Indonesia's balance of payments situation justified the purchase; that the Indonesian response to the recent deterioration in the balance of payments situation had to date been adequate; that Indonesia had declared that it would cooperate with the Fund to find appropriate solutions to its difficulties; and that the shortfall for the year ended March 1983 was largely attributable to factors beyond the control of the member.

With regard to adjustment, Mr. Joyce continued, Indonesia had already demonstrated its willingness and ability to take strong corrective measures. As the deficit had increased, the authorities had taken action promptly without waiting to be forced into doing so by either outside circumstances or outside agencies. However, he recalled that, during the Executive Board discussion in January 1983 (EBM/83/6), concerns had been expressed about the adequacy of the measures that had been taken. A series of further steps had been taken by the authorities following the decrease in oil prices in March 1983, and he congratulated them on their decision to devalue the rupiah and to review and reorder the public sector investment program. The recent steps toward freeing interest rates and removing credit ceilings were commendable. He was pleased that the 1983 Article IV consultation discussions were scheduled to be held in August rather than later in the year. At that time Indonesia's economic situation and prospects in light of developments in the world recovery should be reviewed. A judgment would have to be made as to whether adjustment measures already taken were proving to be adequate both for the short term and for the longer haul, or whether additional measures were needed.

He had no difficulty with the staff's calculations of the shortfall, Mr. Joyce commented. The size of the shortfall for the year ended March 1983 considerably exceeded the amount of the proposed purchase, even when taking account only of non-oil exports.

There were areas that might have broader implications for the operation of the compensatory financing facility, Mr. Joyce observed. He referred to the staff's comment that in general the shortfalls, particularly in the nonenergy sector, were due more to price factors than to volume factors. While external developments in timber undoubtedly had accounted in part for the decline in export receipts, the sharp decline in export volume since 1979/80 had coincided with the introduction of export quotas by the Government. He sympathized with what the authorities were trying to achieve--a higher degree of domestic processing of natural resources. That policy had been pursued in other countries, including Canada. But the issue was not whether the policy was appropriate in developmental or economic terms, but whether it fit under the request for compensatory financing. Such developmental shifts obviously could not be brought about overnight, and during the changeover period, the total volume of exports--in the present case, of forest products--would be lower than might otherwise be the case. In a technical sense, one could argue that part of the shortfall in timber was not beyond the control of the authorities.

In the staff report, the shortfall in rubber had been explained primarily in terms of the weakness in export markets, the fall in rubber prices, and the consequent withdrawal of smallholders from the market, Mr. Joyce noted. But he wondered whether part of the shortfall might not have been due to the aging of the tree stock during the 1970s and the reduction in both the quantity and quality of production. If that were the case, then again one could argue that the decline in earnings from rubber was both foreseeable and avoidable. He asked for further comment from Mr. Ismael or the staff about whether earlier and possibly more imaginative remedial policies might have cushioned the fall in exports. An appreciable increase in export earnings was anticipated in the post-shortfall period. Was that projection based in part on planned supply-side developments, or on a combination of a hoped-for increase in international prices and the ability of smallholders with low-yielding trees to enter the market as prices rose? If the latter were the case, the Fund was helping Indonesia to maintain its situation without a fundamental change in that sector.

It was not necessary to factor oil into the shortfall calculations to justify the present drawing, Mr. Joyce considered; oil exports in the shortfall year had been above the average for the five-year period. But perhaps oil exports might have been even higher if Indonesia had chosen to pursue different policies, which in turn might have reduced the magnitude of the overall shortfall. The policies pursued by the authorities had focused on actively promoting exploration and development, including the development of domestic refinery capacity, while aiming at moderation in the fluctuation of official export prices of oil. He was aware that Indonesia traditionally followed OPEC price developments, although sometimes with a lag. The question was whether Indonesia's pricing policies had had an adverse effect on production or export sales. In the present circumstances, while production was below capacity, one might argue that a more aggressive pricing policy could have maintained or increased Indonesia's market share during periods of weak demand. The staff argued that competitors would have reacted promptly and that the policy would not have resulted in larger oil revenues during 1982/83. He did note that in the second quarter of 1982 Indonesia had not been able to meet its OPEC production quota, although subsequent levels had been exceeded. On a case-by-case basis, he found that on balance Indonesia had been following reasonably cautious oil pricing policies. As a price-taker in a very competitive field, it was unlikely that Indonesia would have been able to carve out a much larger share of the market through more aggressive pricing policies.

More generally, he wondered whether Indonesia could have attenuated the decline in non-oil exports if it had pursued a more flexible exchange rate policy between 1978 and 1983, Mr. Joyce said. He noted, for example, that the real effective exchange rate had appreciated by nearly 22 percent between 1979 and early 1983. While he welcomed the depreciation of March 30, it was possible to argue that the Indonesian authorities should have moved earlier, given the deterioration of the current account in 1981/82, the steady appreciation of the exchange rate through that period, and the accompanying decline in Indonesia's reserves. If action had been taken sooner, the shortfall in 1983 might have been smaller. However, despite his observations and questions, he could support Indonesia's request.

Mr. Alhaimus stated that he supported the proposed drawing by Indonesia under the compensatory financing facility. Indonesia's request met all the requirements of the compensatory financing facility decision, and the need for the purchase was evidenced by the sharp deterioration of the current account, the consequent large drawdown of reserves, and the recourse to sizable borrowing from commercial sources.

The policy responses of the Indonesian authorities to changed circumstances had already been commended by the Board in the discussion of January 7, 1983, Mr. Alhaimus recalled. Further major adjustment measures had been taken since March 1983. A large devaluation of the rupiah had been effected in March, thus reversing a previous policy of gradual exchange rate adjustment. In addition, the authorities had implemented a comprehensive review of the public sector investment program, a substantial reform of interest rate and credit policies, and further consideration of the tax policy review. Those measures had been judged by the staff as an adequate response to recent deterioration in the external position. The Intergovernmental Group on Indonesia had also expressed overwhelming support for those policies aimed at preserving financial stability and laying the foundations for longer-term structural adjustment. He shared Mr. Nimatallah's view that the measures taken by the authorities went well beyond those required for a lower tranche drawing under the compensatory financing facility. The authorities were to be complimented for the strong measures that they had taken.

The shortfall in 1982/83 was largely beyond the control of the Indonesian authorities, as clearly demonstrated in the staff paper, Mr. Alhaimus added. An interesting feature of the shortfall, as stated by the staff, was that "the estimated shortfall of SDR 553 million is accounted for largely by a shortfall of SDR 473 million estimated for earnings from nonenergy exports." Indeed, earnings from oil and liquefied natural gas in the shortfall year were about equal to their medium-term trend value, according to staff calculations. Although he did not want to contest those projections, it was very difficult to endorse any precise trend, given the prevailing uncertainties.

Mr. Hirao stated his support for the proposed decision. It was clear from the well-documented staff paper that there was a balance of payments need. The current account deficit in 1983/84 was projected to be SDR 6 billion, while the overall deficit was projected to be SDR 1.6 billion. The shortfall in export earnings was mainly accounted for by shortfalls in timber, rubber, and tin. With regard to the implications of government policy--to phase out log exports and to promote domestic processing and exports of timber products--for the export shortfall, he noted that exports of processed timber products had not expanded as intended because of weak demand abroad. Indonesia's oil exporting policy as described in the staff report was interesting, but it had little relevance in the present case, as earnings from oil in the shortfall year had been about equal to their medium-term trend value.

He commended the measures taken by the authorities since March, Mr. Hirao commented. A 28 percent devaluation of the rupiah in March and a comprehensive review of the public sector investment program should help to redress the balance of payments difficulties, and the authorities were to be commended for the prompt action. The most recent move to substantially reform interest rate and credit policies was also encouraging, and the freeing of most categories of state bank interest rates should prove helpful in promoting private sector savings and allocating funds for domestic investment more sufficiently over the medium term. Finally, he welcomed the bringing forward of the 1983 Article IV consultation discussions with Indonesia.

Mr. Polak said that he supported the request by Indonesia for a drawing of SDR 360 million, or 50 percent of quota, under the compensatory financing facility. A shortfall of SDR 473 million had been recorded for nonenergy exports--mainly timber and rubber--owing primarily to cyclical factors. He accepted the staff's analysis with regard to increased exports of fabricated timber, rather than the logs previously exported. As to energy products, there was a small excess for oil and a balance for liquefied natural gas. The staff had presented a lengthy and complicated analysis of Indonesia's energy policy, including difficult judgments about oil export earnings and pricing policy in the shortfall year. It was not clear what the consequences would have been for Indonesia's request if answers other than those presented by the staff had seemed more appropriate. He appreciated the provision of such extensive information on the energy component, which was necessary to reach an overall judgment about Indonesia's request.

He could support the request as the overall export shortfall of Indonesia was larger than the proposed purchase of SDR 360 million, Mr. Polak stated. In accordance with the case-by-case approach, it was not necessary to reach a more precise judgment with regard to the energy component. The issue of the requirement of need was met by the balance of payments data provided in Table 1 of the staff report, and he saw no reason for the reservations raised by Mr. Caranicas in connection with that aspect of the request.

With respect to economic policy, Mr. Polak said that he was pleased that Indonesia had acted promptly to reverse the deteriorating trend of the balance of payments. Actions included the recent devaluation, the cut in large investment projects, the freeing of interest rates, and reforms in the fiscal credit areas. Many of those actions followed recommendations by the Board and by the staff during the most recent Article IV consultations, which clearly showed the essential link in the cooperation between the Fund and the member that was a precondition for drawings under the compensatory financing facility. He welcomed the decision to advance the 1983 Article IV consultation discussions, which would constitute a useful opportunity for the Board to appraise in greater depth the adjustment that Indonesia was making in a changing economic environment, and for the authorities to consult with the staff on the measures to implement the radically different monetary policy that they had recently adopted.

The staff had stated that "the measures undertaken by the Indonesian authorities are an adequate response to the recent deterioration in the external position," Mr. Polak noted. In addition, Indonesia's policies had been warmly endorsed at the recent Intergovernmental Group meeting in the Netherlands. Those judgments implied that Indonesia went well beyond meeting the test of cooperation that was applicable to a drawing in the lower 50 percent of quota under the compensatory financing facility. Indeed it seemed to be the judgment of the staff, if endorsed by the Board, that Indonesia would have met the higher test of cooperation had the request been for an amount greater than 50 percent of quota.

Mr. Senior stated that he strongly supported Indonesia's request for a purchase equivalent to SDR 360 million under the compensatory financing facility. Although Indonesia was the first OPEC member to request the use of Fund resources under the facility, a matter that had occupied the Board's attention in the past few months, the request clearly met all the required criteria.

Regarding the balance of payments need, Indonesia's balance of payments had significantly weakened in the past two years, in great part reflecting the lower exports that had resulted mainly from deteriorating external demand, Mr. Senior observed. The current account balance had shifted markedly from a surplus of SDR 1.5 billion in 1980/81 to an estimated deficit of SDR 6.3 billion in 1982/83; during the past year a drawdown in reserves had financed a large part of the deficit. The requirement of need had been more than satisfied.

The estimated shortfall of SDR 553 million was greater than Indonesia's requested purchase of SDR 360 million, so that there was sufficient margin for any estimation error that might occur in the early drawing procedure, Mr. Senior commented. In any case, Indonesia had represented in its request that it would promptly repurchase any overcompensation if it should arise.

He concurred with the staff that the shortfall was mainly accounted for by nonenergy exports and was due largely to circumstances beyond the member's control, Mr. Senior said. Oil and gas exports, on the other hand, had registered a small excess, eliminating any discussion with regard to those controversial commodities, although he was disappointed that the Indonesian case did not present an opportunity to test the issue. He wondered about the inclusion of a lengthy annex on Indonesia's petroleum and natural gas industry, given the nonexistence of a shortfall in the exports of those products, and he considered the annex superfluous. He agreed with Mr. Nimatallah's comments regarding the shortfall calculations for oil export earnings.

With regard to the requirement of cooperation with the Fund, Mr. Senior continued, the Indonesian request was for a purchase equivalent to the first 50 percent of its quota. According to the guidelines, that request could be met only if the Fund was satisfied that the member "will" cooperate with the Fund in finding appropriate solutions to its balance of payments difficulties. He stressed that the requirement was for future cooperation, and not past cooperation, as required for a purchase of greater than 50 percent of quota. He was therefore intrigued by the lengthy exposition in the staff paper of the cooperation requirement and of the measures adopted. As Indonesia had amply demonstrated its willingness to cooperate with the Fund, its future cooperation should not be in doubt. The measures adopted by the authorities were comprehensive and in the staff's view were an adequate response to the recent deterioration in the external position of Indonesia. Thus, it was implied either that the measures taken justified a purchase larger than 50 percent of quota, or that such measures were required for a purchase in the first 50 percent. He expected that the first interpretation was correct, but he asked the staff or Mr. Ismael whether Indonesia was contemplating a purchase larger than 50 percent of quota. If not, he hoped that the abnormally lengthy justification of the cooperation requirement had not been made because Indonesia was a member of OPEC. On previous occasions he had expressed his views on that subject, as well as on the subject of conditionality associated with requests under the compensatory financing facility. The Executive Board's recent discussion on access to the Fund's resources (EBM/83/110 and EBM/83/111) had clarified the views of the majority of the Directors in that respect.

Mr. Laske said that he supported the request by Indonesia for a drawing under the compensatory financing facility. The balance of payments need was unquestionable. The shortfall had been carefully calculated and evaluated by the staff, and the requirement of cooperation had been met for a drawing of the requested amount. He was particularly pleased with the conservative assumptions the staff had made in assessing the post-shortfall years' export forecast.

The balance of payments problem facing Indonesia was greater than a temporary shortfall of exports, which was self-reversing, Mr. Laske commented. The authorities had reacted in a determined and far-reaching way to the new situation. In view of the changes that had occurred and that were under way in Indonesia's economy, he welcomed the bringing forward by three months of the next Article IV consultation discussion, which would provide ample opportunity to look more closely at the history of the present Indonesian problems and at the approach the authorities had chosen to deal with them. He did, however, share Mr. Joyce's concerns regarding the export shortfall for timber and, in particular, logs.

Mr. Camara noted that the staff paper delineated in a clear and concise manner the balance of payments need of Indonesia and showed that the country qualified for a drawing under the compensatory financing facility. Bearing in mind the conclusions reached during the most recent Board discussion of the compensatory financing facility, he saw no element that could prevent the granting of the request. The overall surplus of SDR 640 million reached in 1981/82 had turned into a large deficit of nearly SDR 2.7 billion in 1982/83, and the current account deficit had increased by SDR 3.6 billion during the same period. The causes of the poor balance of payments performance seemed to be beyond the control of the authorities. They had followed the recommendations made during the previous Article IV consultation; nevertheless, difficulties with export levels had continued, reflecting the decline in world demand for oil and the sharp reduction in world market prices for oil and liquefied natural gas.

The recession in industrial countries had caused the demand for exports of Indonesian nonenergy primary commodities, such as timber, rubber, palm oil, and coffee, to fall considerably, bringing their international price to a low level, Mr. Camara continued. As a result, export earnings had dropped to SDR 16.5 billion in the year ended March 1983 from SDR 17.5 billion the previous year. The staff had projected an export shortfall of SDR 553 million, which was expected to be temporary in the wake of the current world recovery and the willingness of the Indonesian authorities to take the necessary steps to further improve the performance of the economy. The authorities were willing to cooperate with the Fund in finding appropriate solutions to the country's balance of payments difficulties, and he noted that there had been a precedent of understanding with the Fund. He therefore stated his chair's support for the proposed decision.

Mr. Taylor recalled that, as the report on recent economic developments for the Article IV consultation had demonstrated, Indonesia's exports were dependent on the behavior of demand in the industrial countries. The marked decline in the volume of exports, intensified by the fall in the price of nonenergy exports, had produced a shortfall in the year to end-March 1983, which was not likely to persist. World recovery should improve Indonesia's export earnings, more particularly in nonenergy fields. Because the shortfall was due primarily to the weakness of world trade, it could be regarded as largely involuntary.

The shortfall was accounted for entirely by non-oil exports if measured by the geometric method, Mr. Taylor noted, and very largely by nonenergy exports if measured by the arithmetic method. That did not mean that the performance of oil exports was irrelevant in the present case, because oil exports were a major item in the trade balance and their behavior inevitably affected the size of the total shortfall. It was appropriate to analyze carefully the oil situation; he did not share the views of those Directors who implied that it was not relevant to the decision before the Board. Oil earnings, in fact, had fallen about 15 percent in the year ended March 1983 compared with the previous year; they were, nevertheless, estimated to be roughly at their trend value for the five-year period taken as a whole.

He agreed that the measurement of the oil trend was very sensitive to the assumptions made for the postshortfall period, Mr. Taylor remarked, reflecting the difficulty of analyzing a commodity that was volatile and hard to assess. Given the uncertainties, it was appropriate that the staff was cautious in making its forecast.

Although Indonesia's membership in OPEC implied that the country could not be described as a pure price-taker in world oil markets, he shared the staff's view that a more flexible pricing policy would probably not have increased oil export earnings in the shortfall year, Mr. Taylor said. Regarding oil volumes, OPEC had decided to respond to the fall in demand in 1982 by quantitative rather than price adjustments. Therefore, while dollar prices had been stable, production quotas had been set and a few members--those with healthy balance of payments positions--had elected to take production cuts. In the case of Indonesia, production had declined during the shortfall year, and there was an OPEC-agreed production quota for three months of the shortfall year. But demand had been so low that production had actually fallen below the quota. As illustrated in Table 4 (EBS/83/145), Indonesia's market share of world oil exports during the shortfall year had been slightly higher than the average during the two preshortfall years, at a time when OPEC's market share as a whole had been declining. For those reasons he could accept that the decline in Indonesia's oil exports was due to factors largely beyond the authorities' control.

Regarding nonenergy exports, Mr. Taylor continued, the shortfall in 1983 was expected to be temporary in all commodities except logs, where the medium-term export quotas had been established for conservation and developmental reasons. The shortfall in exports of other timber products had been largely caused by the global recession, particularly reduced construction activity, which had lowered the demand for unsawn logs below the export quota and had restrained the growth in exports of timber products that the authorities had hoped would offset declining log exports. Export quotas for coffee and tin had been agreed by international commodity organizations composed of both producers and consumers, and it was usual Fund practice to regard such quotas as beyond a member's control.

As for the question of cooperation with the Fund, Mr. Taylor recalled that the Indonesian authorities had been willing not only to receive Fund missions and to bring their Article IV consultation forward but also to take a very impressive series of corrective measures. Those measures, which he imagined had been taken in part as a result of consultation with the Fund, were designed to promote non-oil exports in the short term and medium term, as well as to postpone and rephase some 47 investment projects that would have required about $10 billion in foreign expenditures over the following few years. As much as $3 billion should be saved from the 1983/84 budget.

He encouraged the authorities to continue their responsible policies on public expenditure, taxation, debt, the exchange rate, and export diversification, Mr. Taylor remarked. Their active and timely response to the oil price reduction was a sensible effort to minimize the damaging effects on an already strained balance of payments position. In conclusion, Indonesia had met all the relevant criteria for a drawing under the compensatory financing facility; the balance of payments need was well demonstrated and he could support the proposed decision.

Mr. Orleans-Lindsay said that he agreed with the staff analysis and supported the draft decision for a purchase by Indonesia under the compensatory financing facility. The proposed purchase of SDR 360 million--equivalent to 50 percent of Indonesia's quota--was less than the calculated shortfall of SDR 553 million for the relevant 12-month period ended March 1983. A large proportion of the estimated shortfall of export earnings, about 85 percent, was attributable to nonenergy exports while the value of Indonesia's oil exports showed a small excess. The value of liquefied natural gas exports had recorded no shortfall during the relevant period.

Indonesia's request was for a purchase at the lower end of the range, Mr. Orleans-Lindsay noted. He wondered whether the amount had been suggested by the staff, or whether it was due to the cautious approach of the Indonesian authorities in the management of their affairs.

He agreed with the calculations made by the staff with regard to oil, Mr. Orleans-Lindsay stated. When oil prices had increased sharply and there had been some improvement in the prices for primary products, Indonesia had built up large surpluses on its current account. The authorities had prudently saved a large proportion of the increase in export earnings and invested part in key economic sectors, which in turn had led to an impressive rate of real economic growth. That growth had reached a peak of about 10 percent in 1980/81; but economic developments in Indonesia had begun to show a significant reversal in 1980/81 when the oil markets had weakened. With deepening international recession and a severe drought that had disrupted the steady rise in Indonesia's agricultural production, the growth of real GDP had declined to about 8 percent. The staff had projected that the momentum in real growth rates would decline further, to about 3 percent, in 1982/83. Because of the prudent tight fiscal and monetary policies pursued by the authorities and the relatively comfortable supply situation, the authorities had been able to reduce inflation from about 21 percent in 1979/80 to about 9 percent in 1982/83.

The sizable current account surpluses that had been recorded in previous years on Indonesia's balance of payments had turned into a sharp deficit in 1981/82, Mr. Orleans-Lindsay noted. Pressures on the balance of payments had intensified in 1982/83; the current account deficit had widened to SDR 6.3 billion from SDR 2.7 billion, and the overall balance had moved from a surplus of SDR 0.7 million to a deficit of SDR 2.7 billion. In light of the deteriorating conditions, the authorities had taken commendable adjustment measures, but the pressures on the current account had not eased. The authorities had reinforced their measures with a devaluation of the rupiah in 1983. Other supporting measures, including a review of the investment program to reduce pressures on the current account, had also been taken by the Indonesian authorities. The staff had estimated that the impact of the adjustment measures would substantially improve Indonesia's external payments position in 1983/84, but the current account would still remain in deficit--about SDR 6 billion--while the overall deficit would decline to SDR 1.6 billion. Gross reserves had not changed significantly from the March 1983 position of about seven months' imports. Projections also indicated that the value of exports would continue to decline in the first postshortfall year with a moderate recovery expected in the second postshortfall year.

Indonesia had a balance of payments need that justified the proposed purchase, Mr. Orleans-Lindsay stated. The shortfalls were largely the direct result of circumstances beyond the control of the Indonesian authorities. The test of cooperation with the Fund had been amply demonstrated by the authorities' measures to solve their balance of payments difficulties. The recovery of exports during the second postshortfall year projected by the staff indicated that the calculated shortfall was temporary.

Mr. Wang recalled that in 1982/83 Indonesia's current account had registered a deficit of SDR 6.3 billion, while the overall deficit had been SDR 2.7 billion. The shortfall of SDR 553 million in aggregate earnings had stemmed mainly from weak external demand due to the world recession, and was largely attributable to factors beyond Indonesia's control. It was impressive that the authorities had gone to great lengths to adjust their policies to the recent external deterioration and were cooperating with the Fund in their adjustment efforts. Thus, Indonesia's request for a purchase had met all the requirements set forth in the compensatory financing facility decision, and he therefore supported the request.

Mr. Tvedt commented that Indonesia was one of the countries that had been hit by recent adverse developments in the international commodity markets. Not only its energy production but other products vital to Indonesia's export trade had suffered from those developments. As an oil exporting country, Indonesia in the past had taken the opportunity to increase its foreign exchange reserves, which could be used at present to alleviate its balance of payments problem. In addition, the Indonesian authorities had pursued active and determined adjustment policies; if the authorities continued to do so, he believed that Indonesia would soon overcome its balance of payments difficulties. The authorities had demonstrated their willingness to collaborate with the Fund to restore its external balance. For those reasons, Indonesia clearly qualified for a drawing under the compensatory financing facility, and he therefore supported the proposed decision.

Mr. Malhotra stated that he fully supported the proposed decision, and agreed with previous speakers that all the requirements for a drawing under the compensatory financing facility had been met.

With regard to the test of cooperation, Mr. Malhotra agreed with Mr. Senior and several other Directors that Indonesia's policies and actions went beyond the normal requirements for a drawing in the lower 50 percent of quota under the facility. Like Mr. Caranicas, he noted that 40 percent of the external deficit had been met by Indonesia drawing down its reserves, which had declined to the equivalent of 6.8 months' imports. The balance of payments deficit would also continue to be large in the following year. In assessing balance of payments need, it was necessary to look not only at the absolute level of reserves but also at the movement in reserves. The downward movement of Indonesia's reserves had been very strong. The Fund had of course to support countries in a difficult balance of payments position; at the same time, it should try to prevent serious deterioration in the balance of payments and reserves of countries in a relatively better position.

With regard to oil exports from Indonesia, Mr. Malhotra continued, the staff had pointed out that at present there was a major trade-off between volume and price; the resultant of the two factors was difficult to assess. In view of the decline in world demand for oil, it was clear that several oil producers could not even fulfill their production targets. The declining demand for oil had implications that went beyond the case of Indonesia. The situation would not have improved if Indonesia had dropped oil prices still further. Indeed, such a step could lead to a highly unstable condition of the oil market, which would not be in the interests of the world economy.

It had been suggested that the shortfalls in timber and rubber exports, could in part be attributed to the Indonesian authorities' policies, Mr. Malhotra said. In that connection, he pointed out that according to the staff report, there had been reduced world demand for timber, as activity in shipping and home construction industries had declined. Further, it was a policy objective of the authorities to conserve timber resources; conservation should be a prime objective of all countries with such resources. The balance between the level of exploitation of forest resources and the need to ensure their long-term viability through regeneration and plantings was important. Increased processing was a legitimate objective for a country with large timber resources. While in the short run following the introduction of such salutary policies, there could be some reduction in exports, increased value added, and stable supplies would improve export prospects in the medium term. In the light of such policies, vis-à-vis the compensatory financing facility, the authorities could not be held responsible for a shortfall in timber exports.

With regard to rubber, it had been argued that perhaps lack of adequate replanting of rubber trees might have accounted for an export shortfall, Mr. Malhotra observed. He did not believe that such arguments were relevant to the question of financing under the compensatory financing facility. Of course, the authorities could be advised to correct investment deficiencies in such sectors. It was, however, important to note that most developing countries suffered from lack of capital and had to make difficult investment decisions from year to year.

Mr. Salehkhou remarked that he supported the request by Indonesia for the use of Fund resources under the compensatory financing facility. It was apparent that the country had met all the requirements, especially the test of cooperation with the Fund. Regarding the calculation of the shortfall, he associated himself with Mr. Nimatallah's remarks. The balance of payments need of Indonesia clearly necessitated the drawing under the compensatory financing facility and he hoped that the authorities would soon be able to rectify the situation.

Mr. Erb commented that, on balance, Indonesia's request for a drawing equivalent to 50 percent of quota under the compensatory financing facility met the criteria for the facility. Although he questioned whether the shortfall was largely beyond the control of the authorities, he could support the decision because the calculated shortfall exceeded the requested amount by a substantial margin.

Indonesia faced a major balance of payments adjustment, Mr. Erb observed. Given the policy measures taken and the degree of consultation with the Fund, he believed that Indonesia would cooperate with the Fund to find solutions to its balance of payments problems. Like other Directors, he looked forward to the next Article IV discussion in order to assess the magnitude of the balance of payments adjustment required and whether existing policies were adequate to achieve that adjustment and enable Indonesia to obtain a sustainable balance of payments position.

Although Indonesia's reserves were still high, Mr. Erb continued, they were considerably lower than a year earlier and thus he felt that Indonesia met the requirement of a balance of payments need. The temporary character of the shortfall seemed evident from the projections for a total value of exports. However, it was worth noting from Table 5 of the staff report that some elements of the export basket, such as logs and oil, were not expected to reach earlier export levels.

With regard to the requirement that the shortfall should be largely beyond the member's control, he had difficulty with a number of products, Mr. Erb remarked. The staff had correctly pointed out that there were difficulties related to logs as the shortfall had been partly related to the government policy of phasing out log exports. Of particular concern was the precipitous drop in the volume of log exports during the preshortfall years, which appeared to have contributed to a sharp increase in the price of logs during those years. The unit value of log exports was expected to continue to rise beyond the shortfall year, perhaps due to expected additional cuts in Indonesia's log exports in the shortfall period. But he wondered if the more than doubling of the price of logs since 1979 would not induce more production from potential log producers in other countries or greater competition from products of other materials. Such production increases could work to moderate and perhaps reverse recent price increases, thus influencing the outer year projections. To the extent that the policies adopted were judged to be desirable from the longer-run point of view of the country, he had no disagreement with the country pursuing such policies. The question arose as to whether it was appropriate for the Fund to be providing financing in those circumstances through the compensatory financing facility; if balance of payments funds were required they should be provided through an ordinary stand-by arrangement.

With regard to tin, he noted that Indonesia had agreed to export quotas as part of its obligations under the International Tin Agreement, Mr. Erb observed. Also, Indonesia's coffee exports were subject to quotas with the International Coffee Agreement. Because Indonesia participated in producer arrangements, it was difficult to make a judgment on the beyond-the-control requirement, but he would have liked to see more analysis of whether the behavior of those organizations exacerbated the export shortfall. In that connection, the compensatory financing facility decision did not exempt a commodity from the beyond-the-control test if the country's pricing and production policies for that commodity were determined in a producer-consumer agreement. As he had stated in the past, he preferred to analyze the extent to which the shortfall was exacerbated, or perhaps even reduced, by the activities of the organization.

He attached a great deal of importance to the statement on page 11 of the staff report that annual production of crude oil had been maintained at the capacity output level of roughly 580 million barrels through 1981, Mr. Erb remarked; it had been the intention and objective of Indonesia to increase productive capacity. Thus Indonesia's production policies during the period of rising prices from 1979 through 1981 did not appear to have contributed to the sharp rise in the price of oil during that same period. However, he was concerned about the continued rise in the export unit value of Indonesian oil during late 1981 and into 1982, long after the export unit value on a worldwide basis had begun to decline. The pricing policy appeared to have contributed to the relatively larger decline in Indonesia's exports during 1982. An important question was whether that pricing policy had exacerbated the shortfall. As other Directors had said, there was a judgment about whether a slightly lower price would have induced a volume increase sufficient to have resulted in a higher level of revenues during the shortfall year. He believed that revenue during the shortfall year would have been higher; in making that judgment, he treated Indonesia as a price-taker.

Regarding the postshortfall year, Mr. Erb continued, forecasts for oil prices and exports were subject to a high degree of uncertainty. He did not disagree with the approach the staff had taken on the export forecast. He believed that the staff's assumptions on Indonesia's oil exports and prices were likely to be too high, especially toward 1985, rather than too low, but again the difference in judgment was not significant.

Mr. Teijeiro said that he agreed with the thrust of the staff appraisal and supported Indonesia's purchase under the compensatory financing facility. All conditions had been met in the area of balance of payments need. Indonesia had experienced a dramatic change in its external position in the past few years. Unfavorable external conditions for countries that were exporters of primary products had largely contributed to the outcome. Weak external demand and lower prices for key commodities had been important factors behind Indonesia's recent export performance, causing a decline in the value of exports beyond the authorities' control.

The authorities had reacted appropriately to the unfavorable external developments, Mr. Teijeiro commented. Further deterioration had been prevented by an array of measures adopted on both the external and domestic fronts, in particular, the review of the investment program, the modification of the exchange rate, and the reforms introduced in interest rate and credit policies. The continuation of a flexible exchange rate management and the timely review of the taxation policy would be beneficial in further improving the country's position. He shared Mr. Senior's view that the measures adopted could be taken as an indication of positive cooperation, but they were in no way a necessary condition for approval of the present request.

With respect to calculations of the shortfall, Mr. Teijeiro remarked that he shared the comments made by Mr. Nimatallah that the calculations might be on the conservative side.

Mr. de Maulde stated that the case presented by Indonesia was clear-cut; it fitted almost exactly into the normal framework of drawings in the lower 50 percent of quota under the compensatory financing facility. The balance of payments need existed beyond any doubt; the characteristics of the shortfall were unchallengeable because of its cause and its duration; and the degree of cooperation in finding appropriate solutions to balance of payments difficulties was well demonstrated by the authorities' actions consequent to the emergence of the shortfall. He therefore believed that the request merited full and complete support.

The Economic Counsellor, replying to questions, said that if the shortfall year had been fixed to terminate in June 1983 there would have been a shortfall in oil. That result would have been reached on the basis of the same assumptions for developments in oil exports and oil prices in the two subsequent years.

Turning to Indonesia's oil pricing policy, the Economic Counsellor remarked that the staff had made a judgment that under the unsettled conditions of the oil markets in the first quarter of 1983, export volume might not have increased significantly in the short run even after a substantial price cut. The present case emphasized the need to deal with each instance on its own terms and in relation to the pertinent facts. The staff was required only to show that a price reduction by Indonesia would not necessarily have caused an increase in the value of its oil exports in that year.

In regard to rubber, the Economic Counsellor reported that the World Bank was currently financing projects in Indonesia to replant rubber trees and replace older trees. Those facts were relevant to the point made that developments in rubber earnings were entirely beyond the control of the authorities. With respect to timber and the double objective of conserving timber and upgrading its value he wished to make two observations. First, in 1982 Indonesia's utilization of its timber processing capacity had been only 65 percent, which suggested that had world demand for its processed timber been greater, the success of its policy would have been more evident, meaning that the earnings from its exports would have been greater. The condition of world demand was of predominant importance in analyzing that particular situation. Second, the policy of Indonesia to upgrade the quality of its exports might reduce the value of its export earnings for the commodity involved for a time, but such a result should not be regarded as within the control of the member. That approach had been reaffirmed by the Executive Board in its general discussion of the compensatory financing facility in April 1982.

The annex on Indonesia's petroleum and natural gas industry had been included, the Economic Counsellor remarked, because oil accounted for some 65 percent, or about two thirds, of the exports of the country. In the circumstances, it had been thought useful to provide the information because, even though oil had not shown a shortfall, it had affected the overall shortfall.

The staff representative from the Asian Department commented that an Article IV mission was scheduled to leave shortly to discuss the effects of the measures recently taken by the authorities, including the devaluation and policies introduced in the monetary field. Preliminary data suggested that there had been large net sales of foreign exchange by the central bank through the foreign exchange market in the months up to end-March, when the devaluation had been carried out. Since then, except for a brief period recently, there had been net purchases by the central bank, indicating a substantial reflow of capital to the country.

The recent monetary measures had been significant, and the effects were difficult to predict, the staff representative observed. The interest rate liberalization had given rise to large increases in deposit rates at the state bank. Those rates had been virtually constant over recent years, whereas interest rates in other segments of the financial markets had varied substantially. In addition, funding of bank lending from the central bank through the discount mechanism would be far more limited in the future. That factor suggested the need for increasing domestic savings through the financial system.

In Table 1 of the staff report, the staff representative from the Asian Department explained, the figure for foreign assets given in terms of months of imports was based on total foreign assets of the banking system, not the narrower definition of official assets. The figures included all foreign assets of deposit money banks, which accounted for about one half of the total. There were liabilities in the banking system, swap arrangements, and the need for working balances, which were unquantifiable needs, but which had to be taken into account when interpreting those figures.

The staff representative from the Exchange and Trade Relations Department commented that he would address the general matter of the requirement of cooperation rather than the specific request by Indonesia. It had been stated that a request with the characteristics of the present one might have qualified for a compensatory financing facility drawing of more than 50 percent of quota. As a matter of general policy, a request for a drawing that would go beyond 50 percent of quota would require a detailed discussion of economic policies with the authorities. The discussion would provide management and the Board with a basis to judge the appropriateness of the member's policies to deal with its balance of payments difficulties. Discussions of that nature could take place on occasions such as the Article IV consultations, or in connection with negotiations for Fund arrangements.

In the past 18 months, the majority of requests for compensatory financing in the upper 50 percent of quota had been made by members that had entered or were entering into arrangements with the Fund, the staff representative recalled. Even for requests in below 50 per cent of quota, in a large number of instances the member either had entered or was entering into an arrangement or it was requesting access to the facility in conjunction with an Article IV consultation.

To a question on whether the section on cooperation in the report had been so extensive because Indonesia was a member of OPEC, the staff representative from the Exchange and Trade Relations Department responded that such had not been the case. There had not been a consultation with the country for several months and the intention had been to provide the Board with all the information available, as well as to give the Indonesian authorities full credit for the measures that they had taken recently.

Mr. Prowse recalled that a number of Directors had said that on the score of cooperation, the present proposal would have justified purchases beyond 50 percent. It seemed to him that the staff representative had rebutted that position. He wished to draw the staff's attention to page 5 of the staff report, where it was stated that the measures undertaken by the Indonesian authorities were an adequate response to the recent deterioration in the external position. That statement implied that an assessment had been made that could be accepted by the Board, and that it justified a purchase above 50 percent. The staff report was comprehensive and thorough and the assessment indicated consideration of the Indonesian authorities' measures. The recent experience with the compensatory financing facility where those members purchasing above 50 percent were either proposing to enter into or had entered into an arrangement with the Fund was not conclusive evidence that an arrangement was a requirement for all such purchases. The point had been discussed previously, and he believed that the statement in the report justified the position taken by the Directors.

Mr. Polak said that he agreed with Mr. Prowse and looked forward to a discussion of the question in September. As to the staff's comments regarding reserves, they implied that the level was not as high as cited in the staff report. He believed that a more pertinent argument was the statement in the Articles of Agreement (Article V, Section 3(b)(ii)) that "*the member represents that it has the need to make the purchase* because of its balance of payments or its reserve position or developments in its reserves." The level of reserves, even if as high as Mr. Caranicas thought, should not be quoted against Indonesia.

Mr. Nimatallah indicated his agreement with Mr. Prowse's comments.

The staff representative from the Exchange and Trade Relations Department said that the intent of the sentence stating that the measures taken by Indonesia had represented an adequate response to the recent deterioration in the external position had been to indicate that the request fulfilled the requirement of cooperation. For purchases above 50 percent of quota under the compensatory financing facility, however, the practice had been to discuss with the authorities in more detail their macroeconomic policies in order to assess medium-term balance of payments and debt prospects. As indicated earlier, such discussions could take place during an Article IV consultation, or in the context of a negotiation of an arrangement, without implying that the conclusion of such an arrangement was in any way a compensatory drawing over 50 percent of quota.

The essence of the requirement of cooperation was to provide a basis for an assessment of the appropriateness of the member's policies to deal with its balance of payments difficulties, the staff representative from the Exchange and Trade Relations Department remarked. Distinctions between the requirement of cooperation for a drawing below 50 percent of quota--willingness to cooperate in the future--and the stricter requirement for a drawing over 50 percent--past cooperation--were difficult to define because of the dynamic and continuous nature of the requirement of cooperation.

For upper tranche requests, the Fund must be satisfied that the member "has been cooperating" with it in finding appropriate solutions to the balance of payments difficulties. A detailed discussion of the member's current and prospective policies would normally be needed to assess the fulfillment of that requirement of cooperation.

Mr. Joyce said that he looked forward to an opportunity for further discussion of the issue, but meanwhile wished to say that the staff representative's remarks were perhaps a reflection of the desired, rather than the actual, procedure.

The Chairman noted that the Board was scheduled to discuss the guidelines on conditionality related to the compensatory financing facility, and policy aspects could be discussed further at that time.

Mr. Ismael thanked the Directors for their warm and unanimous support of Indonesia's request for a drawing under the compensatory financing facility and the staff for its assistance. He would convey the comments and advice expressed during the discussion to his Indonesian authorities.

The Executive Board then took the following decision:

Purchase Transaction - Compensatory Financing Facility

1. The Fund has received a request by the Government of Indonesia for a purchase equivalent to SDR 360 million under the Decision on Compensatory Financing of Export Fluctuations (Executive Board Decision No. 6224-(79/135), adopted August 2, 1979).

2. The Fund notes the representations of Indonesia and approves the purchase in accordance with the request.

Decision No. 7482-(83/113), adopted
July 29, 1983

2. YUGOSLAVIA - REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered a paper on the mid-year review under the stand-by arrangement for Yugoslavia (EBS/83/141, 7/8/83; Cor. 1, 7/13/83; and Sup. 1, 7/28/83).

The Director of the European Department noted that on page 3 of Supplement 1 to EBS/83/141 there was a reference to additional fiscal action being taken by the Yugoslav authorities, including a statement that the National Bank account in which the funds were frozen would be brought up to a level of Din 10 billion by August 15, 1983. The Yugoslav authorities had informed the staff that their procedures would not allow them to be certain that Din 10 billion would be frozen as early as that date, and they had asked to substitute the date of August 25. The staff had no difficulty with that change.

The Yugoslav authorities had informed the staff that they intended to increase taxation of nonwage incomes, raising additional receipts of Din 25 billion in 1984, equal to about 0.5 percent of gross social product (GSP), and that that amount would also be frozen, the Director continued. In addition, the current account figures for the balance of payments with the convertible currency area were available for the first five months of the year and indicated a deficit of only $57 million. That figure compared with a deficit of $1,300 million in the same period of the previous year. But it was difficult to categorize the reduction as a genuine improvement because it reflected to a significant extent the effects of the shortage of foreign exchange in compressing imports. Although the staff's estimate of a $500 million deficit in the first half of 1983 appeared exaggerated, he believed it prudent to keep to the estimate of a $750 million deficit for the year as a whole.

Mr. Polak made the following statement:

> In the course of the three-year stand-by arrangement between the Fund and Yugoslavia the collaboration between the two parties has become increasingly close. Indeed, in the first half of 1983 there have been quite a number of staff visits. During the most recent one in June, the Managing Director had discussions with the highest authorities of the country, the President of the Presidency of the Federation and the Prime Minister. In between contacts through missions, major policy discussions also took place in Washington at the times of the meetings of the Interim Committee and the Development Committee. There is also a strong involvement of governments and other international institutions, as well as banks. The authorities are grateful for the many days and hours-per-day that so many staff members have devoted to the country's problems. At the level of the Board, discussions on Yugoslavia now occur roughly on a four-month cycle--three times a year--which is a necessary outcome of the important function that review clauses now perform in the relationship between the Fund and Yugoslavia.
>
> Instead of the earlier pattern based on definite segments of time--annual programs and perhaps mid-year reviews--this relationship has developed into something that approaches a continuous dialogue. The experience of recent months is frequently appraised and from this judgments are derived as to the need for additional measures. Indeed, the Yugoslav authorities in May and again at mid-year, demonstrated their willingness to take further policy actions. The needed measures cannot always be introduced at once, owing in part to the Yugoslav political and economic system, and not everything needed can be compressed into discrete policy packages related to years or half years. Reviews thus become the occasion to look ahead not only to the near, but also to the somewhat more distant, future and to set the ground work for future policy actions. The present review paper contains a number of such indications of future or contingent policy

measures foreseen, for example, for September 1983, or year-end 1983, or in the event that the measures now introduced prove insufficient to achieve the desired result.

Indeed this forward-looking approach between the authorities and the staff goes beyond the terminal point of the current stand-by arrangement. As I indicated in my statement of March 11, on the occasion of the previous review, the decision has already been taken by the Yugoslav Government that it will seek a new stand-by arrangement with the Fund for 1984 and beyond. The point has been taken up by the staff toward the end of its appraisal (page 25) where the staff specifies in very broad strokes the framework within which a further stand-by arrangement could be contemplated.

In the course of 1983 the Yugoslav authorities have had to address simultaneously three separate but closely interrelated tasks:

1. to improve the current account with the convertible currency area;

2. to manage the immediate and near term external financial situation by means of a holding and bridging operation, in order to deal with a heavy debt servicing burden until the success of the first set of measures would make the balance of payments more viable; and

3. to continue the laborious process of restructuring the economy, building into it better instruments of demand management and enhancing efficiency in the broadest economic sense of the word, so as to make growth of the domestic economy compatible with adjustment of the external situation.

The close interrelation of these three tasks is obvious. Without better domestic economic management, the balance of payments objective could not be achieved, or would involve deep deflation and the imposition of controls incompatible with adequate growth. Without a better balance of payments performance--and indeed without convincing domestic and exchange rate measures to assure such performance on a lasting basis--it would be impossible to hope for renewed confidence on the part of foreign creditors whose collaboration was essential to bring about some easing of the international liquidity squeeze.

So far this year progress has been made on each of these three fronts. Except perhaps as regards the current account of the balance of payments, the progress has fallen short of what was hoped for at the beginning of the year.

1. Current account balance

This part of the performance was most nearly successful. The actual results for the first four months of 1983 showed a current account deficit of only $125 million, about $1 billion less than in the same period of 1982. Exports to the convertible currency area were up by 17 percent, while imports were down by 20 percent. It cannot be expected, however, that these sharp movements can be continued through the rest of the year. In the staff's expectation the current account target for the year of a deficit with the convertible area of $500 million will not be fully reached; the staff considers a deficit of $750 million more likely. This figure compares with a deficit of $1.4 billion in 1982 and $1.8 billion in 1981. The authorities are somewhat more optimistic about the outcome for this year, and in any event there is agreement on the need to move to a surplus position in 1984.

2. Package of financial assistance

This package, which is described in detail in Annex I to the paper, has been under negotiation since the early days of 1983, but important components are still not yet in place. As concerns the intergovernmental arrangement, about $200 million of the $1.3 billion total consists of export credits for commodities that could not fit in the Yugoslav import program and can thus not be used. Less than $800 million of the total is likely to benefit the 1983 balance of payments. The World Bank has been prompt in providing a $275 million structural adjustment loan, which will be disbursed over the coming months, but the negotiations with the commercial banks--covering the external debt falling due in 1983 plus a $600 million new medium-term loan--have not yet been completely finalized, although all points of difference with the International Coordination Committee have been resolved. However, the disbursements under these arrangements are conditional upon the release of the remaining $200 million of a BIS bridging loan, which has been held up for many months by Yugoslavia's inability to get releases from all creditors of negative pledge clauses given in connection with earlier credits. The net result of these disappointments and delays will be that the strengthening of Yugoslavia's reserve position that had been foreseen for end-1983 will not materialize; the unduly sharp fall of imports so far this year is also in part attributable to the extremely tight external financial situation.

3. Internal measures

In order to relieve the inflationary pressure, the Government relies on improved income policies that prescribe rules on allowable wage payments by enterprises, on a strengthening of fiscal policy, including the mandatory freezing of a part of tax receipts, and on a very tight monetary policy. Indeed, as regards the latter, the credit ceilings for the fourth quarter of 1983 may be overly tight and the authorities have indicated that they may find it necessary to discuss the ceiling again with the staff later this year (see para. 9 of the letter of intent).

As a general observation on further internal measures, I should note that the Yugoslav authorities, while in full agreement with the staff on the direction of policy required, argued against unduly rapid changes that did not take account of political and economic constraints. They warned in particular against too sharp reductions of real income in the socialized sector and were concerned that the cost effects of higher interest rates and administered prices and the rapid depreciation of the dinar were quite damaging to the financial position of the enterprise sector.

Incomes policy, in conjunction with a higher than expected rate of inflation, has produced a severe compression of real wages in the socialized sector. Nevertheless, private consumption has fallen so far this year by only some 2 percent, and other incomes have shown sharp increases.

To enhance the efficient operation of the economy, many administered prices have been brought to more appropriate levels early in this year; unfortunately, the rate of inflation since then--some 30-35 percent--will make it necessary to repeat this operation. A somewhat similar observation applies to past increases in interest rates that were based on the expectation of a more moderate inflation rate. These interest rates are also again being raised. Since most interest rates will now be in the range of 20-30 percent, they would come close to being positive in real terms if there is a modest abatement in the current inflation rate, which the authorities strongly hope will be the case.

Finally, on the exchange rate, substantial moves were made in 1983 to enhance export incentives; these included efforts to rationalize the allocation of foreign exchange coupled with a 21 percent depreciation of the dinar in real terms over the first six months. It is the intention of the authorities to continue to pursue an active exchange rate policy, and to ensure adequate export incentives by further measures to improve the foreign exchange allocation system.

With these and a wide variety of other measures--including some already announced to be taken in the coming months--as described in detail in the staff report, the authorities intend to provide the domestic structure of restrained demand and effective incentives that will provide the basis for the attainment of their balance of payments target.

Mr. Senior said that Yugoslavia had maintained close and frequent consultations with the Fund. Given the Fund's relative lack of experience with planned economies, those consultations seemed timely and allowed structuring of the economic program on what might be called a trial-and-error basis. The short span of the quantitative performance criteria, and the periodic reviews required under the program, clearly allowed for that approach and the consequent minimization of error. The conceptual framework had worked well in the case of Yugoslavia, and close consultations would continue because of Yugoslavia's expressed intention to seek a new stand-by arrangement with the Fund for 1984 and beyond. He supported that intention, given Yugoslavia's present circumstances and the need for further adjustment after the end of the present program.

Progress under the program had been significant, Mr. Senior commented, although it had fallen short of certain targets. In general, however, performance had been satisfactory and the authorities should be commended for their determination and perseverance, which were reflected in the authorities' additional efforts to further adjust the economy in order to reach the program's objectives.

With regard to the balance of payments, Mr. Senior continued, the actual results for the first few months of the year were encouraging, with a deficit in the current account much lower than that in the same period the previous year and significantly better than the program projections. For the year as a whole, however, the outcome in the current account would not reach the program target of a $500 million deficit, but would be about $750 million, as exports to the convertible area would fall off. Imports from the same area would have to be substantially increased to prevent a deterioration of economic activity and exports. He hoped that the authorities' more optimistic outlook, rather than the staff's outlook, would in the end prove to be the actual outcome for the current account balance.

The financial assistance package for Yugoslavia, which had been under negotiation since the beginning of the year, was an essential element of the present stabilization program, Mr. Senior remarked. Without that assistance it would be difficult for the authorities to attain their objective, as the assistance would change the mix of adjustment and financing that would assure the implementation of the stabilization program. He was disappointed that there had been delays in completing the financial assistance package, which had already had a negative effect on the strengthening of Yugoslavia's reserve position, and had in part caused the marked fall in imports; he urged that it be completed as soon as possible. The adjustment efforts made by the authorities in the area of prices, incomes policy, and exchange rates clearly showed their determination.

Mr. Malhotra said that he was in broad agreement with the thrust of the staff appraisal and that he fully supported the proposed decision. The Fund staff and the Yugoslav authorities had been working closely on the program. The authorities had been responsive while the staff had gained insights into an economy with which it had not been familiar. In light of the experience with the current arrangement, he could advocate consideration of a new stand-by arrangement in 1984.

Mr. Casey remarked that, given the rate of inflation of almost 40 percent and the prospects of higher imports, a tightening of policies was necessary in Yugoslavia. In view of the continuing low confidence of international capital markets--reflecting in part the phenomenon of regionalization--the authorities could not afford to leave anything to chance. Improvements in economic efficiency were vitally important. He remained concerned at the continuing divergence between the staff's projections and the authorities' overoptimistic projections.

On the external side, Mr. Casey went on, he would be interested in a more detailed explanation of the Fund's revision of Yugoslavia's current account deficit in convertible currencies for 1983 from $500 million to $750 million. Although the low level of imports in January-April was probably unsustainable, trade in Yugoslavia tended to be seasonal, with most exports coming in the second half of the year. With a deficit of only $116 million for the first four months of 1983 and an expected increase in exports, the Fund projection implied an extremely large increase in imports and a deterioration in the services account for the remainder of the year. The increase in the projected current account deficit had largely removed room for maneuver, and it would leave the balance of payments and reserves in only slightly better shape at the end of 1983 than in 1982. It was difficult to understand the lack of adjustment, given the devaluation of the dinar, the compression of domestic demand, and various other measures. Continued slippage in the balance of payments raised doubts about the authorities' ability to reach a viable balance of payments position, and he believed that the Fund should be concerned about the duration of continued support for Yugoslavia. Creditor governments might once again be asked to provide a combination of new credits and refinancing in 1984. Without consistently positive signs of adjustment, governments had reason for concern over how effectively the emergency financing for Yugoslavia was being utilized.

The new law giving commercial banks responsibility for ensuring that enterprises would earn sufficient foreign exchange to pay for foreign borrowing was innovative and apparently beneficial, Mr. Casey commented. However, overzealous application of such rules could be harmful in the long run because a strict link between foreign borrowing and the earnings of foreign exchange could inhibit rational resource allocation across the economy. As for the foreign exchange market, he supported steps to improve flexibility. The move to a sectoral rather than regional balance of payments approach was a positive step, as was the proposed Bank-Fund study on foreign exchange markets.

A major source of inflationary pressure was the high rate of money growth, Mr. Casey remarked. The large projected increase in velocity in 1983 put the effective M-1 growth in the 30 percent range. He questioned whether the credit limits set for the second half of 1983 were as tight as implied by the Yugoslav authorities. Because of the unknown amount of excess liquidity, it was difficult to assess accurately any given stance of policy. The time schedule for increases in interest rates seemed long drawn out, as most relevant interest rates would still be negative over the balance of the program period. Negative interest rates on household deposits would not enhance savings and would encourage the continued holding of substantial parts of household wealth in foreign currency accounts. The level of foreign currency holdings had made the general program of restraint more difficult as those holdings in domestic terms increased with the devaluation of the dinar. More negative interest rates would not provide the necessary incentive to curtail interenterprise credit lending, which had consistently undercut monetary restraint. The authorities had taken steps to impose financial discipline in the enterprise sector through legal restrictions on interenterprise lending; however, it was not clear whether legal restrictions could substitute for appropriate interest rates.

As to pricing, Mr. Casey continued, if the authorities were serious about moving to increased reliance on market forces, it would be in their interest to make the changes as rapidly as possible. The present system seemed to be leading to a multiplication of price distortions. Although some increases in administered prices had been implemented earlier in the year, part of the effect had been offset by subsequent increases in general inflation. In addition, severe price distortions remained due to the failure to pass through the price effect of the dinar devaluation. The decision to implement a series of administered price increases over the following 18 months was a positive step, as was the decision to pass on all future effects of devaluations. It should be emphasized, however, that administrative adjustments to prices had an inherent inflexibility that made it difficult to ensure that relative prices would react in a timely manner to changing conditions.

A major element of the program of restraint was the freezing of public enterprise revenue, Mr. Casey observed. It was not clear what would happen to those frozen funds; if, for example, they were suddenly released back into the economy they could create serious inflationary pressures, and he would appreciate some clarification on their disposition.

The policy mix seemed skewed, Mr. Casey commented; there was a reasonable degree of demand management but not enough structural adjustment, or in other words, relatively too much expenditure reduction and not enough expenditure switching.

With regard to incomes policy, Table 5 of the staff report indicated that historically there had been a close correlation of real wages in the noneconomic and economic sectors of the socialized sector, Mr. Casey remarked. Unless transfers and capital gains had been exceptionally high in the first part of the year, it was not clear why there had been a large disparity between wage and nonwage incomes. Given the significance of the economic sector in the whole economy, he agreed with the staff and the authorities regarding the necessity of imposing higher taxes to keep nominal demand within targeted levels.

In sum, adjustment efforts were still needed, Mr. Casey stated. It was disappointing that the balance of payments was still far from sustainable after a three-year stand-by arrangement. Although he would be prepared to consider a follow-on program, he would not wish the Fund to be drawn into a situation where it was financing Yugoslavia's deficit on an ongoing basis. In view of the difficulties encountered so far with the current program, the extent of Fund assistance in any new program should be determined by the degree to which the authorities demonstrated an ability to move the economy to a viable balance of payments position. Prior conditions or perhaps a shadow program could be useful in that context.

Supplement 1 to the staff report proposed another waiver on external arrears as well as a waiver for public sector performance, Mr. Casey said, bringing the total to at least four waivers in the Yugoslav case. When a member of his constituency had missed one performance criterion because of a natural disaster, a waiver had not been suggested and the next purchase had been automatically suspended. The staff should look into the circumstances of four or more waivers in one program, which was probably a record. In addition, earlier in the program it had become clear that the monetary tests were virtually meaningless. In general, he was concerned that the Yugoslav case was undermining the credibility of Fund conditionality. He hoped that it was an exceptional case, as Yugoslavia's was certainly a complex economy. Although it might be easy to design a program for either a laissez-faire economy or a centrally planned economy, the economic system of Yugoslavia was neither and seemed to be in the process of moving from one category to another in an ambivalent fashion. The economic system was internally inconsistent: regulated prices combined with free market prices; central control at the federal level and no control over the republics; a socialized sector and an economic sector. While there was abundant goodwill, the problems remained, and they were in fact more systemic than structural.

Mr. Barbone remarked that he agreed with the thrust of the staff appraisal. The two major problem areas in the implementation of the program, aside from the difficulties in securing the financial package, had been incomes and monetary policies. He asked the staff for more details about expected developments in the trade balance. While he could accept the judgment that the compression of imports in the first four months of the year had been excessive and unsustainable, he wondered whether the pattern was consistent with the needed restrained level of activity in the remaining part of the year. Starting from a low level, imports from the convertible area were forecast to rise above the original estimate, although trade in convertible currencies would still register an overall deficit.

With regard to incomes policy, Mr. Barbone continued, the staff had noted that slippages were registered mainly in incomes stemming from the nonsocialized sector, whereas real wages in the socialized sector had been severely compressed. There was a lack of statistical information on nonsocialized incomes, which were mentioned only in passing in the staff report but which constituted approximately 50 percent of household incomes. Since they were a critical area, more information should be included in future staff papers. Furthermore, it would be interesting to see how the taxation of nonwage income announced by the Director of the European Department would be implemented, given the particular structure of income taxation currently in place in Yugoslavia. The potential risk of having the socialized sector bear a disproportionate amount of the adjustment costs had already been exemplified by the reduction of over 15 percent in real wages in the past three years.

Incomes policy would remain a crucial component of the policy package in the future, and the understandings to that effect were appropriate, Mr. Barbone commented. Monetary policy had proved to be less reliable, as shown by an increase in velocity considerably above program projections. The stated intention of the authorities to be cautious was appropriate in the circumstances; should monetary conditions turn out to be too tight, new ceilings might be set to avoid unnecessary deflationary impulses to the economy, particularly if the new legislation aimed at controlling interenterprise credit proved effective.

On interest rates, Mr. Barbone remarked that the authorities' attitude seemed appropriate, and he could support their argument that inflationary expectations were lower than the current rate of inflation, and that therefore the real rate of interest might be less negative than it appeared. From the discussion in the staff report on the less than expected drop in private consumption it could be inferred that the income effect of higher interest rates might be stronger than the substitution effect in the savings function of the Yugoslav population. In other words, the extra income going to the household sector as a consequence of higher interest rates might conflict with the short-term objective of restraining expenditure. In those conditions, the attainment of positive real rates might be postponed, at least with regard to deposits, or the authorities might want to consider the introduction of a specific tax on that income item.

He could accept the proposed waiver of the performance criterion on revenues, given the authorities' intention to freeze the excess, Mr. Barbone stated. However, he asked the staff to give the reasons that had led to the choice of a ceiling on revenues, rather than on expenditures. The budget tended to be balanced, but in retrospect he wondered whether a ceiling on expenditures would not have been appropriate.

The allocation system of foreign exchange seemed an unsettled area, Mr. Barbone remarked. Some progress had been made, but the system clearly remained cumbersome and far from perfect. He welcomed the intention of the authorities to seek Fund and World Bank assistance in those matters. Was it correct to construe the imposition of a surrender requirement for export proceeds as an added disincentive to exporters? Reasonable profitability, generated by an appropriate exchange rate policy, should be the incentive, rather than actual possession of foreign exchange. He welcomed the added information on the status of the financial package and on the elimination of arrears. Given the crucial importance of securing external finance, he could agree to the procedures suggested in the supplement whereby the August purchase would be conditional on the communication to the Fund of the availability date for the first advance.

Although one could say that Yugoslavia was perhaps in worse shape than at the beginning of the program, it could also be said that the change was due to a series of events outside the control of the authorities and despite the strong measures undertaken, Mr. Barbone concluded. There were no other options at present but to continue the adjustment effort, as witnessed by the tight situation in the foreign exchange reserves forecast for the year. He appreciated the intention of the authorities to continue to seek Fund assistance through a further stand-by arrangement, which would be a necessary step toward medium-term recovery.

Mr. Taylor said that he was in general agreement with the staff appraisal. It was disappointing that Yugoslavia had made so little progress over the past two and one-half years toward achieving a viable economy capable of being financed through regular commercial channels. He wished to associate himself with many of the concerns expressed by Mr. Casey. The authorities had managed to halve the projected convertible currency account deficit in the first half of 1983; however, it made the revised projection for the deficit in the seasonally strong second half all the more disappointing, and he would be interested to hear the staff's explanations of this alarming deterioration. The deficit foreseen for the year as a whole would significantly exceed the projection made by the staff in May 1983. It was particularly discouraging because the performance criteria under the arrangement had been met so far, although his chair had been worried for some time about the adequacy of the policy instruments available to the authorities in implementing their objectives.

Fairly basic economic reforms, as recommended by the staff, could not take place overnight, Mr. Taylor continued, especially when there was a difference of view about the desirability of shifting to a more market-oriented system. There were also manifest and important difficulties in an economy where the Central Government had to obtain agreement in the various regions and from member governments to implement the policies that had been decided with the staff. The modest progress achieved so far reflected a lack of urgency on the part of the authorities in implementing relatively straightforward measures, particularly in the interest rate and pricing fields, that should be taken promptly in light of the country's difficult external position and the need to bring the allocation of resources onto a more economically efficient and viable basis.

He shared the staff's concern about the inadequacy of recent interest rate increases, Mr. Taylor commented. The authorities had underestimated the rate of inflation and, as a result, the effects of the February increases in interest rates had been undermined. Consequently, rates were even more negative than had been expected at the start of the year's program, and they would remain negative despite the increases promised for the second half of the year. That development would have a distorting effect on both the stock and the distribution of credit, as well as on the level of savings in the economy.

He welcomed the steps taken by the authorities to raise certain domestic prices during the year, Mr. Taylor remarked; the initially adverse effects of such increases on inflation would in due course be outweighed by the benefits resulting from a more efficient utilization of resources. However, as both private consumption and final domestic demand had fallen less than projected for the year, the authorities should consider speeding up the pace of bringing domestic prices broadly in line with international prices. It was regrettable that the selective price freeze had been prolonged through the first half of 1983 and that prices were fully liberalized for only 40 percent of industrial goods. Subsidies in the energy sector, notably for petroleum products and gas, were of particular concern because of their distorting effects throughout the economy, and particularly on imports. He strongly endorsed the staff's view that further liberalization of prices should be implemented urgently and with determination.

Serious external financing constraints would persist for Yugoslavia over a number of years, Mr. Taylor observed. He would have welcomed a fuller discussion of Yugoslavia's financing prospects for 1984 and beyond in the staff paper. Table 11 indicated that amortization of almost $3 billion would be due on medium-term and long-term convertible currency debt, including that to the IMF, each year until 1986. In addition, the short-term commercial debt rescheduled under the 1983 bank agreement would begin to fall due in 1985, increasing amortization to over $4.5 billion. A more explicit emphasis on the impact of those bunching maturities would have been salutory. He stressed the urgency of further adjustment measures in light of the need to manage both the immediate and longer-term debt problem.

Neither the continued support of the Fund nor of Yugoslavia's major creditors could be taken for granted, Mr. Taylor continued. He noted the authorities' desire to enter into a new stand-by arrangement after the current one had expired. The main elements of a far-reaching program of adjustment, together with evidence of sufficient action, should be in place before that request came to the Board, for example, action in interest rates and subsidies and the more effective containment of inter-enterprise credits through a viable incentive system. Action before the implementation of a new program would be necessary to demonstrate that the benefits of the reform undertaken would actually come through during the program and also to persuade other creditors to continue to support Yugoslavia. In view of Yugoslavia's difficulties in obtaining credit, the staff should take early soundings among the creditors if a follow-on program were drawn up.

The improvement of the convertible currency account to approximate balance by 1984--which the Chairman had said in November should be the object of the program for 1983--would depend on progress in implementing firmer and more immediate structural adjustment measures than the Government seemed willing to contemplate at present, Mr. Taylor continued. Although it was understandable and perhaps inevitable that domestic political problems would be encountered in the process, they could not be reduced by further postponement of the necessary adjustment measures.

He could support the proposed revised decision, including the request for a waiver of the performance criterion relating to public sector revenues, Mr. Taylor concluded. He noted that that criterion aimed at controlling public sector expenditure in a situation that was difficult to monitor, and was pleased that the authorities would sterilize excessive revenues over the ceiling by placing them in frozen accounts that could not be used to finance greater expenditure. However, he shared Mr. Casey's concern that the frozen revenues should not be available to finance expenditure when the present unfavorable situation improved. What steps did the staff have in mind to ensure strict adherence to that criterion? It was unconventional, and he suggested that the staff should consider whether it could not devise a more meaningful criterion to achieve public expenditure restraint.

Mr. Grosche observed that the Yugoslav authorities had addressed three main tasks in the course of the year: first, to improve the current account with the convertible currency area; second, to secure external financing; and third, to lay the foundation for future sustained growth. Progress in those areas had fallen short of the expectations of the Board earlier in the year. The disappointing performance was worrisome because foreign exchange was expected to remain scarce despite Yugoslavia's efforts to promote exports and the higher than warranted contraction of real domestic demand.

Actions taken by the authorities had been partly overtaken by events because the structural weaknesses continued to prevail in the economy, Mr. Grosche remarked. Although some administered prices had been adjusted upward, the restructuring of the price system for better resource allocation had not been satisfactory, owing in part to a higher than expected rate of inflation. The higher rate had not been attributable to the devaluation of the dinar, as higher import costs had not been fully passed through. More vigorous actions in achieving an appropriate price structure were clearly called for in order to bring output and absorption into better balance.

The intention of the Federal Government to continue its flexible exchange rate policy was noteworthy, Mr. Grosche continued. However, increased prices as a consequence of a further devaluation should be adequately reflected in internal costs. Correct pricing policies were also the key to increased profitability for enterprises. Before closing ailing companies, the authorities should look at whether the companies had been allowed to charge prices that reflected the economic scarcity of their products. He encouraged the authorities to place more reliance on the price mechanism.

The main problem in implementing a more restrictive monetary policy and the main reason for the acceleration in inflation continued to be the existence of interenterprise credits, Mr. Grosche stated. The recently approved law to improve the financial discipline of enterprises was welcome. The principle of repaying outstanding bills before distributing income to employees might impose sufficient restrictions on companies, provided the authorities were able to enforce the new provisions effectively. Monetary policy would have a better chance to exert a more restrictive stance if the authorities could control the excessive growth in interenterprise credits. Because it would take time before the results of that reform would be apparent, the authorities should not be worried about the tightness of credit ceilings suggested by the staff. There was still enough flexibility in the system to accommodate the demand for credit. Monetary policy, to be a powerful instrument for demand management, had to make full use of interest rates. Although the higher rates effective July 10 had been partly outpaced by the accelerated rate of inflation, he considered the action a sign of goodwill. He did not overlook the legislative problems involved in conducting a timely and flexible interest rate policy in Yugoslavia, although the recent adjustment should be considered only as a first step. He encouraged the authorities to review the measure in light of the prevailing high rate of inflation.

He was in broad agreement with the staff appraisal, Mr. Grosche concluded. In view of the additional commitments undertaken by the Yugoslav authorities, including the further tightening of fiscal policy, he could support the revised decision.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/83/112 (7/27/83) and EBM/83/113 (7/29/83).

3. PUBLICATION OF "INTEREST RATE POLICIES IN DEVELOPING COUNTRIES"

The Executive Board approves the proposal set forth in EBD/83/197 (7/22/83).

Adopted July 28, 1983

4. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/83/172, Supplement 1 (7/26/83) is approved.

5. STAFF TRAVEL

Travel by the Managing Director as set forth in EBAP/83/197 (7/28/83) is approved.

APPROVED: February 6, 1984

LEO VAN HOUTVEN
Secretary