FOR AGENDA

EBS/83/141

CONFIDENTIAL

July 8, 1983

To: Members of the Executive Board

From: The Acting Secretary

Subject: Yugoslavia - Review Under Stand-By Arrangement

Attached for consideration by the Executive Directors is a paper on the mid-year review under the stand-by arrangement for Yugoslavia. A draft decision appears on pages 26 and 27.

It is proposed to bring this subject to the agenda for discussion on Friday, July 29, 1983.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Leif Hansen (ext. 76009) or Mr. Wayne E. Lewis (ext. 76016).

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

YUGOSLAVIA

Review Under Stand-By Arrangement

Prepared by the European Department and the
Exchange and Trade Relations Department

(In consultation with the Legal Department, the Research Department,
and the Treasurer's Department)

Approved by L. A. Whittome and Subimal Mookerjee

July 8, 1983

I. Introduction

On January 30, 1981, the Fund approved a three-year stand-by arrangement for Yugoslavia in an amount equivalent to SDR 1,662 million, or 400 per cent of quota. Yugoslavia has made ten purchases under this arrangement totaling SDR 1,433 million, the most recent on May 16, 1983. A Fund mission visited Belgrade during the period May 31-June 29, 1983 to review developments under the stand-by arrangements during the first half of 1983 and to reach understandings on the program for the second half of the year. The Yugoslav representatives included officials of the National Bank of Yugoslavia, the Federal Secretariat for Finance, and other federal secretariats and agencies concerned with economic matters. Policy discussions were held with Mr. Z. Dragan and Mr. B. Srebić, Vice Presidents of the Federal Executive Council; Mr. J. Smole, Member of the Federal Executive Council; Mr. J. Florjančić, Federal Secretary for Finance; Mr. R. Makić, Governor of the National Bank of Yugoslavia; Mr. M. Veljković, Deputy Governor of the National Bank of Yugoslavia; and other officials. The staff representatives were Mr. P. P. Mentré (Head), Ms. D. Ripley (part-time), Mr. L. Hansen, Mr. L. G. Manison (all EUR), Mr. A. Petersen (ETR), Mr. W. Lewis (EUR) and, as secretary, Miss L. Pike (EUR). Mr. Whittome led the discussions when he was in Belgrade during the period June 5-10. The Managing Director visited Belgrade also during the negotiations and met with Mrs. M. Planinc, Prime Minister, and Mr. M. Spiljak, the President of the Presidency of the Federation; Mr. J. J. Polak participated in these meetings. The policies and prospects for the remainder of 1983 are described in the attached letter, dated July 8, 1983, signed by the Federal Secretary for Finance and the Governor of the National Bank of Yugoslavia, which supplement their letters of December 30, 1982, February 18, 1983, and May 4, 1983.

On June 30, 1983, Fund holdings of dinars subject to repurchase amounted to the equivalent of SDR 1,858.0 million, or 447 per cent of quota (see Appendix). Excluding purchases under the compensatory financing facility, use of Fund credit amounted to SDR 1,667.6 million, or 401 per cent of quota. If the remaining SDR 229 million available under the present stand-by arrangement is purchased by the end of 1983, and taking into account scheduled repurchases, the use of Fund credit, excluding the compensatory financing facility, will rise to SDR 1,854 million by December 31, 1983 or 446 per cent of the present quota.

The performance criteria for the first half of 1983 included limitations on increases in the net domestic assets of the banking system, on credit from the National Bank of Yugoslavia to the budget of the Federation, on foreign borrowing, on public sector expenditures, and also provisions on the pursuit of an active exchange rate policy. The performance criterion on net domestic assets of the banking system for the first quarter was met (Table 2). The National Bank expects the limits for the second quarter to be observed; the data will be available in early August. The limitations on central bank credit to the budget of the Federation and on medium- and long-term foreign borrowing are expected to be met throughout the first half of 1983. The performance criterion on public expenditure appears to have been satisfied thus far in 1983, although fulfillment of the criterion for June 1983 would be assured only if there proves to have been some further deceleration in public revenue growth from May to June. The end-June performance criterion on the exchange rate was observed.

Agreement was reached in June 1983 on a structural adjustment loan (SAL) for US$275 million from the World Bank to Yugoslavia. The SAL is designed to support the Government's medium-term stabilization program which calls for further adjustment of the current external account in convertible currencies as well as structural change that will lay the foundation for future sustained growth. As such it is consistent with the Fund's stand-by program, since it puts emphasis on adequate interest rates, appropriate relative prices, financial discipline of enterprises, export incentives, and improvement in foreign exchange allocation and external debt management. There has been an extensive exchange of information and regular consultation between the Bank and the Fund over the last several months, including the participation of a Bank staff member in the December 1982 Fund mission.

II. Economic Performance

The program for 1983 which was drawn up at the beginning of the year attached the highest priority to improving the external liquidity position of Yugoslavia so as to ensure that the Government could meet its financial obligations and rebuild its international reserves to a more adequate level. The strategy adopted had three main interrelated objectives: to secure improvement in the current account with the convertible currency area; to secure external financing that would make the foreseen development in the current balance viable; and to lay the foundation for future sustained growth. First, and foremost, there was a need to reduce the deficit on current account with the convertible currency area through a combination of restrictive demand management policies and an active exchange rate policy. Parallel efforts were to be undertaken to eliminate the export surplus in nonconvertible currencies so that a given improvement in the external current account in convertible currencies would imply less of a cutback in domestic absorption. In view of the difficulties that were anticipated in assembling a financing package from the convertible currency countries, it was considered essential that the surplus with the nonconvertible currency area be sharply reduced. Restrictive credit and incomes policies were to curb domestic demand and restrain inflationary pressures. The second objective consisted of efforts to buttress the external position by the provision of special external financial assistance on a scale sufficient to lead to a buildup in Yugoslavia's official reserves by the end of 1983. (The status of these efforts is discussed in section 2.b below and described in detail in Annex I.)

The third feature of the strategy was to support the restrictive demand management policies through a series of measures designed to improve the efficiency of the economy and thus enhance growth prospects. These included significant increases in administered prices as a first step in the elimination of price distortions; a significant upward adjustment of interest rates, bringing them somewhat closer to the inflation rate, thus promoting both a more efficient allocation of resources and reducing the disincentive to domestic savings in dinar-denominated assets; and an amendment to the foreign exchange law intended to promote a more unified foreign exchange market. In addition, several other changes were set in motion through the legislative process and through social compacts, including actions designed to strengthen the financial discipline of enterprises, to reduce the scope for interenterprise credit and to introduce a greater flexibility into the system of price and wage determination.

1. Domestic economy

a. Demand and supply

Domestic demand has been curtailed in the first four months of 1983, partly because of the compression of imports. But the decline in final domestic demand, estimated to be 3-5 per cent below the level a year earlier, must be seen against the revised forecast for a fall of 5 per cent for the year as a whole (Table 3). (By contrast, the original projection of a 10 per cent decline in 1983 that was incorporated in the annual plan resolution was difficult to interpret because of the discrepancy between the official forecasts for aggregate demand and for output.) The revised Yugoslav forecast brings the expected developments in aggregate demand more closely in line with those for gross social product (GSP) from the output side. GSP declined in the early months of the year and is projected by the Yugoslav authorities to fall by 1/2 per cent for the year as a whole.

Private consumption appears to have fallen in volume terms by about 2 per cent in the first 4-5 months of 1983, compared with a year earlier, approximately in line with the staff forecast for the year as a whole. The revised forecast by the Yugoslav authorities expects a 3 per cent decline for the year. Private consumption has been more buoyant than would be expected on the basis of the sharp drop in real wages in the socialized sector in early 1983, both because of a significant rise in nonwage incomes (e.g., from self-employment or from interest income), which comprises about 50 per cent of household income, and because of an apparent reduction in the personal savings ratio. Public consumption has been declining in real terms so far in 1983, reflecting the curtailment of planned expenditure at various levels of government. Gross fixed investment has fallen more rapidly than consumption, owing to the Government's policy to contain such expenditures coupled with credit limitations and constraints on imports; the fall in volume terms in the first four months of 1983 is estimated to be slightly less sharp than the 10 per cent revised forecast for the year as a whole.

Industrial production was essentially stagnant in the first quarter of 1983 but fell in the subsequent two months, so that the index of industrial production for the first five months in 1983 was 1 per cent lower than a year earlier. This decline can be traced to weak demand and, in the second quarter, probably also to some shortages of imported inputs. Output in the construction industry is estimated to have fallen by some 5-6 per cent in the first four months of 1983 compared with a year earlier.

b. Prices and incomes

The rise in the cost of living index accelerated in the first five months of 1983, though the rate of growth of industrial producer prices remained stable at about 25 per cent (Table 4). The cost of living index, which was 35.6 per cent higher in the first five months of 1983 than a year earlier, has risen more rapidly than the retail price index because of its larger share of agricultural products; the year-on-year increase in the price of food, which carries a 43 per cent weight in the cost of living index, was 42 per cent in January-May 1983. These figures contrast with an officially projected rate of inflation of 20 per cent, and a rate projected by the staff of some 30-35 per cent. The various increases in administered prices agreed for the first half of 1983 have been put into effect, although the increase in rents will be fully reflected in the cost of living index only in June 1983. Rents,

which were to have been increased by about 30 per cent, are estimated to have actually risen by some 40 per cent on average. Other increases in administered prices included a 29 per cent increase for meat and live animals, 25 per cent for petroleum products at the retail level, a 25 per cent increase in electricity and coal prices, and a 35 per cent increase in railway fares. The stability of the growth of industrial producer prices suggests that some inflationary pressure may have been suppressed, as the price freeze has effectively kept the effects of the depreciation on import costs from being fully passed through into output prices. However, prices outside the socialized sector have been rising rapidly, and retailers have increased their profit margins.

The deceleration in the growth of nominal personal incomes in the socialized sector which took place in the second half of 1982 continued in the initial months of 1983 (Table 5). The year-on-year growth rate of nominal net personal incomes per employee which had averaged 31 per cent in the first half of 1982 fell to 23 per cent by the fourth quarter and was reduced further to 20 per cent by the first quarter of 1983. However, the specific objective of incomes policy for the first quarter of 1983, namely, that nominal net personal incomes per employee in this quarter should be no higher than in the fourth quarter of 1982, was not quite achieved; this would have required that the year-on-year growth in the first quarter should not have exceeded 19 per cent. In line with one of the objectives of incomes policy, wages in the noneconomic sector (public sector and other services), especially for public sector employees, have been rising at a slower rate than in the economic sector (industry, construction, etc.).

The moderation in nominal personal incomes growth coupled with the faster consumer price increases has resulted in sharp declines in real wages. Real personal incomes in the socialized sector, after falling by 4 per cent in 1982, declined by nearly 10 per cent in the first four months of 1983 compared with the same period of 1982. The decline in real personal incomes in the noneconomic sector was estimated to be around 3 percentage points higher than that in the economic sector producing manufactured goods. However, the fall in real personal incomes in these sectors appears to have been partly offset by households receiving income from nonwage sources. Indeed, household receipts derived from sources other than wages in the socialized sector rose by 33 per cent in the first four months of 1983 compared with the same period of 1982. Nonetheless, the real income of urban workers with no income outside the socialized sector has been severely compressed, registering a further decline after having fallen by an estimated 15 per cent over the three years 1980-82.

2. External sector

a. Current account developments and prospects

During the first few months of the year, developments in the current account of the overall balance of payments were somewhat better than expected. Exports were approximately on target in value terms and

receipts from services were larger than expected, registering an improvement of US$140 million rather than a decline as projected in the program. However, the improvement in the current account was primarily due to a larger-than-expected compression of imports. Questions arise as to the extent to which the compression of imports and the growth of exports are sustainable.

Exports to the convertible currency area have risen rapidly in response to increased incentives including the recent exchange rate developments (see Chart); the period January-May showed an increase of 17.3 per cent 1/ over the same period of last year: the volume of exports appears to have risen by nearly 10 per cent, against projected market growth of about 1 per cent. Exports for the first half of the year are likely to be very close to the program target (Table 6). Imports, however, fell by some US$275 million more than targeted to a level which could adversely affect economic activity if they remain so compressed over a prolonged period. This sharp fall was due to the shortage of foreign exchange available to importers and to the cuts in domestic investment which were reflected particularly in the marked decline in imports of investment goods. Service receipts were stronger than expected, apparently on account of both workers' remittances and tourism. During the first four months, a net service surplus of US$469 million was realized compared with the original target of US$205 million for the first six months of the year (Table 7). Thus, a current account deficit of around US$500 million for the convertible currency area appears likely in the first half of the year, compared with an originally forecast deficit of US$1,100 million.

The favorable current account outturn for the first half of the year is not likely to be sustainable throughout the year for several reasons. The trade balance with the convertible area during the first five months of the year was helped by a substantial turnaround in trade with the nonconvertible currency area, in particular by the sharp increase in imports, and it is unlikely that this shift can be maintained. Indeed, the presently agreed commodity lists for trade with the nonconvertible currency area would not accommodate a continuation of the present growth rate of imports. Nevertheless, for the year as a whole, Yugoslavia should register a trade deficit with the nonconvertible currency area (Table 8), which would partly offset the surpluses of previous years (US$690 million in 1982), and which, through the resulting switch of trade flows to the convertible currency area, will contribute importantly to the improvement in the balance with the latter area.

A part of the restraint on imports from the convertible area in the first half of the year will need to be compensated for in the second half year if export performance is not to suffer. For the year as a whole, imports are likely to exceed the programmed level somewhat as oil imports are likely to be higher than planned. In the first five months

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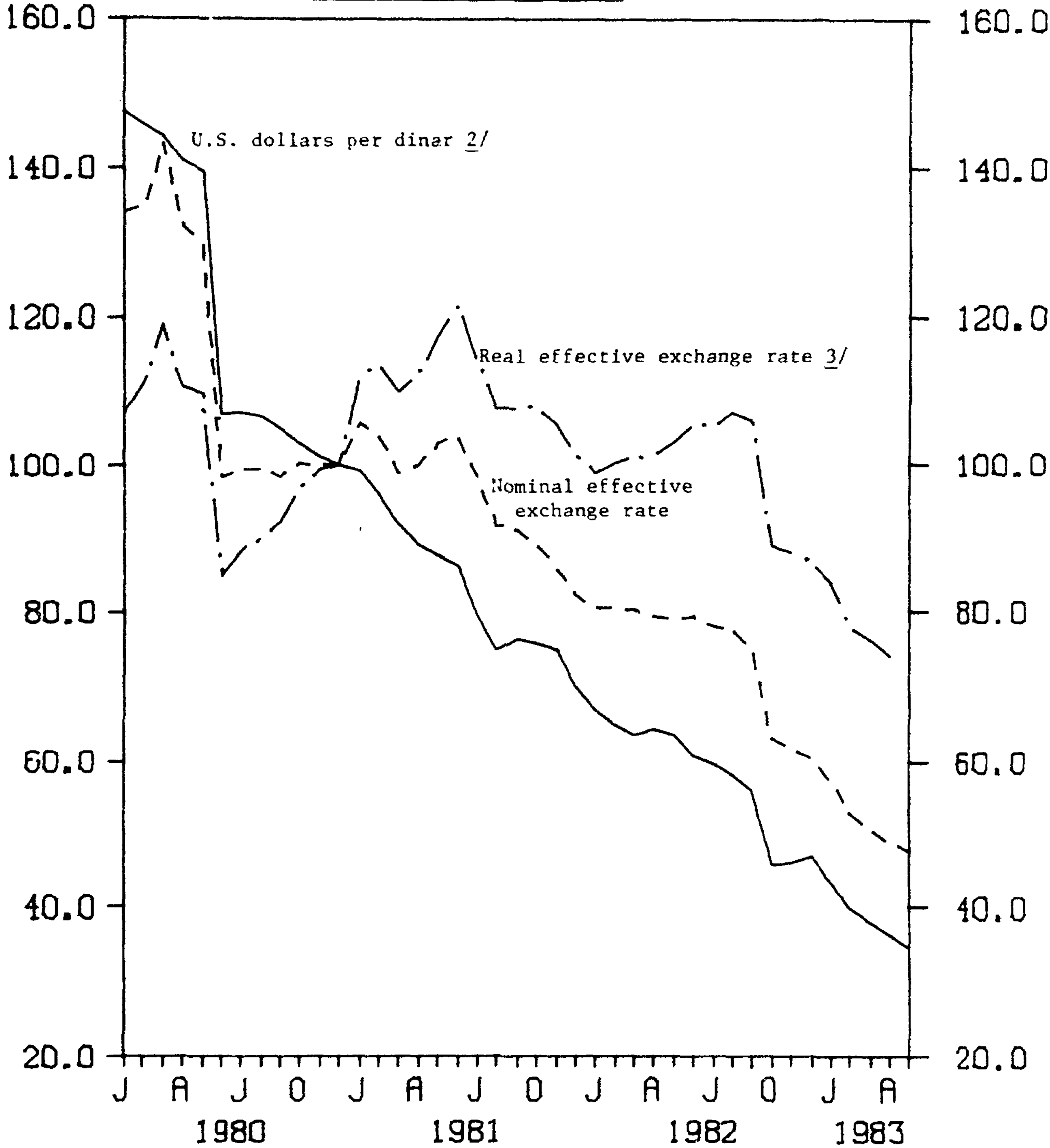
1/ Calculated at the statistical exchange rate (the rate prevailing on a particular date); if calculated at actual exchange rates, the increase in terms of U.S. dollars amounted to 12.8 per cent.

YUGOSLAVIA

Exchange Rate of the Dinar 1/

(End of December 1980 = 100)



Sources: IMF, International Financial Statistics: data provided by the Yugoslav authorities; and staff estimates.

1/ Nominal and real effective exchange rate indices are based on the European Department's exchange rate indices (bilateral trade weights).
2/ End-of-month values.
3/ Adjusted for relative producer prices.

of 1983 the volume of oil imports was about 4 per cent lower than a year earlier; at the same time there was a pronounced shift between currency areas, as imports from the convertible currency area fell by about 30 per cent in volume and oil imports from the nonconvertible area rose by 33 per cent. This shift is expected to be less pronounced later in the year and the volume of crude oil imports is expected to pick up and may increase by some 10 per cent for the year as a whole. Furthermore, the recent sharp rise in imports from the nonconvertible area is unlikely to be maintained and the present rate of oil imports from the convertible currency area will most probably have to increase. All in all, although the export performance should be only marginally below target, the trade deficit with the convertible currency area is likely to exceed the programmed level by some US$450 million. This is likely to be partly offset by higher-than-expected receipts from workers remittances and certain services other than tourism. Tourism was more buoyant than expected in the first part of the year, but is likely to show only a small advance for 1983 as a whole as prospects for the main tourist season on the basis of advance bookings are disappointing. In sum, the current account is likely to register a deficit of around US$750 million, or some US$250 million more than programmed. The Yugoslav authorities are more optimistic as regards export growth and service receipts and project a somewhat lower deficit.

b. External financing

During the first half of 1983 pressures on Yugoslavia's external payments position were contained despite shortfalls in the disbursement of funds from the international financial support package (Table 9). The greater-than-expected cutback in imports, the higher-than-contemplated surplus on invisibles account, the agreed standstill in repayments to banks, and a larger-than-previously-foreseen disbursements of suppliers' credits outside the Berne package of intergovernmental financial support all helped to prevent a further depletion in international reserves and any worsening in external payments delays. Disbursements of suppliers' credits in the first half of 1983, including nearly US$500 million outside the Berne package, were in excess of original estimates by around US$200 million and helped in part to offset delays in obtaining the second tranche (US$200 million) of a US$500 million credit from the BIS and a new medium-term financial credit from Western commercial banks. In the first half of 1983 external reserves remained approximately unchanged compared with a US$300 million increase projected under the original program, and a decline of US$900 million in the same period of 1982.

The agreement on the financial facilities to be provided to Yugoslavia by foreign banks under the auspices of an International Coordinating Committee (ICC) for commercial banks' support to Yugoslavia provided for the rolling over of short-term credits outstanding in January 1983; for the refinancing of medium- and long-term maturities falling due in 1983 of US$1.4 billion; and for US$0.6 billion in new medium-term money. The ICC has recommended that the agreement be accepted by all participating banks and it is expected to be signed in late July or early August. The

agreement on the new medium-term credit provides that disbursements are to be phased over the second half of 1983 in line with purchases from the Fund under the stand-by arrangement, with the first disbursement under the World Bank structural adjustment loan, and with the utilization of credits under the Berne agreement on intergovernmental support to Yugoslavia.

The agreement on the short-term facility provides that the bulk of short-term credit outstanding as of January 17, 1983 be rolled over until January 1985; total short-term debt at the end of 1982 was estimated by the Yugoslav authorities at US$1.8 billion (Table 10). However, as trade debt will be repaid on a revolving basis as it falls due, scope exists for short-term capital outflow unless new trade credits are quickly taken up.

After a slow beginning, due to some delays in concluding the bilateral negotiations with certain of the governments that had pledged support to Yugoslavia in Berne in January 1983, progress is now being made in utilizing amounts committed by participating governments. In the second half of 1983 it is officially estimated that in addition to financial credits nearly US$500 million in suppliers' credits will be disbursed under the Berne package, most of which is to be utilized for raw material and intermediate goods imports. A structural adjustment loan for US$275 million from the World Bank was agreed on June 28, 1983; disbursements will be in two tranches with the first, amounting to US$175 million, expected to be fully disbursed before the end of 1983.

With the current account of the balance of payments with the convertible currency area expected to be in deficit in the second half of 1983, with new money from the banks being partly used to clean up payments arrears, with the possibility of some short-term capital outflow and with little credit being provided by the participating governments on a net basis, a small decline in external reserves is expected during the last six months of 1983. As a result, Yugoslavia will end 1983 in a similar situation to 1982, that is, with stocks of imported goods and international reserves at minimal levels and with little in the way of foreign credits in the pipeline to bridge the seasonally difficult first half of 1984. In addition, external debt service payments will continue to be substantial in 1984 (Table 11).

III. Economic Policies and Prospects

In view of the greater buoyancy of domestic demand and higher-than-expected inflation in the first half of 1983 and the need to overcome continuing pressures on the balance of payments, the authorities have strengthened demand management policies. They have also taken further actions to improve the efficiency of the economy and promote the shift of resources to export-oriented and import-substituting activities. These policies and actions are described below.

1. Monetary and credit policy

The framework program within which the credit program for the first half of 1983 was determined was based on a rise in M1 during 1983 of 12 per cent and an increase in income velocity of 14 1/2 per cent. Foreign exchange deposits (at fixed exchange rates) were assumed to increase by 6 per cent and dinar savings deposits by 21 per cent--the latter relatively sharp increase was expected to come about in response to the increase in deposit rates in February 1983 and the introduction of a wider range of maturities for deposit accounts. The program was also based on the forecast of an external current deficit with the convertible currency area of US$500 million and an assumption that this would result in an increase of nearly US$650 million (about Din 40 billion at fixed exchange rates) in net foreign liabilities of the banking system in 1983. Net domestic assets (NDA) were therefore programmed to increase during 1983 by Din 317 billion (or 11.7 per cent) to Din 3,031 billion at the end of 1983 (Table 12). Within this framework the performance criteria on NDA were fixed at Din 2,758 billion for the average of the end-month figures for the first quarter of 1983 and Din 2,824 billion for the average of the end-month figures for the second quarter of 1983. It was also a performance criterion that the National Bank of Yugoslavia would not extend credit to the Federal Government in 1983.

The performance criterion on NDA for the first quarter of 1983 was observed, but monetary policy was nevertheless not as tight as intended. At the end of March 1983, M2 was 35 per cent and M1 nearly 26 per cent higher than a year earlier, compared with 31 1/2 per cent and 26 1/2 per cent, respectively, at the end of 1982 (Table 13). At end-April the rate of growth of M2 was 34 per cent and that of M1 22 1/2 per cent. In addition, the income velocity of circulation of money appears to have increased more than anticipated during the opening months of 1983 both because of a larger-than-expected rise in interenterprise credits and an increase in the velocity of deposits denominated in dinars. The valuation effect of the depreciation of the dinar on foreign exchange deposits was primarily responsible for the relatively high rate of increase of M2 and also contributed to the rise in the velocity of circulation of deposits denominated in dinars.

In view of these developments and the more adverse external outlook, the authorities considered that a tightening of monetary policy was necessary in the second half of the year. Accordingly, the monetary program for this period envisages a reduction in the rate of growth of

M2 to about 31 per cent and M1 to about 11 per cent by the end of December compared with average year-on-year rates of growth of 32 per cent and 24 1/2 per cent, respectively, in the first four months of the year. The relatively modest programmed decline in the rate of growth of M2 is mainly an automatic consequence of the valuation effects of the rapid depreciation of the dinar on foreign exchange deposits. The income velocity of M1 is forecast to increase by about 18 per cent.

There is considerable debate as to how the stance of monetary policy should be assessed in Yugoslavia. The revised credit ceilings mentioned below are expected to be compatible with a growth of M1 of 11 per cent over 1983. This appears very tight given an expected growth of nominal GSP of 31 per cent. However, two overlapping points must be emphasized. First, in recent years there has been no good correlation between the development of M1 and nominal GSP and, second, there is an unknown amount of excess liquidity in the Yugoslav system. If monetary policy is measured in terms of M2, other difficulties arise. Essentially they surround the correct treatment of the dinar counterpart of foreign exchange accounts. Statistically these are regarded as part of M2 and certainly they are readily encashable by holders in case of need. Nevertheless, the high dinar rate of return available on these deposits, taking into account that their capital value and interest paid on them are tied to foreign currencies, makes it wholly unlikely that they will be readily used, and thus in comparison with dinar deposits they tend to have a much lower velocity of circulation.

The program is also based on a revised forecast for the external current account deficit with the convertible area of US$750 million and an assumption that this will result in an increase in net foreign liabilities (NFL) of the banking system of US$2.1 billion. The reason for the much larger increase in NFL of the banking system compared with the original forecast is an institutional change in the treatment of suppliers' credits. Enterprises are now required, as a normal rule, to channel such credits through the banking system instead of obtaining them directly from abroad. In view of the uncertainty regarding the date of disbursement of suppliers' credits under the Berne package (estimated at Din 30 billion), it has been decided to keep these outside the estimate for NFL in determining the limits on NDA for the second half of the year.

On the basis of this forecast for NFL, adjusted for exchange rate changes, and the targeted M2, with the foreign exchange component also adjusted for exchange rate changes, NDA will increase during 1983 by Din 307 billion (or 11.3 per cent) to Din 3,021 billion. The average stock of NDA of the banking system for the end of July, August, and September 1983 will be limited to Din 2,977 billion and that for the end of October, November, and December 1983 to Din 2,998 billion. The limits for the stock of net domestic assets on September 30 and December 31, 1983 will be Din 2,947 billion and Din 3,021 billion, respectively. Within these overall limits, government revenue frozen with the National Bank of Yugoslavia up to an amount of Din 10 billion by the end of September 1983 and Din 35 billion by the end of December 1983 will be

released as credit to the private sector. The limits for NDA for the third and fourth quarters can be exceeded by the dinar value (at fixed exchange rates) of suppliers' credits actually disbursed under the Berne package up to a limit of Din 30 billion. The Yugoslav authorities stressed that the limits on NDA for the fourth quarter of the year were very tight. They considered this appropriate but warned that if an analysis were made of the impact of the refinancing through banks of existing suppliers' credits on net foreign liabilities and foreign currency credits, and therefore on dinar credits within the proposed ceiling for NDA, it would suggest that there could well be a need to review later in 1983 the limits for the fourth quarter on dinar credits and net domestic assets.

During 1982 unsecured dinar bills, not covered by instruments of payment, rose sharply from Din 113 billion to Din 174 billion or 54 per cent. The statistics for this item cover both such bills that are legally (i.e., within 15 days from the initiation of a creditor-debtor relationship) not covered by an instrument of payment and those that are illegally uncovered. The first category should increase more or less in line with the turnover of enterprises. However, the recent growth in these credits has been much faster than the rate of inflation. Legislation to improve the financial discipline of enterprises and help control the undesired growth of interenterprise credits was passed in June 1983. It will require that in cases where enterprises have insufficient resources to meet payments obligations then, to the extent that such obligations are not settled within a period of 15 days and no credit instrument has been issued, they will have to be honored before personal income payments beyond the minimum guaranteed level or contributions for collective consumption can be made. The Social Accounting Service (SDK) will be given the power to disallow nonpriority payments until the required repayments of enterprise credits have been settled. So far no progress has been made in reducing the amount of unsecured bills. By the end of March 1983 the outstanding stock had gone up to Din 215 billion. If the outstanding stock has not been reduced by Din 50 billion from the end-1982 level by September 1983, namely, to Din 124 billion, the Government will develop further the penalty mechanism.

2. Interest rates

Interest rates on deposits and National Bank credits were increased by a range of 5-8 percentage points in February 1983 as one step in the direction of achieving the medium-term goal of establishing positive real interest rates. However, with the higher-than-expected increase in the rate of inflation, interest rates in real terms have been more negative than contemplated. In order to correct this the authorities have agreed to increase interest rates in accordance with the scheduled changes in Table 14. Interest rates on National Bank selective credits were increased by 10 percentage points and the discount rate by 8 percentage points to 30 per cent by July 10, 1983. Commercial bank rates on deposits will be increased by up to 7 percentage points before the end of 1983, to a maximum of 30 per cent for three-year deposits held by households. A higher increase in interest rates on deposits of enterprises will take place. This might help limit the increase in interenterprise

credits and should also moderate some of the cost increases to enterprises from the increase in lending rates of banks. It is estimated that the costs of funds to the banking system will be increased by Din 58 billion on a full-year basis, in addition to the estimated cost increase of Din 53 billion resulting from the February 1983 interest rate increase. Average loan rates are expected to rise by 6-7 percentage points in response to the increase in bank costs resulting from interest rate changes to be introduced in the second half of 1983. In addition, a floor lending rate for new credits, though with important exemptions, will be introduced by January 1, 1984 and will be adjusted in line with developments in the price level.

3. Fiscal policy

In accordance with the medium-term objective of reducing the relative size of the public sector, fiscal policy in 1983 has aimed at reducing the rate of growth of public expenditure. Revenues and expenditures of the public sector are traditionally in approximate balance, so that data on total public sector revenue may be used to monitor expenditure developments. No net new credits are to be extended by the National Bank of Yugoslavia to finance the budget of the Federation. The annual plan resolution for 1983 contained little quantification of fiscal policy objectives for the year, but it did specify that the growth in nominal terms of general and collective consumption in 1983 (hence also the revenue earmarked for it) should be at least 10 percentage points lower than the growth of national income in that year.

In the first four months of 1983, revenues of the federal budget (comprising less than one fifth of total public sector revenue) were about 20 per cent higher than a year earlier, while expenditure of the Federation was about 17 per cent higher. For the full year, it is expected that federal revenues will grow by 23 per cent (Table 15). Total public sector revenues in January-April 1983 were 23.7 per cent above their level of a year earlier (Table 16).

One specific objective of fiscal policy for the first quarter of 1983 was that revenue (and expenditure) of the public sector should be no larger than the quarterly average for 1982, which for the entire public sector would have implied a 16.5 per cent increase in revenue over the first quarter of 1983. According to legislation passed at the end of December 1982, revenue in excess of this limit was to be placed in special blocked accounts monitored by the Social Accounting Service (SDK); however, less than half of total public sector revenue was subject to this freezing scheme (see Annex II for a description). The effectiveness of this arrangement was impaired by the fact that the public sector other than the Federal Government was expected to reduce taxation if revenues exceeded expenditures. The revenue from the first quarter actually frozen amounted to Din 5.6 billion, most of which was designated for collective consumption and was immobilized in commercial banks. The system of freezing public sector revenue was extended and strengthened at the end of March 1983 through an amendment to the December 1982 legislation (see Annex II). The cumulative excess revenue from the

first four months of 1983 amounted to Din 5.0 billion, implying that revenue was unfrozen for some public sector entities with excess revenue in the first quarter and a shortfall in April.

It became increasingly evident to the authorities that the unexpectedly severe external constraints implied a greater need than previously for fiscal policy to contribute to the restraint of domestic demand. As a consequence, the letter of May 4 to the Managing Director, while referring to the actions taken at the end of March, also stressed the need for greater reliance than before on the freezing of excess public sector revenue, and less on returning it to the economy through tax cuts. At midyear the authorities decided to extend the revenue-freezing scheme to the end of December and to strengthen it in a number of respects so as to share more of the burden borne by credit policy in restraining domestic demand. Minimum amounts were determined on the cumulative public sector revenue to be frozen by the end of September (Din 10 billion) and December 1983 (Din 35 billion). The latter figure corresponds to about 4 per cent of total public sector revenue in 1982, or some 1 per cent of GSP. Also, it was decided that the revenues once frozen should remain immobilized in the National Bank of Yugoslavia at least until the end of 1985. To help contribute to the required accumulation of public sector deposits in blocked accounts, the turnover taxes on specified products (petroleum, tobacco, alcohol, etc.) will be either increased or restructured not later than October 1. In addition, other forms of indirect taxation as well as the effective rates of taxation on nonwage income and on property will be raised by the end of the year. For example, at present income tax is paid only if one's personal income exceeds three times the average in the particular republic or province. It is proposed to reduce this threshold to perhaps twice the average personal income. (Such an "income tax" is additional to "contributions from personal income payments" which are deducted at the enterprise level.) This would, in addition, bring a much needed contribution to the overall incomes policy. The 12-monthly rate of increase for total public sector revenue will be limited to 18 per cent in the second half of 1983, excluding the amounts of surplus revenue blocked in a special account with the National Bank of Yugoslavia.

4. Incomes policy

A major objective of incomes policy in 1982 and 1983 has been to keep the growth of payments for personal incomes and contributions for collective consumption below that of net enterprise incomes. While this goal was not achieved in 1982 due to the excessively rapid rise in personal incomes in the first part of the year, social action and the more active role of the trade unions have kept the growth of personal incomes and contributions for collective consumption below that of net enterprise incomes since mid-1982. Indeed, total personal incomes paid out rose less than net enterprise income in the first quarter of 1983, or by 24 per cent and 26 per cent, respectively, and contributed to a rise in the internal savings of enterprises.

In addition to the incomes policy guidelines on the distribution of enterprise income, it is the target in the plan resolution for 1983 to reduce real wages in the socialized sector by 7.5 per cent in 1983. A number of measures are to be taken during the remainder of the year to strengthen action to achieve the incomes policy objectives. An agreement unifying incomes policy criteria and guidelines within a social compact on a federation-wide basis (the first since 1975) is to be adopted in the coming months and will have the strong support of the trade unions. The authorities intend to monitor closely the evolution of nominal personal incomes and, in the event of an increase in their growth, they would stand ready to take direct action at the federal level to limit the rise in nominal personal incomes in the second half of the year. More specifically, if the growth of nominal personal incomes per employee accelerates in the second quarter of 1983, measures will be taken to bring the 12-monthly growth rate in these incomes in line with the 20 per cent target for the fourth quarter of 1983. As noted above, the authorities will implement by the end of the year tax legislation aimed at siphoning off purchasing power arising from the excessively rapid growth of nonwage incomes.

5. Price policy

The Government's price policies are oriented toward increasing the role of world market prices and domestic market forces in price formation. These objectives are being pursued both through changes in the price system and through specific adjustments in prices of key goods and services that remain subject to administrative control. For example, prices of certain key commodities, such as electricity, coal, railway fares, live animals, meat, and petroleum products, were raised by 25-35 per cent in early 1983. Rents have also been increased substantially. A selective price freeze introduced at the end of July 1982 has been prolonged through the first half of 1983, although in January 1983 prices were decontrolled in a limited number of instances, including wood products, crafts, and some services. In July 1983 the price system reverts from one of price determination at the federal level to one of partial decontrol and some decentralization of price control. For industrial products, the setting of prices will fall into three categories. First, prices for an estimated 10 per cent of the value of industrial goods will remain subject to price ceilings set at the federal level, including petroleum products, cigarettes, and medicines. Under a second, less stringent, form of price control, lists of proposed price increases covering 50 per cent of industrial products would be prepared for approval by Communities for Prices (half by the Federal Community for Prices and half by the republican and provincial price authorities). Prices of the remaining 40 per cent of industrial goods would be fully liberalized.

However, the effectiveness of discrete adjustments in administered prices has been diminished by the rise of the general price level. In order to recoup some of the gains that had been made in adjusting relative prices and reducing price distortions, further price increases for coal, coke, electricity, domestically produced natural gas, and petroleum

products will be made before the end of the year. The price of domestically produced natural gas was raised by an average of nearly 60 per cent in June 1983, though it remains well below half the price of imported natural gas; accordingly, prices will again be raised significantly before the end of the year. With the planned adjustment of petroleum product prices by the beginning of October, a formula will be introduced for automatic price adjustments four times yearly on the basis of international price developments. For the other tradable goods, the adjustments in relative prices effected by the discrete price increases in 1983 will, at a minimum, be sustained by regularly adjusting these commodity prices in line with developments in world market prices. Similarly, for nontraded goods and services, such as railway fares and rents, the progress made in bringing prices closer to economic levels is to be consolidated through additional adjustments on a regular basis. These pricing policies are in line with the findings of the World Bank on the relation between domestic and international prices and on its recommendations for eliminating distortions.

The recent depreciation of the dinar has resulted in new price distortions under the selective price freeze because the higher imported input costs have not been adequately passed through into producer prices. In conjunction with the liberalization of price control in July 1983, price policy will be directed toward permitting the full and timely pass-through of cost increases resulting from rising dinar prices of imports.

6. Exchange and trade policies

The authorities remain committed to providing adequate incentives for a sustained expansion of export production and to ensuring that import decisions are based on realistic assessments of foreign exchange costs through appropriate exchange rate policies. This will be achieved through the continuation of an active exchange rate policy. During the first six months of 1983, the dinar was depreciated by 21 per cent in real terms against a basket of 11 currencies. During the remainder of the year, Yugoslavia intends to continue a system of gradual adjustment to ensure adequate export competitiveness with the aim of achieving a market clearing rate at a sustainable level of capital flows. A study of a more appropriate basket for monitoring movements in the effective exchange rate is to be completed by end-October 1983 and the agreed recommendations put into effect by January 1, 1984.

In the present circumstances of acute foreign exchange shortages, the fragmentation of the foreign exchange market prevents an efficient utilization of available foreign exchange resources. In order to alleviate this problem, the authorities introduced with effect from January 1, 1983 several amendments to the foreign exchange law. (These are described in detail in the Annex III.) The major changes included the replacement of a regional approach to the balance of payments by a sectoral approach, the introduction of limited surrender requirements of foreign exchange proceeds to a unified foreign exchange market, and the granting of a larger role to the banking system in assessing the economic soundness of foreign borrowing transactions. However, the *de facto* link

between export earnings and imports under the system of foreign exchange allocation by self-management agreements among enterprises, which has been one of the major factors behind the compression of imports in 1982 and 1983, remained in effect.

In spite of the recent changes to the foreign exchange allocation system, this system as presently implemented still remains fragmented and is not sufficiently flexible to ensure the appropriate allocation of scarce foreign exchange resources. The Yugoslav authorities consider that improvements in this important policy area are needed and have undertaken a study which is to be reviewed with the World Bank and the Fund. This study will be discussed during the next quarterly visit. Changes are to be introduced with effect from January 1, 1984 and are to include larger surrender requirements to the unified market (or adequate pooling of enterprise foreign exchange resources within banks), and steps to ensure a proper functioning of the interbank market in foreign exchange.

The authorities remain committed to a liberalization of trade policies once the present foreign exchange shortages have been overcome. Yugoslavia maintains a restriction under Article VIII on the availability of exchange for foreign travel arising from the limitation on the export and import of dinars to Din 1,500 per person for the first trip, and Din 200 per person for each subsequent trip during the year. A 10 per cent discount scheme for foreign tourists who effect payments through special dinar-denominated travelers checks issued by the National Bank of Yugoslavia also gives rise to a multiple currency practice. These restrictions including the 10 per cent discount have been approved by the Fund's Executive Board until the end of February 1984, or until the next Article IV consultation. Furthermore, external payments arrears estimated at around US$200-300 million arose toward the end of 1982, and in early 1983. These were reduced by end-June, and will be eliminated as soon as the first disbursements under the financing package described in Annex I are received, and in any event before the August purchase under the stand-by arrangement.

7. External debt management

The Yugoslav authorities are in the process of improving the monitoring and coordination of foreign borrowing, and the Government is exercising strict control over new borrowing. The amendments introduced to the foreign exchange law in May 1982, and reinforced by the new amendments with effect from January 1, 1983, make new borrowing subject to the approval of the National Bank within the framework of overall guidelines approved by the Federal Executive Council. Commercial banks are responsible for ascertaining that any foreign borrowing by enterprises will be for projects that generate a sufficient flow of convertible currency to meet repayment and interest schedules, and are required to issue a guarantee to the National Bank to this effect. In the case of short-term credits used for raw materials, additional requirements are that they can only be used to finance export production, and that imports of such raw materials must only account for up to 50 per cent of the value of the finished export product.

Under the proposed refinancing arrangement with foreign commercial banks on bank debts falling due in 1983, liabilities of the enterprise sector will become the foreign liabilities of the banking system, with these liabilities being guaranteed by the Federal Government (see Annex I).

During 1983, the contraction of new loans with a maturity of at least one and up to ten years will be limited to a maximum of US$1.5 billion, of which no more than US$0.5 billion is to be with a maturity of between one and three years. The limits exclude borrowing either by the National Bank of Yugoslavia or under National Bank guarantee. At the end of March 1983, the contraction of new loans subject to this ceiling amounted to US$252 million.

8. Medium-term policies

A revision of the 1981-85 Medium-Term Plan is under way and is expected to be completed by the end of 1983. The revision is expected to scale back previous investment plans and aim for a relatively modest growth of GSP and industrial output in 1984-85 of 3 per cent per annum, reflecting the need to continue a stabilization program of restrained domestic demand beyond 1983. An objective of policy over the next two years will be to continue the emphasis on external adjustment through a sustained rapid growth of exports to the convertible currency area.

At the same time, the Government continues to hold to its medium-term objectives of enhancing economic efficiency and the prospects for growth in a less inflationary environment. Recent and prospective increases in interest rates and selective price increases designed to correct price distortions are a part of the effort to stimulate a more efficient allocation of resources through increased reliance on market forces. Emphasis is also being placed on improved financial discipline of enterprises, notably those incurring losses, to encourage a reallocation of resources to sectors and regions where they will be used more efficiently. The growth of personal incomes and contributions for collective consumption will be kept below that of net income of enterprises so that they can rely more on internal savings, and hence less on bank credit, to finance their investments.

In June 1983 the Government concluded a structural adjustment loan with the World Bank, which is supported by a medium-term program designed to ensure significant institutional and policy changes bearing inter alia on investment planning, foreign exchange allocation, enterprise decision-making, and medium-term planning in the energy and agricultural sectors. In the ongoing revision of the medium-term plan, investment programs are being scaled back and priority sectors more clearly delineated and narrowed to bring them in line with the savings capacity of the economy. For the remainder of the 1981-85 plan period, the sectors accorded the highest priority are export-oriented industry, the energy sector, and the agricultural sector, followed by the basic metals, transportation, and tourism sectors.

IV. Outlook

With a tightening of credit and fiscal policies and a reinforcement of commitments to adhere to restrictive incomes policies, declines in domestic demand in the first five months of 1983 are expected to be sustained during the remainder of the year. Private consumption is forecast to decline by 3 per cent, implying that real wages in the socialized sector will continue to be restrained and that consumer spending out of nonwage income will slow down. A greater measure of control over the latter element of household income will be achieved only in 1984 with a sharpening by the end of 1983 of the effective taxation of nonwage incomes. Public consumption is officially forecast to remain unchanged in volume terms, but the limitations imposed on the growth of public expenditures together with the freezing of Din 35 billion in public sector revenue will ensure a decline in public consumption.

The revised forecast for gross fixed investment in 1983 indicates a decline of 10 per cent in volume, due largely to the impact on investment of the tight credit policy as well as to limitations on imports of investment goods. The authorities have not revised the official projections of the foreign balance in real terms, implying a fall in real GSP of 1/2 per cent in 1983. Staff forecasts, which incorporate a less optimistic estimate for exports than the official projections, indicate a decline of 2-3 per cent in real GSP.

The more restrictive demand management policies and the continued pursuit of a flexible exchange rate policy together with some buildup of the severely depleted stocks of imported raw materials should enable a continuation of the rapid growth of earnings from exports of goods and services and further progress to be made in moving the current account of the balance of payments with the convertible currency area toward a surplus. While the Yugoslav authorities will be aiming at a surplus in the current account next year, the latest staff projections indicate approximate balance in 1984.

V. Performance Criteria and Periodic Reviews

The following performance criteria, the quantitative components of which are set out in Table 2, are applicable for the remaining period of the stand-by arrangement. Items c.-f. have already been established as performance criteria in earlier Board decisions and item b. is a modification of an existing performance criterion.

a. Limits on net domestic assets of the banking system through December 1983.

b. Limit on public sector revenue increase.

c. Limit on credit from the National Bank of Yugoslavia to the budget of the Federation.

d. Depreciation of the effective exchange rate of the dinar.

e. Limit on the increase in new foreign borrowing in convertible currency.

f. The standard performance criterion on trade and payments restrictions.

Changes in rediscount rates for selective National Bank credits to banks for on-lending to priority sectors, in the general discount rate, and on liquidity credits and certain changes in domestic prices will have been implemented by the time the Executive Directors consider the review of the stand-by arrangement.

The stand-by arrangement provides for staff visits to review recent and prospective economic developments and to assess the effectiveness of policies being implemented. In particular, the currency basket used to calculate the effective exchange rate will be reviewed and agreed recommendations implemented by January 1, 1984. Further, the limits on NDA for the fourth quarter of 1983 will be reviewed with the staff at the time of the autumn staff visit. At that time the implementation of the amendments to the foreign exchange allocation law will also be discussed and understandings will be reached on additional measures to become effective January 1, 1984. Progress in reducing the outstanding amount of unsecured bills will likewise be discussed during the autumn staff visit. These developments will be important for any additional stabilization measures put in place in 1984.

VI. Staff Appraisal

The three-year stand-by arrangement approved in January 1981 provided Fund support for Yugoslavia's adjustment program. More restrictive demand management policies were necessary both on account of world conditions and of a previous period of overrapid domestic expansion; policies were also needed to reduce the structural distortions that had become increasingly obvious and in themselves impeded the efficiency of the economy. Policies were implemented to move the Yugoslav external accounts into what appeared to be a sustainable position, taking into account expectations of medium-term net capital inflows that appeared reasonable at that time.

During 1981 as new medium-term borrowing became increasingly difficult, Yugoslav banks sharply and dangerously increased their short-term borrowing. In 1982, in the wake of the Polish crisis, when foreign banks sought to reduce their exposure to countries that they regarded as associated with Eastern Europe, Yugoslavia was particularly vulnerable given the structure of its indebtedness and the compartmentalization of its foreign exchange market. External liquidity difficulties spread from the most exposed Yugoslav banks and arrears began to accumulate. The foreign exchange crisis and the realization that prospects for capital imports had been dramatically reduced, not just in the short term, forced the adoption of a series of additional adjustment measures designed to achieve a much greater and more rapid improvement in Yugoslavia's current account in convertible currencies than earlier envisaged. These measures were supported by a coordinated program of international support in which the Fund program for 1983 played a pivotal role.

The current account deficit in convertible currencies amounted to US$1,420 million in 1982. The Fund program envisaged that it would fall to US$500 million in 1983. To this end the program sought a sharp compression of domestic demand, through restraining incomes and credit, but also through a series of measures including an active exchange rate policy and adjustments of administered prices and interest rates, designed to set the scene for more efficient use of resources and thus more balanced future growth. Given that by end-1982 usable foreign exchange reserves were at a very low level as were stocks of imported commodities, an ambitious program of international financial support was negotiated. Its main elements, in addition to drawings on the Fund, were an intergovernmental package amounting to US$1.3 billion, a consolidation of external debt falling due to foreign commercial banks in 1983, and finally a new medium-term loan by the banks of US$600 million to enable accumulated arrears to be paid off, and foreign exchange holdings to be strengthened. In addition, the World Bank was prepared to consider a structural adjustment loan and, in order to help cope with the seasonally difficult first half of the year, a bridging loan by the BIS was contemplated.

In a series of visits the staff has reviewed with the Yugoslav authorities the progress made during the early months of 1983 and the prospects for the remainder of 1983 and beyond. The progress made toward

the achievement of a more viable balance of payments position has been considerable but at the same time it is clear that greater efforts are required, both because there is a danger of slippage and because of uncertainties on external financial resources.

In late 1982 the authorities publicly projected a fall in real domestic demand in 1983 by 10 per cent, although in the staff's view a fall of approximately half this amount would have been sufficient and, on the basis of policies adopted, such a large fall could not have been expected. The authorities placed their main emphasis on incomes policy rather than on restrictive financial policies to contain the development of personal incomes and restrain domestic demand. In the staff view, however, it was essential that full attention be paid to supporting financial policies, including increased financial discipline, and also to changes in the price mechanism to improve the responsiveness to changes in the exchange rate and interest rates, and to reduce the distortions that emanated from the administered price system.

In the first four months of 1983 real wages fell by 10 per cent compared with the same period of 1982. This is a remarkable achievement. However, any assessment has to take into account the fact that nonwage income, a term which embraces all income arising from outside the socialized sector, rose much faster. Because a large part of savings is held in foreign currency accounts, large capital gains accrued to savers in the wake of the repeated exchange rate adjustments. Thus, real disposable incomes and wealth declined much less than wage incomes, and the volume of retail sales seems in recent months to have been declining at an annual rate of 2 to 3 per cent against the publicly envisaged fall of 6 per cent in real private consumption. In addition, there is a risk of attempts to recoup some of the loss of real wages which could initiate a price-wage spiral. It is these concerns that have led the authorities to take further measures to support their incomes policy objectives by seeking to contain the nominal rate of growth both through regulations and enhanced financial discipline, through tighter monetary policy and by a more active use of fiscal policy to restrain demand. The authorities intend to subject nonwage income to greater direct taxation. The practical difficulties of enforcing equitable taxation of wage and nonwage incomes need no underlining, but the attempt to move in this direction is fully justified in the opinion of the staff, though a sustained increase in the overall tax burden on the economy should be resisted.

Although the performance criteria for NDA have been fully observed, prices have been rising at an annual rate of some 35 per cent which is at the top end of the range that the staff expected but significantly higher than the 20 per cent rate of rise embodied in the annual plan resolution. The fiscal performance criterion on the growth of public sector revenues was also satisfied, and, in addition, the authorities introduced additional measures at the end of March to ensure that any excess revenue growth would be sterilized.

On the surface, the balance of payments position appears to have improved dramatically with the current account in convertible currencies

recording a deficit of US$125 million in the first four months of 1983, compared with a deficit of US$1,189 million in the same period of 1982. However, in part this improvement was not sustainable as the shortage of foreign exchange led to a sharp drop in imports from the convertible currency area (over 20 per cent in the first four months of 1983 compared with the same period of 1982) despite a sharp rise in imports from the nonconvertible area. There are now reports of production, including production for exports, being hampered by a shortage of imported inputs. A revival of imports is therefore to be expected and indeed some revival of imports is essential once the foreign exchange position improves. Exports to the convertible currency area have risen by 17 per cent in the first four months of 1983 compared with the corresponding period a year earlier. In the circumstances this is a significant achievement. At the same time Yugoslavia's trade with the nonconvertible currency area has swung from a large surplus (about US$700 million in 1982) to approximate balance; this development is to be welcomed, and in the staff view it is important that it be sustained and indeed carried further.

The tightness of the foreign exchange position is largely a consequence of the much slower than earlier expected disbursement of the foreign assistance package, with a larger proportion of unusable suppliers' credits and a smaller share of financial credits to be disbursed in 1983. With the benefit of hindsight it appears that unrealistic hopes as regards the extent and the speed of disbursement of the foreign assistance program were allowed to build up. It now seems that of the intergovernmental package of US$1.3 billion pledged in Berne on January 19, 1983 only around US$1.0 billion is likely to be disbursed. Moreover, in addition to the planned disbursements of financial credits, slowness in implementation means that only up to US$500 million in suppliers' credits from the package now seems likely to be utilized during 1983.

Agreement on the bank program has also been reached more slowly than had been initially expected partly due to the time needed for the collection of data and the working out of terms that were mutually acceptable. The agreement for short-term debt seemingly gives rise to significant dangers of an outflow of short-term capital, though the outflow may prove temporary. Further, the agreement with foreign banks is likely to be finalized only in late July or early August, and the drawing on the Fund for mid-August is contingent on its finalization. Full disbursement of the BIS bridging loan has also been delayed by a time-consuming need to obtain waivers of generalized negative pledge clauses earlier provided to a series of bank creditors. The World Bank Board approved a US$275 million SAL for Yugoslavia at the end of June.

The need for some expansion in imports and the uncertainties surrounding tourist receipts and remittances have led the staff to increase their forecast of the expected current account deficit in convertible currencies in 1983 to US$750 million against an earlier projection of US$500 million. This combined with smaller and slower disbursements in 1983 of the foreign assistance program means that there can now be no realistic expectation that Yugoslav official reserves will rise by the earlier projected US$800 million by end-year. Although the Yugoslav

authorities still hope that the current account deficit in convertible currencies will be smaller than projected by the staff, they agree that the balance of payments outlook coupled with the acceleration in the rate of inflation requires a further tightening of policies.

The tightening of policies is fully described in the body of this report. In summary the authorities have reiterated their intention to hold the increase in nominal personal incomes per employee in the socialized sector to 20 per cent. Some backup measures are contemplated should this end-result seem in danger of not being realized.

Incomes policy will be supported by a tightening of monetary policy. This is also regarded as an essential precondition for the containment of inflationary pressures. The Yugoslav authorities have set the credit ceilings governing the third and fourth quarters at what they regard as very tight levels. They consider that, given the economic difficulties they face, it is preferable to err if anything on the side of excessive restraint, but they have felt bound to warn that later in 1983 they may need to review with the staff the fourth quarter ceiling to see whether a marginal increase is not called for. The staff agrees that by all normal relationships monetary policy is now seemingly quite stringent, but, given the past capacity of the system to adapt to a tightening of measured monetary conditions through an apparent offsetting increase in velocity, the staff feels that the new ceilings are appropriate and should be attainable. The Yugoslav authorities have taken measures to enhance financial discipline of the enterprise sector which should diminish the dangers of a sharp rise in velocity. The staff welcomes these supporting measures but feels that more discipline will be called for in coming years.

The authorities have also decided that fiscal policy should be used to constrain consumption expenditure by freezing by the end of the year an amount equivalent to some 1 per cent of GSP. This amount is to be obtained by a continued tight control of expenditures supported by an increase in indirect taxation. The staff endorses this move which will, within the NDA ceiling, allow a greater amount of credit to be extended to enterprises. However, the staff feels that the burden of the public sector--and the distortions that the operation of this sector may give rise to--must be reviewed with an eye to enhancing the efficiency of the economy, and particularly the viability of the finances of the enterprise sector.

The authorities have decided to continue their policy of eliminating price distortions and pursuing an active exchange rate policy. The good export performance is to be supported by a continued flexible use of the exchange rate designed to ensure the competitive position of Yugoslav enterprises. More efficient allocation of scarce foreign exchange resources is to be looked for through greater unification of the foreign exchange markets. The changes in administered prices announced in early 1983 have in part been overtaken by the higher-than-expected rate of inflation. A series of additional increases in administered prices, in line with the findings of the World Bank, will therefore be introduced

during the second half of 1983 and at the beginning of 1984. These increases focus particularly on the energy sector. At the same time, the intention of the authorities to further liberalize price formation is to be welcomed and should be implemented with determination.

The staff believes that both the policies on the exchange rate and on prices are fully justified. Admittedly, it is very difficult to measure the competitiveness of the Yugoslav economy at a time when the pricing system is being revised, when domestic prices are being brought increasingly into line with international prices,and when simultaneously a considerable part of the required improvement in the current account in convertible currencies is to be secured by a move from a substantial surplus to balance or a small deficit in Yugoslavia's current account with the nonconvertible currency area.

These series of adjustments are to be complemented by a further sharp rise in interest rates. As a result, interest rates charged by the National Bank on credits to banks for on-lending to privileged borrowers, a category which given the present restriction on credit comprises the great bulk of new bank lending, will have risen in a series of steps from 1 to 6 per cent in the first half of 1982 to 18 to 22 per cent in July 1983. Given that most Yugoslav enterprises are heavily indebted to banks, if only because of the negative real interest rates they have faced and the heavy fiscal burdens they have supported, such a change has had a marked effect on the profit and loss accounts of enterprises.

However, measured in terms of real interest rates, the new lending rates for privileged borrowers remain negative though those for other categories of borrowers have become positive. Of equal concern, the interest rates available on dinar deposits to households, which will again be increased before the end of 1983, will remain negative in real terms and therefore conspicuously less attractive than the returns available on foreign exchange deposits. The staff continues to feel that progress has to be made in the direction of ensuring that real interest rates are not negative. The Yugoslav authorities emphasize that the current rate of inflation is accounted for in part by some once-for-all adjustments and should not therefore be used as a yardstick against which to measure real rates of interest. In their opinion, the Yugoslav public expects a slower rate of inflation to be ruling in the next several months. The authorities also emphasize the dislocation caused to the monetary system by abrupt changes in interest rates. The staff, taking account of these views, has argued in favor of a series of step increases designed to avoid excessive dislocative effects but not so gradual as to vitiate substantial progress. The staff considers that the recent interest rate decisions should be looked on as the latest in a series of such increases and would emphasize that, in its opinion, the process has not yet been completed.

In the staff's opinion, the series of decisions taken by the Yugoslav authorities should be sufficient to contain the current account deficit with the convertible currency area at US$750 million in 1983 as a whole and to set the scene for a further marked improvement in the current

account in 1984 when it would surely be necessary to seek a surplus. It is important that the Yugoslav authorities demonstrate their commitment to the international community to pursue the needed adjustment policies so as to gain the support of the community and to ensure that external debt obligations continue to be serviced in an orderly fashion in coming years. The staff notes that the slower-than-expected improvement in Yugoslavia's balance of payments position and especially the unlikelihood that official reserves will be able to be built up to an adequate level by the end of 1983 means that the Government's adjustment program will have to be continued certainly through 1984 and will need to be adequately supported. In this context, the Yugoslav authorities, who concur with this view, have expressed their desire to enter into a new stand-by program with the Fund after the present one expires. The staff is of the view that, provided the authorities demonstrate their adherence to tighter demand management policies and continue to take action to significantly restructure their economy, then a further stand-by arrangement with the Fund could be contemplated.

Clearly, on the domestic side there is a need for further movement in the direction of structural reforms aimed at greater reliance on the price mechanism, at enhanced financial discipline, better control of income developments, and institutional changes aiming at a reduction in existing distortions. The financial situation of enterprises is particularly worrisome, and hampers the putting in place of much needed measures. On the external side, there is a clear need to move toward a more efficient foreign exchange allocation system, a more rational handling of foreign exchange accounts of residents, and a better external debt management system. The revision of the Foreign Exchange Law to be implemented on January 1, 1984 is of considerable importance in this context. The Yugoslav authorities fully share these concerns and it has been agreed that the next quarterly review will be largely devoted to these issues, together with balance of payments prospects for 1984 and beyond.

Medium-term projections show that Yugoslavia will need to record a very rapid expansion of exports of goods to the convertible currency area in the coming years in order to bring about a sustained improvement in the balance of payments and to overcome its fragile external debt position. While demand restraint can play a role, increased reliance will have to be placed upon the restructuring of the economy to shift resources into export-oriented activities. This in return will require a greater reliance on market forces so that the incentives for export production reflecting comparative advantage can be enhanced. It must be stressed that no administrative strategy can be an adequate substitute for an effective price mechanism reflecting the relative scarcity of goods, capital, and foreign exchange.

In view of the additional commitments undertaken by the Yugoslav authorities, the following draft decision is proposed for adoption by the Executive Board.

VII. Proposed Decision

1. The Government of Yugoslavia has consulted in accordance with paragraph 3(d) of Executive Board Decision No. 7363-(83/47), 3/11/83, and paragraph 12 of the letter from the Governor of the National Bank of Yugoslavia and the Federal Secretary for Finance of Yugoslavia dated December 30, 1982 in order to establish performance criteria subject to which purchases may be made by Yugoslavia during the remaining period of the stand-by arrangement for Yugoslavia (EBS/81/5, Supplement 2(2/2/81)).

2. The letter from the Governor of the National Bank of Yugoslavia and the Federal Secretary for Finance of Yugoslavia, dated July 8, 1983, setting forth the policies and measures which the authorities of Yugoslavia will pursue for the remaining period of the stand-by arrangement, shall be annexed to the stand-by arrangement for Yugoslavia, and the letter of December 30, 1982, annexed to the stand-by arrangement as supplemented by the letters of February 18, 1983 and May 4, 1983, shall be read as supplemented by the letter of July 8, 1983.

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

resulting from purchases of supplementary financing to more than 12.5 per cent of quota during any period in which the data for the preceding period indicate that the limit on outstanding net domestic assets of the banking system described in sentence 6 of paragraph 9 of the annexed letter, and as specified in the attached Memorandum of Understanding, has been exceeded.

4. In accordance with the letter from the Governor of the National Bank of Yugoslavia and the Federal Secretary for Finance of Yugoslavia, dated July 8, 1983, the intentions relating to public sector expenditures referred to in paragraph 3(b)(iv) of Executive Board Decision No. 7363-(83/47), 3/11/83, shall be supplemented and modified in accordance with the last three sentences of paragraph 7 of the annexed letter.

Table 1. Yugoslavia: Selected Economic and Financial Indicators, 1980–83

	1980	1981		1982		1983		
	Actual	Program	Actual	Program	Latest estimates	Plan	Revised official estimates	Staff forecast
	(Annual per cent changes, unless otherwise specified)							
National incomes, prices, and cost:								
GSP at constant prices	2	2	1 1/2	2 1/2	1	1	-1/2	-2 1/2
Final domestic demand	--	--	-4	-2	-2	-10	-5	-4
GSP deflator	31	20	40	20	31	20	30	35
Retail prices 1/	39	20	39	15	31	20	24	36
External sector (with convertible currency area)								
Export volume	2 1/2	7	2	12	-2 1/2	20	10	6
Import volume	-14 1/2	-3	-5	1	-11	-10	-7	[illegible]
Terms of trade (deterioration -)	-1	-5	-5	--	2	--	--	--
Nominal effective change rate (depreciation -) 2/	-30	3/	-23	3/	-30	...	...	...
Real effective exchange rate (depreciation -) 2/	-10	3/	-2	3/	-15	...	...	...
Federal government								
Total revenue	17	50	51	24	21	23	23	23
Total expenditure	33	28	29	21	17	24 1/2	24 1/2	24 1/2
Money and credit								
Domestic bank credit 1/ 4/	28	22	23	16 1/2	17	11 3/4	11 1/2	11 1/2
Central bank credit to Central Government 1/	10	5	4	--	-0.5	--	--	--
Money (M1) 1/	23	22	27	17	26 1/2	18	11	11
Velocity (GSP relative to M1)	8	--	12	2	4	3	14 1/2	14
Interest rate (annual rate, one year savings deposit)	9	...	9	5/	6/	18 7/	8/	[illegible]
	(In per cent of GSP)							
Public sector expenditure	39	37	35	35	34	33	33	34
Federal government expenditure	8	9	7	7	7	7	7	7
Federal government deficit	1.3	-0.1	0.1	-0.1	-0.1	--	--	--
Gross fixed investment	34	32	31	28	29	23	24	25
Money (M1); end of period	30	30	26	26	25	25	22	[illegible]
Current account balance	-4	-2 1/2	-1 1/2	-1	-2 1/2	2 1/2	-1	-1 1/2
External convertible currency debt; end of period	28	...	29	...	32	...	...	...
	(Other ratios and data)							
External debt service ratio on convertible currencies (in per cent of exports of goods and services)	21	19	24	23	24 1/2	27	...	35
Interest payments in convertible currencies (in per cent of exports of goods and services)	8	[illegible]	12 1/2	12	13	[illegible]	...	[illegible]
Gross official reserves (weeks of total merchandise imports)	5	6	6	[illegible]	3	[illegible]	...	[illegible]
Overall balance of payments with convertible currency area (in millions of U.S. dollars)	-172	-350	-435	-592	-1,575	-171	132	[illegible]

Sources: Yugoslav authorities; and staff estimates.

1/ Twelve-monthly change to end of period.
2/ End of year over end of preceding year; Yugoslav payments-weighted currency basket.
3/ The nominal exchange rate was to be adjusted in line with the differential between the change in Yugoslav prices and costs relative to those in trading partner countries.
4/ Stand-by definition; for 1983 refers to net domestic assets of the banking system.
5/ The interest rate on bank deposits of households of one year's maturity was increased to [illegible] per cent in March 1982. Interest rates were to be reviewed against the background of price developments [illegible]
6/ The interest rate on one-year saving deposits was increased further to 13 per cent on October 1, 1982.
7/ The interest rate on one-year deposits of households were raised to [illegible] per cent in February.
8/ The interest rate on one-year deposits of households is to be raised to [illegible] per cent before the end of 1983.

Table 2. Yugoslavia: Quantitative Performance Criteria

A. Credit ceilings	Net Domestic Assets of the Banking System		Credit from the National Bank to the Budget of the Federati[on]	
	(In billions of dinars)			
	Limit	Actual	Limit	Actual
1983 January-March 1/	2,758	2,750	--	-0.1
April-June 1/	2,824	...	--	...
July-September 1/	2,927	...	--	...
September 2/	2,947	...	--	...
October-December 1/	2,998	...	--	...
December 2/	3,021	...	--	...

B. Contracting of new foreign loans during 1983	Limit	Actual
	(In billions of U.S. dollars)	
With maturities of one and up to ten years	1.5	0.3 3/
With maturities of between one year and three years	0.5	-- 3/

Sources: Yugoslav authorities; and IMF staff.

1/ Average of end of month data.
2/ End month data.
3/ January-March.

Table 3. Yugoslavia: National Accounts

	1981				1982		1983		
	In billions of dinars	In per cent of GSP	1980	1981	Plan 1/	Estimate	Plan 1/	Revised forecast 2/	Staff forecast
			In 1980 prices; percentage change						
National accounts									
Private consumption	1,143	51.8	0.7	-1.0	--	0.5	-6.0	-3.0	-2.0
Public consumption	198	9.0	2.7	-0.7	-0.3	-1.6	0.2	--	-5.0
Gross fixed investment	664	30.0	-1.7	-9.3	-6.0	-6.2	-20.0	-10.0	-7.0
Final domestic demand	2,005	90.8	--	-3.9	-2.1	-2.0	-10.0	-5.0	-4.0
Stockbuilding 3/	262	11.9	1.4	3.0	-0.7	-0.4	-0.9	-0.2	--
Statistical discrepancy 3/4/	17	0.7	-4.4	-0.8	2.7	0.6	7.8	1.3	--
Total domestic demand	2,284	103.4	-2.8	-1.6	0.1	-1.6	-1.8	-3.2	-3.5
Exports of goods and nonfactor services	469	21.2	8.9	13.1	8.5	-3.7	8.8	8.8	1.7
Imports of goods and nonfactor services	545	24.6	-10.0	-2.1	-1.4	-13.5	-4.3	-4.3	-2.3
Foreign balance 3/	-76	-3.4	5.3	3.1	2.4	2.5	2.7	2.7	0.9
Gross social product	2,208	100.0	2.2	1.4	2.5	0.9	0.9	-0.5	-2.6

Sources: Federal Statistical Office, Indeks; data provided by the Yugoslav authorities; and staff estimates.

1/ Resolution for the Annual Plan for the year indicated.
2/ Revised by the Yugoslav authorities, but without the official status of the forecasts published in the resolution for the Annual Plan.
3/ Changes in per cent of preceding year's GSP in constant prices.
4/ Changes for 1983 represent "unallocated consumption," the discrepancy between demand and production estimates.

Table 4. Yugoslavia: Domestic Price Developments

(Percentage change from a year earlier)

	1980	1981	1982	1983 Jan.-May	1980 Dec.	1981 Dec.	1982 June	1982 Dec.	1983 Mar.	1983 May
Industrial producer prices	27.3	44.7	25.0	24.8	39.8	37.4	24.3	24.7	24.6	23.7
Investment goods	12.3	25.0	15.8	18.7	22.2	18.7	15.3	17.9	18.1	19.6
Intermediate goods	34.3	47.1	27.1	24.8	46.7	40.8	26.6	26.2	23.7	22.3
Consumer goods	21.1	42.9	24.8	26.8	33.7	38.3	23.5	24.6	27.9	27.5
Retail prices	30.4	46.0	29.5	32.6	39.2	39.3	27.5	30.7	31.9	34.3
Agricultural products	34.1	39.2	43.8	46.2	42.2	36.0	42.8	44.7	47.4	42.4
Industrial products	31.6	49.4	28.6	31.6	41.7	41.5	26.5	30.0	30.4	34.4
Services	22.7	29.2	20.3	22.5	24.3	27.0	18.6	19.7	21.8	24.5
Cost of living	30.3	40.7	31.7	35.6	37.3	36.2	30.5	32.7	35.6	37.4
Of which: Food	31.6	42.9	38.8	42.0	40.3	38.0	37.3	40.1	42.7	40.6
Clothing	24.0	37.5	35.2	34.8	29.1	37.6	35.0	36.1	33.3	38.0
Rent	29.4	29.9	18.0	26.1	25.7	34.6	25.5	18.1	21.7	36.2
Services 1/	20.5	17.6	23.0	24.4	22.7	25.5	22.0	23.1	22.8	29.8
GSP deflator	31.0	40.2	27.0							

Sources: Federal Statistical Office, Indeks; and data supplied by the Yugoslav authorities.

1/ Exclusive of rents.

Table 5. Yugoslavia: Nominal and Real Net Personal Income per Worker in the Socialized Sector

	Net Personal Income Per Worker				Cost of Living	Real Net Personal Income Per Worker			
	Socialized sector		Of which: economic sector			Socialized sector		Of which: economic sector	
	Dinars per month	Per cent change 1/	Dinars per month	Per cent change 1/	1981=100	1981=100	Per cent change 1/	1981=100	Per cent change 1/
1978	5,075	20.8	4,913	20.6	45.4	113.5	5.7	111.8	5.5
1979	6,113	20.5	5,928	20.7	54.7	113.4	--	111.9	0.1
1980	7,368	20.5	7,167	20.9	71.3	105.0	-7.4	104.0	-7.1
1981	9,846	33.6	9,675	35.0	100.0	100.0	-4.8	100.0	-3.8
1982	12,542	27.4	12,336	27.5	131.6	96.8	-3.2	96.9	-3.1
1980 December	8,650	27.0	8,331	27.8	82.1	107.0	-7.5	104.9	-6.9
1981 December	11,590	34.0	11,277	35.4	111.6	105.5	-1.4	104.4	-0.4
1982 1st quarter	11,425	33.2	11,223	33.7	116.9	99.2	3.4	99.2	3.8
2nd quarter	12,316	29.5	12,090	29.7	127.3	98.3	-0.1	98.2	0.1
3rd quarter	12,803	26.5	12,644	26.2	136.7	95.1	-6.0	95.6	-6.2
4th quarter	13,594	22.2	13,327	22.1	145.4	95.0	-8.0	94.7	-8.1
1983 1st quarter	13,703	19.9			156.9	88.7	-10.6		

Sources: Federal Statistical Office, Indeks; and data provided by the Yugoslav authorities.

1/ Change from corresponding period of preceding year.

Table 6. Yugoslavia: Balance of Payments with the Convertible Currency Area, 1983

(In millions of U.S. dollars)

	1st Half		2nd Half		Total Year	
	Program	Revised est.	Program	Revised proj.	Program	Revised proj.
A. Goods, services, and unrequited transfers	-1,100	-501	600	-249	-500	-750
Exports	2,970	2,926	3,330	3,274	6,300	6,200
Imports	-4,275	-3,999	4,325	-4,951	8,600	-8,950
Trade balance	-1,305	-1,073	-995	-1,677	-2,300	-2,750
Invisibles (net)	205	572	1,595	1,428	1,800	2,000
B. Medium- and long-term capital	609	42	98	599	707	601
Drawings	2,270	605	1,480	2,855	3,750	3,459
Repayments	-1,586	-502	-1,257	-2,206	-2,843	-2,708
Loans extended	-75	-61	-125	-89	-200	-150
C. Short-term capital	--	-100	--	-250	--	-350
D. Total (A through C)	-491	-559	698	60	207	-499
Use of Fund credit	316	292	105	122	421	414
Use of BIS credit	500	250	-500	-250	--	--
Reserve movements (-increase)	-325	17	-303	68	-628	85

Sources: Data provided by the Yugoslav authorities; and staff estimates.

Table 7. Yugoslavia: Balance of Payments with the Convertible Currency Area, 1979-84

(In millions of U.S. dollars) 1/

	1979	1980	1981	1982	1982 Jan.-Apr.	1983 Jan.-Apr. 2/	1983 Projections	1984 Projections
A. Goods and services, and unregistered transfers	-3,304	-2,203	-1,821	-1,420	-1,189	-125	-750	--
Exports	4,766	5,656	5,720	5,858	1,618	1,874	6,200	7,050
Imports	-11,336	-11,321	10,600	-9,637	-3,126	-2,488	-8,950	9,300
Trade balance	-6,570	-5,665	-4,880	-3,779	-1,568	-594	-2,750	-2,250
Workers' remittances	1,690 3/	1,521 3/	1,689 3/	1,240	478	466	1,150	1,300
Tourism	1,000 3/	1,474 3/	1,545 3/	1,377	207	310	1,630	1,900
Other services	576 3/	431 3/	175 3/	-258	-366	-307	-780	-950
Invisibles (net)	3,266	3,462	3,059	2,359	319	469	2,000	2,250
B. Medium- and long-term capital	1,212	1,830	583	-61	213	483	601	...
Drawings	2,903	3,909	2,513	1,804	752	874	3,459	...
Repayments	-1,568	1,844	-1,695	-1,690	-499	-363	-2,708	-2,705
Loans extended	-123	-235	-235	-175	-40	-28	-150	...
C. Short-term capital	218	739	167	-506	-320	-109	-350	...
D. Allocation of SDRs	37	37	38	--	--	--	--	...
E. Errors and omissions	491	-575	598	412	373	-365	--	...
F. Total (A through E)	-1,346	-172	-435	-1,575	-923	-116	-499	...
Use of Fund credit	218	304	672	563	... 4/	... 4/	414	...
Use of BIS credits	--	--	--	--	--	300	--	
Reserve movements (increase)	1,128	-132	-237	1,012	923	-184	85	...

Sources: Data provided by the Yugoslav authorities; and staff estimates.

1/ Computed on the basis of statistical conversion rates of currencies (other than dinars) to the U.S. dollar. For 1981, use of these rates tend to marginally underestimate balance of payments flows. For 1982 and 1983, the results are significant, but uneven, overestimates of most balance of payments flows in convertible currencies depending on currency composition. Staff calculations suggest that the change in trade flows in both years is overestimated by some 4 percentage points while workers' remittances and tourism are overestimated by some 7 percentage points. The staff estimates show, however, that the current account outcome would only differ marginally if actual exchange rates were used.

2/ Unofficial estimates of the Yugoslav authorities.

3/ Staff estimates.

4/ Included in medium- and long-term capital.

Table 8. Yugoslavia: Balance of Payments with the Nonconvertible Currency Area, 1979-84

(In millions of U.S. dollars)

	1979	1980	1981	1982	1982 Jan.-Apr.	1983 Jan.-Apr. 1/	1983 Projections	1984 Projections
A. Current account	-357	-88	875	956	442	73	--	-200
Exports	2,028	3,322	4,485	4,389	1,431	1,164	3,800	3,930
Imports	-2,683	-3,743	-3,928	-3,699	-1,067	-1,155	4,000	4,350
Trade balance	-655	-421	557	690	364	9	-200	-420
Services (net)	298	333	318	266	78	64	200	220
B. Capital (net)	115	94	-35	-33	-14	21	50	...
C. Errors and omissions	-500	-360	-64	-118	258	96	--	...
Total (A through C)	-742	-354	776	805	686	190	50	...

Sources: Data provided by the Yugoslav authorities; and staff estimates.

1/ Unofficial estimates of Yugoslav authorities.

Table 9. Yugoslavia: External Financing Flows Vis-à-Vis the Convertible Currency Area

(In billions of U.S. dollars)

	1983 Orig. program Total	1983 Orig. program 1st half	1983 Total	1983 1st half	1983 2nd half
			Latest staff estimates		
Use of funds					
Current account balance	-0.5	-1.1	-0.7	-0.5	-0.2
Medium- and long-term maturities	-2.6	-1.1	-2.7	-0.5	-2.2
Short-term maturities	-1.8	-1.0	-1.8	-1.0	-0.8
Other obligations	-0.6	-0.5	-0.6	-0.3	-0.3
	-5.5	-3.7	-5.8	-2.3	-3.5
Sources of funds					
Suppliers' credits	0.7	0.3	0.9	0.5	0.4
World Bank, EIB	0.5	0.1	0.5	0.1	0.4
IMF	0.6	0.4	0.6	0.4	0.2
Rollover of short-term debt	1.8	1.0	1.5	0.9	0.6
Government financial credits	0.3	0.1	0.2	0.1	0.1
BIS	--	0.5	--	0.3	-0.3
Bank financial credits	2.4	1.6	2.0	0.0	2.0
	6.3	4.0	5.7	2.3	3.4
Change in reserves	0.8	0.3	-0.1	--	-0.1

Sources: National Bank of Yugoslavia; and staff estimates.

Table 10. Yugsolavia: External Debt Disbursed and Outstanding

(In millions of U.S. dollars; end of period)

	1975	1979	1980	1981	1982
Repayable in convertible currency	5,816	13,680	17,608	18,337	18,280
Medium and long term	5,613	12,812	15,558	16,025	16,470
Public or publicly guaranteed	2,294	3,530	4,697	5,957	6,380
IMF	182	456	760	1,252	1,754
IBRD	560	1,143	1,359	1,483	1,576
Other	1,552	1,931	2,578	3,222	3,050
Private	3,319	9,282	10,861	10,068	10,090
Commercial banks	1,230	5,120	6,110	6,350	6,040
Other	2,089	4,162	4,751	3,718	4,050
Short term	203	868	2,050	2,312	1,810
Repayable in bilateral currency	768	1,490	1,542	1,531	1,528
Total debt	6,584	15,170	19,150	19,868	19,808

Sources: Data provided by the Yugoslav authorities; and staff projections.

Table 11. Yugoslavia: Debt Service Payments on Medium- and Long-Term Debts 1/

	1980	1981	1982 Prelim.	1983 Projections 2/	1984	1985	1986
	(In millions of U.S. dollars)						
Repayable in convertible currencies, excluding IMF							
Amortization	1,844	1,695	1,690 3/	2,708 3/	2,705	2,340	2,555
Interest 4/	1,205	1,887	1,960	2,000	2,100	2,000	1,800
Total	3,049	3,582	3,650	4,708	4,805	4,340	4,355
Repayable in bilateral currencies							
Amortization	162	238	260	298	253	250	184
Interest	45	40	45	70	60	55	50
Total	207	278	305	368	313	305	234
Total debt service	3,256	3,860	3,955	5,076	5,118	4,645	4,589
Memorandum items:							
Debt service to IMF 5/							
Repurchases	70	88	45	182	295	353	376
Charges	31	60	118	162	180	169	156
Total	101	148	163	344	475	522	532
	(In per cent)						
Debt service/exports of goods and services							
Convertible currencies, excluding IMF	21.0	23.9	24.7	35.2	31.8	25.7	23.4

Sources: Data provided by the Yugoslav authorities; and staff projections.

1/ Debts with an original maturity of over one year, excluding IMF.

2/ Staff projections on debt service payments on estimated outstanding debt in 1982, and projected new borrowing including commercial bank rescheduling in 1983.

3/ There were delays of scheduled payments in 1982, which are projected to be eliminated in 1983 and included in debt service payments for that year.

4/ Includes interest on short-term debt.

5/ On purchases outstanding at end-December 1982; SDR amounts converted to U.S. dollars at average exchange rates through 1982, thereafter at the rate of SDR 1 = US$1.095.

Table 12. Yugoslavia: Actual and Projected Net Domestic Assets of the Banking System

(In billions of dinars)

	Dec. 1981 Actual	Dec. 1982 Actual	March 1983 Actual	April 1983 Actual	June 1983 Program EBS/83/46	Sept. 1983 Proposed program	December 1983 EBS/83/46	December 1983 Proposed program
1. Net foreign liabilities 1/	537.1	587.9	570.7	588.0	615.2	654.0	627.7	681.0
2. Money (M1)	584.3	739.8	747.3	757.8	784.5	802.0	828.3	821.0
3. 4 + 5 Quasi-money	1231.6	1386.7	1453.4	1442.5	1446.0	1490.5	1575.2	1519.0
4. Foreign exchange deposits 1/	668.2	671.7	706.6	699.8	675.6	711.0	711.0	711.0
5. Other quasi-money	563.4	715.0	746.8	742.7	770.4	779.5	864.2	808.0
6. 1 + 2 + 3 net domestic assets	2353.0	2714.4	2771.4	2788.3	2845.7	2946.5	3031.2	3021.0
					(Percentage change from previous year)			
Memorandum items:								
Money	26.6	26.6	25.9	22.6	27.3	20.6	12.0	11.0
Foreign exchange deposits 1/	...	0.5	...	...	-1.7	...	5.9	5.9
Other quasi-money	25.2	26.9	24.3	17.4	21.6	17.0	20.9	13.0
Net domestic assets	...	15.4	...	...	13.4	...	11.7	11.3

Sources: National Bank of Yugoslavia; and staff estimates.

1/ Adjusted for exchange rate changes.

Table 13. Yugoslavia: Monetary Survey 1980-1983

(In billions of dinars)

	1980	1981	1982				1983			
	Dec.	Dec.	March	June	Sept.	Dec.	Jan.	Feb.	Mar.	April
Money supply (M1)	461.6	584.3	593.8	616.3	664.9	739.8	741.0	743.6	747.3	757.8
Quasi-money	768.7	1030.0	1118.7	1157.1	1210.0	1386.7	1441.8	1493.9	1568.5	1593.9
of which:										
Foreign exchange deposits	(318.7)	(466.6)	(517.7)	(523.5)	(544.1)	(671.7)	(720.6)	(767.9)	(821.7)	(851.2)
Broad money (M2)	1230.3	1614.3	1712.5	1773.4	1874.9	2126.5	2182.8	2237.5	2315.8	2351.7
Net foreign assets	-254.5	-375.1	-415.5	-436.1	-468.9	-587.9	-600.4	-658.2	-688.6	-736.1
Net domestic assets	1484.8	1989.4	2128.0	2209.5	2343.8	2714.4	2783.2	2895.7	3004.4	3087.8
Other items, net	-83.5	61.6	115.0	102.3	132.7	345.2	363.9	432.8	486.0	521.0
Domestic credit	1568.3	1927.8	2013.0	2108.3	2211.1	2369.2	2419.3	2462.9	2518.4	2566.8
			(Percentage change from previous year)							
Memorandum items:										
M1	23.0	26.6	24.5	21.8	21.9	26.6	24.4	25.0	25.9	22.6
M2	33.6	31.2	33.1	30.7	27.7	31.7	28.9	30.0	35.2	34.2

Source: National Bank of Yugoslavia.

Table 14. Yugoslavia: Interest Rate Schedule

(In per cent per annum)

	Weight 1/ In per cent	Interest Rates Present	Interest Rates New 2/	Effects 3/ In billions of dinars
Deposit money				
OALs 4/	17.5	4	7.5	9.7
National Bank credits				
Discounts and credits for liquidity	2.4	22	30	3.0
Selective credits	16.4	8-12	18-22 5/	26.0
Interest-free credits	18.9	0	0	0
Household deposits with maturities less than one year				
Sight	10.3	7.5	7.5	0
Three months	1.9	12	16	0.8
Six months	1.9	15	19	0.8
Restricted OAL deposits	4.7	4	7.5	2.6
Short-term deposits of OALs	1.9	7	7.5	0.2
Long-term deposits				
Households				
Time	4.6	18-28	24-30 6/	2.8
Housing	4.6	13	20	3.2
OALs and other	14.9	17	23	8.9
Total	100.0			58.0 7/

Sources: Data supplied by the Yugoslav authorities; and staff estimates.

1/ Based on average of end-1982 and end-1983 estimated amounts outstanding; estimated by the National Bank of Yugoslavia, except that amount of interest-free credit is assumed to grow at same rate during 1983 as selective credits.

2/ New National Bank interest rates on credits are to be introduced by July 10, 1983; new commercial bank deposit rates will come into effect before the end of the year.

3/ On an annual basis.

4/ Organizations of Associated Labor.

5/ Credits to exporters, 18 per cent; for agriculture, 20 per cent; imports and other, 22 per cent.

6/ One-year deposits, 24 per cent; two-year deposits, 28 per cent; three-year deposits, 30 per cent.

7/ On the basis of average stock figures for 1983-84 calculated by the Yugoslav authorities it is estimated that the increase in bank costs will amount to around Din 66 billion.

Table 15. Yugoslavia: Budget of the Federation

(In billions of dinars)

	1980	1981	1982		1983	
			Year	Jan.-Apr.	Budget 1/	Jan.-Apr.
Revenue						
Customs duties and other import fees	20.7	26.2	28.3	7.0	39.0	10.6
Contributions from republics and provinces	38.5	63.8	80.4	22.3	94.0	25.3
General turnover and sales taxes	47.4	71.3	85.2	20.3	106.2	23.0
Other taxes	0.2	0.2	0.3	0.1	0.4	0.1
Nontax revenue	2.5	3.3	4.8	1.1	5.7	1.8
Total revenue	109.4	164.8	199.0	50.8	245.3	60.8
Expenditure						
Administration	18.6	21.9	25.5	10.0	29.3	10.0
Defense	76.1	99.8	116.4	26.1	150.6	28.6
Grants to republics and provinces	14.3	16.6	20.7	7.3	24.3	7.2
Grants to funds and communities of interest	18.7	24.8	29.6	8.2	34.1	13.9
Investment	0.8	0.9	0.4	0.1	1.0	0.7
Other or discrepancy	1.2	3.7	2.9	0.8	4.6	1.0
Total expenditure	129.7	167.1	195.7	52.6	243.9	61.4
Surplus or deficit	-20.3	-2.2	3.3	-1.9	1.4	-0.6
(As a percentage of GSP)	(-1.3)	(-0.1)	(0.1)		(--)	

Source: Data supplied by the Yugoslav authorities.

1/ From the resolution for the Annual Plan for 1983.
2/ There is no external financing of the budget.

Table 16. Yugoslavia: Public Sector Revenue

	Revenue for General Consumption						
	Budgets						
	Federation	Republics, provinces	Local governments	Other 1/	Total 2/	Revenue for Collective Consumption 3/	Total Public Sector Revenue
	(In billions of dinars)						
1978	46.4	45.7	28.0	25.6	145.7	192.6	338.3
1979	58.9	68.5	35.8	28.3	191.5	233.8	425.3
1980	66.9	89.4	44.5	30.4	231.2	292.0	523.2
1981	95.2	129.3	57.1	39.2	320.8	386.6	707.4
1982	117.0	151.8	73.6	49.5	391.8	499.8	891.7
1983 January-April	45.5	55.0	23.7	21.3	145.5	184.1	329.6
	(Percentage change from year earlier)						
1981	42.3	44.6	28.3	29.0	38.7	32.4	35.2
1982	22.9	17.4	28.9	26.3	22.1	29.3	26.0
1983 January-April	26.1	20.6	19.7	46.0	25.3	22.5	23.7

Source: Data provided by the Yugoslav authorities.

1/ Consists primarily of customs duties.
2/ Equal to total revenue of sociopolitical communities.
3/ Revenue of communities of interest for collective consumption.

Status of Arrangements Connected with Joint Financing Package for Yugoslavia

1. Arrangements with foreign commercial banks

On March 25, 1983 the Yugoslav authorities, including representatives of the National Bank of Yugoslavia, and certain other Yugoslav banking institutions, reached preliminary agreement with the International Coordinating Committee (ICC) of foreign commercial banks on the broad terms and conditions of financing arrangements which were aimed at assisting Yugoslavia to manage more effectively its external debt and implement its stabilization program. This financial assistance was to take the form of a medium-term facility and short-term facilities. The precise details of these financing arrangements are presently being finalized. However, the broad outlines and certain agreed terms are described below.

a. Medium-term facility

Under the medium-term facility, the joint borrowers are the National Bank of Yugoslavia and certain Yugoslav commercial banks. The guarantor of this financing arrangement is the Socialist Federal Republic of Yugoslavia. The medium-term facility is divided into two parts. First, Yugoslav financial institutions will receive an amount of up to US$600 million with the amount allocated between participating lenders in proportion to their base obligations (nonguaranteed debt outstanding on November 30, 1982). The phasing of the disbursements of the loan will be such that 60 per cent of the loan will be available shortly after the effective date of the signing of the loan. A further 15 per cent of the loan will be disbursed not earlier than the later of August 20, 1983 or the date five working days after the penultimate disbursement under the Fund stand-by arrangement for 1983. It will depend also on a satisfactory amount of credit having been disbursed under the Berne package. The final disbursement of 25 per cent can be made no earlier than the later of November 20, 1983 or following the full disbursement of the first tranche of the World Bank structural adjustment loan. This disbursement will require also that specific progress has been recorded in implementing the Berne package.

The availability of the first advance under the medium-term facility is contingent upon the fulfillment of a number of precedent conditions. First, there should be a report indicating satisfactory progress in the implementation of intergovernmental financial support under the Berne package (see description below). Second, there should be credits from the BIS totaling US$500 million effectively disbursed to Yugoslavia in 1983. Third, there should be agreement with the Fund on the availability of an SDR 554 million stand-by arrangement in 1983, out of which SDR 325 million would be available before June 30, 1983. Fourth, the World Bank would be "proceeding in a timely manner" with its intention of agreeing with the Yugoslav authorities on a structural adjustment loan for no less than US$250 million before January 1, 1984.

The second part of the medium-term facility comprises refinancing by each lender of nonguaranteed medium- and long-term maturities falling due between January 17, 1983 and December 31, 1983. With the refinancing arrangements relevant enterprise foreign liabilities will become the foreign liabilities of their Yugoslav commercial banks. Repayments of the medium-term loan are to take place in seven semiannual installments beginning June 30, 1986, and for refinanced debt commencing January 1986.

b. The short-term facilities 1/

Under the short-term facilities the guarantor is the National Bank of Yugoslavia. The maturities of outstanding nontrade short-term obligations are extended for two years through January 17, 1985, through the entering of each creditor and each borrower into an extension loan agreement. Trade debt and new interbank deposits are to be repaid when due but the availability of such credit is to be thereupon restored until January 17, 1985 under "continuing credit facilities." A revolving facility enables the borrower to restore its indebtedness if a suitable transaction can be found. The short-term trade credits are to be made available to Yugoslav banks instead of Yugoslav enterprises which means that the enterprise making the repayment or any other enterprise with the same bank as the repaying enterprise can avail itself of the revolving credit. This does not preclude the transfer of foreign credits from one Yugoslav bank to another.

2. Intergovernmental arrangement

At meetings in Berne in January 1983 representatives of the governments of 15 Western countries agreed to a package of financial support for Yugoslavia. This has been termed the "Berne package" or "Berne agreement." Each of the 15 countries pledged financial support which was valued at US$1.3 billion. The bulk of the financial assistance was to take the form of suppliers' credits tied to exports from the lending countries. Bilateral negotiations between individual governments and the Yugoslav authorities on the types of credits to be taken up have largely been concluded. Mainly because of administrative delays and the desire of the Yugoslav authorities to keep suppliers' credits for capital goods outside of the Berne package, the amount of assistance committed under the Berne agreement now totals around US$1.1 billion. A large part of the commitments (US$600-700 million) takes the form of suppliers' credits for raw materials and intermediate goods. The remaining amounts comprise largely export credits for certain capital and consumer goods imports and tied and untied financial credits, including rollovers or extensions of guarantees or insurance on maturing bank debts. The suppliers' credits, most of which are medium term, are to be extended by individual countries to particular Yugoslav associated banks who in turn will

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1/ Not all short-term debt outstanding as of January 17, 1983 is included in the proposed agreement on the short-term facilities. Among the exemptions are short-term indebtedness guaranteed by foreign governments or agencies, arrears outstanding prior to January 18, 1983, spot and forward exchange contracts, and floating rate notes.

on-lend the credits on a revolving basis to Yugoslav enterprises which are judged as having the best prospects for quickly earning foreign exchange on the basis of the goods imported.

The staff estimates that up to US$500 million in export credits and about US$200-300 million in tied and untied financial credits could be disbursed under the Berne package in 1983, with a further amount of approximately US$200 million to be disbursed in 1984.

3. World Bank structural adjustment loan

The Board of Directors of the World Bank agreed to the provision of a structural adjustment loan amounting to US$275 million to Udruzena Beogradska Banka on June 28, 1983, with the guarantor of the loan being the Socialist Federal Republic of Yugoslavia. The loan is to be disbursed in two tranches of US$175 million and US$100 million, respectively, with the first part expected to be disbursed before end-1983 and the entire loan expected to be disbursed by June 30, 1984. The loan is for 15 years, with a 3-year grace period. The proceeds of the loan would be on-lent to Yugoslav industrial enterprises (including agroindustries) on a revolving basis of up to 18 months depending on the type of export-oriented production to be financed. The loan is designed to support the implementation of the Government's structural adjustment program.

Freezing of Public Sector Revenue

Legislation passed at the end of 1982 provided for the freezing of excess revenue of the public sector in respect of the first quarter of 1983. The revenue to be frozen would be the amount by which revenue of a public entity in the first quarter of 1983 exceeded the quarterly average for 1982. Owing inter alia to seasonal factors, this rule still allowed public revenue to be some 16.5 per cent higher in the first quarter of 1983 than a year earlier. Public sector revenue is understood to comprise revenue both for "general consumption" (essentially the budgets of the various levels of government) and for "collective consumption" (education, health services, pensions, etc.), but three categories of public sector revenue were exempted from the freezing scheme. They are the direct revenue of the federal budget (first column in Table 16), republican and provincial budget revenues that are earmarked for transfer to the Federation, and revenue earmarked for transfers having the character of personal incomes (e.g., pensions, but excluding wages of public sector employees). The latter category of revenue is exempt because the growth of such transfer payments is already formally linked to the growth of personal incomes in the socialized sector. The first two exemptions would allow a more rapid growth of the budget of the Federation than of other segments of the public sector, but it was expected that even with these exemptions the growth of total public sector revenue would be sufficiently restrained. The revenues subject to the freezing system comprised an estimated 47 per cent of total public sector revenue in 1982.

The freezing system was initially designed to put greater emphasis on restraining the growth of the public sector than on curtailing domestic demand. Thus, the legislation on freezing excess revenue required a public entity (except the Federation itself), upon acquiring excess revenue, to reduce tax rates or rates of contribution for collective consumption within 35 days in proportion to the excess revenue earned.

This system of immobilizing excess revenue was strengthened at the end of March 1983 not only to provide for a continuation of the freezing scheme but now to have it implemented on a monthly basis for April through July 1983. For each of the cumulative monthly periods from January-April 1983 to January-July 1983, excess revenue would be defined as the revenue in excess of that specified on a monthly revenue schedule for 1983 drawn up by each public entity. These schedules were required to incorporate a deceleration of revenue during 1983 such that revenue subject to freezing in the period January-July 1983 would, for general consumption, be at most 11 per cent higher than a year earlier, or, for collective consumption, at most 13 per cent higher. The same exemptions applied as before.

These maximum growth rates were set at low levels so that, even with a more rapid growth of revenues exempt from the freezing system, the 12-monthly growth of total public sector revenue should remain within the 18 per cent limit specified in the letter of intent. The March legislation provided that revenue once placed in a blocked account could be

unfrozen later in the year in the event of a subsequent revenue shortfall. Some such shortfalls might well be expected, given the requirement to reduce taxation in the event of excess revenue.

As noted in section III.3., the need to shift the emphasis of fiscal policy, hence the revenue freezing scheme, more toward restraint of domestic demand was perceived in the second quarter of 1983, resulting in an extension and strengthening of the revenue freezing system. The most important change was the authorities' decision to require minimum amounts of excess public sector revenue to be frozen, rather than to stress, and indeed require, returning revenue to the economy at large through tax cuts. The aggregate amount to be placed in a blocked account with the National Bank of Yugoslavia is to reach a minimum of Din 10 billion by the end of September 1983, and Din 35 billion by the end of December 1983. Also, the revenue once frozen is to remain immobilized at least until the end of 1985.

Yugoslavia - Foreign Exchange Allocation System

The foreign exchange allocation system of Yugoslavia is based on the Law on Foreign Exchange Operations and Credit Relations with Foreign Countries introduced in 1977. In the area of foreign exchange acquisition and disposition, the principle is that organizations of associated labor which participate in production that earns foreign exchange are also the owners of the foreign exchange. Export earnings are to be shared between the final exporters and suppliers of intermediate goods and services according to self-management agreements based on their contribution to the final product.

The foreign exchange crisis that emerged in 1982 led to severe debt servicing problems and, partly in response to this, temporary provisions were introduced in May 1982 with the Law on the Terms and Procedures for the Disposition and Use of Foreign Exchange for External Payments and on *External Borrowing in 1982, which placed priority on debt repayment in* the use of foreign exchange. Self-management agreements concluded on the basis of this law set aside around 60 per cent of current foreign exchange earnings for the Federation and republican/provincial governments to meet payments for debt service and oil payments. This resulted in a significant reduction in the proportion of foreign exchange earnings that exporters could retain for their own use and as a consequence substantially reduced both their ability to import and existing export incentives.

The Law on Foreign Exchange Operations and Credit Relations with Foreign Countries was further amended by the Decision on the Common Foreign Exchange Policy of Yugoslavia for 1983, which was promulgated on December 31, 1982. This decision made a number of the temporary regulations adopted in May 1982 permanent and added a number of new provisions. A major new element was a considerable strengthening of the role of federal entities at the expense of the regional entities. The emphasis on the balance of payments positions of individual republics, that characterized the previous method of allocating foreign exchange, was replaced by a sectoral distribution system. Furthermore, the banking system was accorded greater responsibility in the allocative system. Commercial banks would be responsible for ascertaining that any foreign borrowing by enterprises would be for projects that generate a sufficient flow of convertible currency to meet repayment and interest schedules. The commercial banks would be required to give assurance to the National Bank of Yugoslavia that each foreign credit is thus secured. In addition, Yugoslav enterprises borrowing foreign exchange from a domestic bank would be required to repay these banks at the market rate of exchange of the date of repayment rather than pass the exchange rate risk of foreign currency indebtedness to the banking system, as they in some cases were able to do in the past. In order to strengthen the authorities' supervisory capabilities, enterprises have been limited to one foreign exchange bank account with effect from July 1, 1983.

The law established a mandatory allocation system for the foreign exchange earnings of enterprises. First, 25 per cent would go to the

the federal sector: 5 per cent for the federal administration, 3 per cent into the reserves of the National Bank, and 17 per cent for energy supplies. Foreign exchange is thereafter allocated according to the following priorities: (i) the meeting of exporting enterprises' own debt and trade credit obligations and essential import needs; (ii) allocations for imports by suppliers of export-oriented enterprises, (iii) allocations for those enterprises whose production is based on established import needs, but who do not participate directly in export activities, and for some other users in the productive sector; (iv) provision for the needs of the republican and communal governments; and (v) allocation to infrastructure and miscellaneous other needs. Any remaining foreign exchange is to be sold through authorized banks to the unified foreign exchange market.

The amended law provided a framework for the allocation of foreign exchange which was to be filled in in the context of self-management agreements among groups of enterprises under the aegis of the Federal Community of Interest for External Relations and the Federal Chamber of the Economy. Originally, these agreements were to have been concluded by the end of June, but the process has proven difficult, and only a few groups, including the textiles and wood processing sectors, have reached tentative agreements. Agreements are now expected to be reached by August. Certain special arrangements have been concluded. Thus 28 per cent of foreign exchange receipts realized from exports of agricultural food products, tobacco, and forest products will be allocated for imports of raw materials for fertilizers and pesticides. Also it has been determined that the allocation for republics and provinces will amount to a maximum of 15 per cent.

The present system is clearly more advantageous for exporters than that in effect in the second half of 1982. After allocations for the federal sector, oil imports, and republics and provinces, 60 per cent is left to cover the exporting enterprises' own import and debt service needs and for sharing with suppliers and the rest of the economy, compared with some 40 per cent in the second half of 1982. Most of this improvement is due to the lower net debt service payments because of the rollover of debt owed to foreign commercial banks. The potential loss of export incentives on account of the introduction of limited surrender requirements for a unified market appears to have been more than offset by the flexible exchange rate policy being pursued.

At the beginning of July, Yugoslavia further amended its legislation regarding foreign borrowing. The main thrust of the legislation is a further strengthening of federal control over foreign borrowing and debt service payments.

In spite of the amendments to the foreign exchange law, the foreign exchange allocation system remains heavily compartmentalized. It appears that the system under the self-management agreements that is in the process of being concluded will be insufficient to ensure the proper functioning of a unified market. The Yugoslav authorities are aware of this and concur that additional measures need to be taken on the basis

of a study to be completed by September. They intend to review the whole system with the Fund in the context of the next quarterly review and with the World Bank in the framework of the SAL arrangement. Additional measures that will enhance the efficient functioning of the foreign exchange market will be introduced with effect from January 1, 1984. This will include a strengthening of the unified market through the establishment of minimum amounts to be surrendered to it by exporting enterprises (or adequate pooling of enterprise resources within individual banks). In this way emphasis on the supply of foreign exchange through the unified market will be increased. An additional requirement would be to ensure the proper functioning of the interbank market in foreign exchange which could be confined to a limited number of large banks. Further, the introduction of explicit rules for what may be considered normal working balances of foreign exchange for banks and the requirement that excesses over such levels be sold or on-lent to other banks or to the National Bank of Yugoslavia should enhance the efficiency of the interbank market.

Supplement to the Letter of Intent Dated December 30, 1982

Dear Mr. de Larosière:

In accordance with our letter of January 15, 1981, as supplemented in our letter of December 30, 1982, supplemented by our letters of February 18, 1983 and May 4, 1983, we are writing to you to describe the economic situation and to outline the policies and measures to be pursued during the second half of 1983.

The plan resolution for 1983 gave the highest priority to improving the external liquidity position of Yugoslavia so as to ensure the fulfillment of international financial obligations and move toward a sustainable improvement in our balance of payments. To this end restrictive demand management policies were implemented, a number of administered prices were adjusted to reduce price distortions and further our objective of harmonizing domestic and international prices by the end of 1984; and an active exchange rate policy has been pursued to enhance export incentives. An amendment to the foreign exchange law was introduced to promote a more unified foreign exchange market, and thus to increase efficiency in the allocation of scarce foreign exchange resources. An increase in interest rates was introduced to further our objective of moving to a positive real interest rate.

We have recorded progress in a number of areas thus far in 1983. Most notably, the current account with the convertible currency area improved by over US$1 billion in the first four months of 1983 from a year earlier (to a deficit of US$125 million). A strengthening of export performance to the convertible currency area and a high inflow on invisibles account contributed to this improvement. There has been a marked deceleration in the growth of nominal incomes per employee in the first quarter of 1983. Nonetheless, domestic demand is more buoyant than we had expected, notwithstanding the policy of credit restraint pursued by the National Bank of Yugoslavia, in part because of the rapid growth of incomes outside the organized economic sector and the substantial rise in interenterprise credits. This buoyancy is also reflected in the higher-than-expected rise in domestic prices. On the external side, exports to the convertible currency area were encouraged by an active exchange rate policy. (The dinar depreciated in nominal effective terms by more than 30 per cent between end-December 1982 and end-May 1983.) Exports were diverted from the nonconvertible currency area to the convertible currency area in response to this strengthening of incentives. However, much of the improvement arose out of a shift of import demand to the nonconvertible currency area and a compression of imports to levels that are adversely affecting production both for the domestic market and for exports. Foreign exchange shortages resulting partly from delays in the realization of the planned international financial support package have contributed to the lower imports which have hindered production and exports.

A review of developments at midyear clearly indicates that the external adjustment needs are greater than had been perceived at the time

of the adoption of the annual plan resolution for 1983; efforts in addition to the supplementary measures thus far adopted in 1983 are needed to bring about this adjustment. Demand restraint must be intensified and financial discipline must be improved. We are continuing to carefully review the adequacy of export incentives as well as measures to reduce distortions in the economy. This means further action is called for on prices, on interest rates, and on the allocation of foreign exchange, as well as in the areas of credit and fiscal policy.

1. The Government considers incomes policy to be one of the essential elements in the medium-term stabilization program. For 1983 the target was to hold personal incomes per employee in nominal terms in the first quarter at the level of the fourth quarter of 1982, and to reduce real personal incomes per employee on a year-on-year basis by 7 1/2 per cent; personal incomes of those who work in the noneconomic sector were to decline in real terms even more sharply. The outturn for the first quarter was approximately in line with the target set for that quarter and the results for the first four months showed a decline of 10 per cent for real personal incomes. A federation-wide social compact on incomes policies, which unifies incomes policy criteria and guidelines, will be adopted in the coming months, and confirms our commitment to moderation in the growth of personal incomes. The effects of this compact will be reinforced by new laws relating to the SDK and the priority of payments. We are, however, determined that our incomes policy objectives will be achieved and that pressures emanating from the fall in real personal incomes in the first quarter and continuing strong price pressures do not give rise to a resurgence in the rapid growth of personal incomes and an upward personal incomes-price spiral. It will be our objective to ensure that the growth in nominal personal incomes per employee does not accelerate during the remainder of 1983. To the extent that the year-on-year increase in nominal personal incomes per employee in the second quarter of 1983 exceeds that in the first quarter of 1983, then the Federal Government will stand ready to take action to fully reduce this excess by the fourth quarter of 1983 through measures to moderate the growth of nominal personal incomes in the second half of 1983.

2. To further the Government's aim to reduce distortions in relative prices and not to allow new ones to rise, major price changes were implemented in the first half of 1983 for electricity, coal, transportation tariffs, petroleum products, and meat. Rents were also increased substantially. However, the effectiveness of many of these measures has tended to be impaired by a rapidly rising general price level. We are giving further close consideration to price developments in these specific products and we will review price movements in other important products with a view to eliminating price distortions.

3. In June the price of domestically produced natural gas was raised on average by nearly 60 per cent, with a further significant increase to be introduced before the end of 1983. The price of oil products will be increased in line with international prices, which on the basis of present estimates would mean by around 20 per cent, not later than October 1, 1983. Thereafter, we intend to introduce a formula for oil refineries'

prices to be adjusted four times a year, which would ensure that domestic prices reflect world prices, and that price parity between domestic and imported crude oil be maintained. Prices of coal and coke will also be adjusted upward in the final quarter of 1983. A review of the level and structure of electricity tariffs in the framework of an overall review of priority sector prices will be completed during October, and the price adjustments that are deemed necessary to bring revenues more in line with the costs of generating electricity will be implemented not later than November 1, 1983. At the beginning of 1984 there will be further increases in transportation charges, electricity tariffs, and rents to further correct and narrow price distortions. All of these specific adjustments in relative prices will be sustained by regularly adjusting these commodity prices in line with developments in world market prices, in the case of internationally traded goods, or in line with the general price level for services and nontraded goods.

4. The recent movements in the exchange rate, although effective in enhancing export incentives, have permitted new price distortions to arise, since in many instances increased production costs stemming from a higher cost of imported inputs have not been passed through fully or quickly into producer prices. Price policy will be directed toward permitting the full and fast pass-through of cost increases resulting from changes in import prices. Not only will this reduce price distortions, but it will also strengthen the financial position of a number of working organizations dependent on imported inputs.

5. The Government intends to liberalize the formation of many prices in July, with the lapse of the decision on control of prices, so that 40 per cent of industrial producer prices will be determined by OALs themselves, within the framework of our price system. In addition, another 50 per cent of industrial producer prices will be set by OALs subject to the approval of communities for prices, which have as their main criterion in sanctioning price increases that prices be harmonized with international prices. Accordingly, only 10 per cent of industrial producer prices will be subject to official maximum price limits. Thereafter, we will continue our intended policy of giving greater flexibility to OALs in price formation. This deregulation of prices should improve the efficiency of the pricing mechanism. Price competition will be further enhanced when external constraints have diminished sufficiently to permit a liberalization of import restrictions. Certain agricultural prices have recently been increased, including rises in producer prices for wheat. We will ensure that they continue to offer adequate incentives for production, both for the home and the international market. Appropriate agricultural prices for 1984, reflecting these principles, will be established this fall in anticipation of the planting season.

6. The operation of a more active exchange rate policy has greatly assisted in promoting the rapid growth of exports to the convertible currency area. With imports from this area compressed to an unsustainably low level and with the need for further substantial external adjustment, a continued strengthening of export growth is crucial. To ensure the achievement of this objective we will continue to pursue an active

exchange rate policy. In addition, the currency basket used to calculate the effective exchange rate is being reviewed to assess the appropriateness of the weighting system. The study of the basket will be completed by end-October 1983 and the agreed recommendations implemented by January 1, 1984.

7. Fiscal policy is being increasingly used to help dampen the growth of domestic demand. For 1983 it continues to be our target to control public expenditure by limiting the effective use of certain public sector revenues and revenues for collective consumption in accordance with our intentions expressed in the February 18, 1983 supplement to the letter of intent and in our letter of May 4, 1983 to you. Excesses in public sector revenues above these growth limits are to be immobilized in special blocked accounts. The legislation introduced in March 1983 required that excess public sector revenues over the period January-July 1983 be placed in special blocked accounts by the Social Accounting Service. By June 1983 this legislation had given rise to the blocking of Din 5 billion in blocked accounts. It is the intention of the authorities to extend this legislation requiring the immobilization of excess public sector revenues through the second half of 1983 so as to maintain restraint on demand for general and collective consumption. To this end, Din 10 billion of public sector revenues will be placed in blocked accounts with the National Bank of Yugoslavia by the end of September 1983 and this sum will rise to Din 35 billion by end-December 1983 (see agreed memorandum of understanding). The system of freezing excess revenues as introduced in March 1983 will be extended through to the end of the year and will be modified so that excess revenues will be frozen until end-1985 and placed in a special blocked account with the National Bank of Yugoslavia. In addition, in view of the continued importance of restraining the growth of public sector expenditure, the 12-monthly increase in total public sector revenue (i.e., revenue for general and collective consumption), excluding the frozen revenue placed in a special blocked account with the National Bank of Yugoslavia, will be limited to 18 per cent in the second half of 1983. A 12-monthly growth rate of public sector revenue in excess of this rate of 18 per cent for any period of three successive months will be taken as not commensurate with the program agreed in the letter of intent. A deviation of 2 percentage points will be acceptable.

8. To help contribute to the accumulation of these deposits in blocked accounts, the turnover tax rates will be increased or revenue of the turnover tax will be restructured on specified products (petroleum, tobacco products, alcohol, etc.) not later than October 1. In addition, other forms of indirect taxation and also the effective rates of taxation on nonwage income and on property will be raised. These tax changes will support the objectives of incomes policy and will themselves contribute to the control of consumption by the household sector.

9. Monetary policy was restraining in the opening months of 1983. However, because of the rapid growth of incomes outside the organized economic sector and the substantial rise in interenterprise credits domestic demand was higher than expected. The Yugoslav authorities are

keenly aware of the need to pursue a restrictive monetary policy with the aim of reducing domestic demand and holding back the inflationary impulses from the depreciation of the dinar and the adjustment of administered prices. Accordingly, the monetary program for the second half of 1983 envisages a reduction in the rate of growth of adjusted M2 to about 10 per cent by the end of December, compared with 17 per cent at the end of 1982. This is considered the maximum reduction possible during this period in which the credit needs of both agriculture (because of a large harvest and a sharp increase in prices) and exports (because of the depreciation of the dinar) are particularly large, and the policy described will result in a curtailment of credits for other purposes. Compatible with the target for monetary expansion, we shall ensure that the average stock of net domestic assets of the banking system for the end of July, August, and September 1983 will not exceed Din 2,927 billion and that for the end of October, November, and December 1983 will not exceed Din 2,998 billion. The limits for the stock of net domestic assets on September 30, 1983 and December 31, 1983 will be Din 2,947 billion and Din 3,021 billion, respectively. If at the time of a Fund staff mission in September the liquidity position is excessively tight, then we shall reserve our right to request formally an earlier revision of the ceilings for the final quarter of 1983. Dinar counterpart deposits of the Government at the National Bank of Yugoslavia originating from external financing credits will be sterilized. Finally, Din 35 billion of total public sector revenues will be deposited in a blocked account with the National Bank of Yugoslavia.

10. In view of the higher-than-previously-foreseen rate of inflation in the first part of 1983, we consider that a further rise in interest rates is necessary. The new higher structure of interest rates (see attached table) will be accomplished, firstly, by immediately raising interest rates directly subject to the control of the National Bank of Yugoslavia. Rediscount rates for selective National Bank credits to priority sectors will be raised by 10 percentage points by July 10, 1983, while the discount rate and the rate on liquidity credits will be further increased on the same date to 30 per cent. We also intend to raise interest rates on all household time deposits with a rate of 30 per cent on three-year deposits. Parallel increases in interest rates on deposits of OALs will take place also. Because uniform bank deposit rates in Yugoslavia are determined by a self-management agreement requiring the consensus of all banks, it will take some time to agree to the new proposed interest rate schedule, but the new schedule for bank deposit rates will be introduced as soon as possible and anyway before the end of the year 1983. The increase in the cost of funds to banks, estimated to be Din [illegible] billion on an annual basis, will drive up bank lending rates. In addition, a floor lending rate for new credits with certain exemptions for new credits from domestic commercial bank resources will be introduced by January 1, 1984, and will be adjusted in line with developments in the price level. We reaffirm that our policy will be designed to move interest rates toward our medium-term goal of real positive rates.

11. The law governing the priority of payments was adopted in order to increase financial discipline and to reduce the outstanding amount of

unsecured bills, estimated at the end of 1982 at Din 174 billion, by Din 50 billion. In view of the limited progress that has been made thus far in bringing about this reduction, the Government will develop a penalty mechanism to be introduced in September should the targeted reduction not have been achieved by that time. In addition, the Government is introducing other regulations aimed at enhancing financial discipline in the enterprise system and restoring the financial viability of loss-making enterprises.

12. We have with effect from January 1, 1983 introduced certain amendments to the foreign exchange allocation law to overcome the fragmentation of the foreign exchange allocation system which had become evident at the end of 1982. A major provision of the amendment was to abolish the regional approach to balance of payments objectives by establishing unified criteria for the whole of the country for the allocation of foreign exchange. Another major change was the introduction of partial surrender requirements for enterprises with a view to strengthening the unified foreign exchange market. The system is presently being put in place through the negotiation of a comprehensive set of self-management agreements which are expected to be concluded by the end of June. The introduction of surrender requirements may have reduced export incentives somewhat but these disincentives will be offset by a continued active exchange rate policy as described in paragraph 6. We intend to review the system by September 1983 in order to make sure that the objectives of the amendments are being met. The report based on this review will be available for discussion with the Fund by the end of October. We will agree at that time on additional measures to be effective from January 1, 1984 to enhance the efficient functioning of the foreign exchange market. These will include a strengthening of the unified market through the establishment of minimum amounts to be surrendered to it by exporting enterprises (or adequate pooling of enterprise resources within individual banks). In this way it would be hoped that emphasis gradually be increased on the supply of foreign exchange through the unified market. An additional requirement would be to ensure the proper functioning of the interbank market in foreign exchange which could be confined to a limited number of large banks. This should be done through the introduction of explicit rules for what may be considered normal working balances of foreign exchange for banks and the requirement that excesses over such levels be sold or on-lent to other banks or to the National Bank of Yugoslavia. The foreign exchange law will also be amended in such a way so as to permit the National Bank of Yugoslavia to introduce a charge on interest-free credits granted to banks in exchange for foreign exchange deposits.

13. The Government continues to hold to its medium-term objectives of enhancing economic efficiency and the prospects for growth in a less inflationary environment. Increased efficiency will be sought by carefully reviewing institutional structures that could give rise to undue rigidities, and by reducing the share of public sector consumption in the social product. Increased labor mobility and improved financial discipline of the OALs, notably for loss-making enterprises, will enable greater flexibility and more efficiency in the allocation of productive

resources though initial moves toward a rationalization of the structure of production are costly. Further greater reliance on market forces for the determination of interest rates (which in our view should be positive in real terms) and of the prices of foreign exchange and goods will contribute to the reduction of existing distortions and prevent new ones from arising. A realistic exchange rate policy must be pursued, and competition from abroad must be encouraged to secure an appropriate pattern of resource allocation. The growth of personal incomes and contributions for collective consumption will be kept below that of the income of OALs so that they can rely more on internal savings than on bank credit to finance working capital and fixed investments. Enhanced efficiency will permit the economy to respond more rapidly and more fully to a change in the external environment while also improving the longer-term prospects for growth and employment.

Radovan Makić
Governor, National Bank of Yugoslavia

Joze Florjančić
Federal Secretary for Finance

AGREED MEMORANDUM OF UNDERSTANDING

Subject: Technical Note on Incomes Policy

The last two sentences of paragraph 1 on incomes policy should be understood as follows: If the year-on-year increase in nominal personal incomes per employee in the second quarter of 1983 were greater by 2 or more percentage points than in the first quarter of 1983, then the Federal Government should take measures to lower the growth of nominal personal incomes per employee in the second half of the year to ensure that this excess in the growth rate is fully eliminated by the fourth quarter of 1983. That is, action by the Federal Government should be such as to bring the year-on-year growth rate in nominal personal incomes per employee to 20 per cent in the fourth quarter of 1983, and that a margin of 2 percentage points will be acceptable.

AGREED MEMORANDUM OF UNDERSTANDING

Subject: Technical Note on the Freezing of Surplus Public Sector Revenue

It is understood that the public sector revenue to be frozen will be placed in a special blocked account with the National Bank of Yugoslavia with the amounts outstanding in this account specifically identifed in the National Bank's monthly balance sheet. The public sector revenue is defined to comprise revenue of sociopolitical communities plus revenue for collective consumption, which in 1982 totaled Din 892.036 billion. In the case of revenue of communities of interest for collective consumption, surplus revenue held on deposit with one or more commercial banks and registered by the Social Accounting Service (SDK) will be redeposited with the National Bank of Yugoslavia. The amounts of public sector revenue frozen in the special blocked account of the National Bank of Yugoslavia will be derived either from the excessive growth of revenues of particular public sector bodies in relation to prescribed revenue targets or from increases in rates of taxation. All revenue once placed in the blocked account will remain in that account until the end of 1985.

In the monetary survey and for the purpose of calculating net domestic assets under the performance criterion, the National Bank of Yugoslavia will exclude the funds in this blocked account up to the limits of Din 10 billion by September 1983 and Din 35 billion by December 1983 from ordinary government deposits and from the definition of money. Consequently, "other assets, net" in the monetary survey will be reduced by the amount of the frozen revenue excluded from the definition of money, and for a given ceiling on net domestic assets there will be a corresponding increase in the permissible expansion of domestic credit to the economic sector.

Public sector revenue will be frozen during each of the months July-December 1983, and the dinar value of the outstanding amounts frozen will be telexed to the Fund within three weeks of the end of each of these six months, showing separately the frozen revenue of sociopolitical communities and that of self-management communities of interest.

AGREED MEMORANDUM OF UNDERSTANDING

Subject: Technical Note on Net Domestic Assets Ceiling of the Yugoslav Banking System

The banking system for purposes of this ceiling is defined as the consolidated accounts of the national banks and the basic and associated banks. The net domestic assets (NDA) of the above-mentioned banks are calculated to equal the sum of the following items in the monetary survey:

	End-December 1982 (In billions of dinars)
Net foreign liabilities	587.9
Money	739.8
Quasi-money	1,386.7
	2,714.4

In setting the ceiling for NDA the effects of changes in the exchange rate on net foreign liabilities of the banking system and on foreign currency liabilities to residents (the latter are included in quasi-money) are eliminated by applying valuation adjustments to the relevant data. Drawings on suppliers' credits under the Berne agreement are also excluded from the calculation of NDA up to a limit of US$480 million. Figures for suppliers' credits under the Berne agreement should be reported to the Fund on a monthly basis.

Yugoslavia: Interest Rate Schedule

(In per cent per annum)

	Weight 1/ In per cent	Interest Rates Present	Interest Rates New 2/	Effects 3/ In billions of dinars
Deposit money				
OALs 4/	17.5	4	7.5	9.7
National Bank credits				
Discounts and credits for liquidity	2.4	22	30	3.0
Selective credits	16.4	8-12	18-22 5/	26.0
Interest-free credits	18.9	0	0	0
Household deposits with maturities less than one year				
Sight	10.3	7.5	7.5	0
Three months	1.9	12	16	0.8
Six months	1.9	15	19	0.8
Restricted OAL deposits	4.7	4	7.5	2.6
Short-term deposits of OALs	1.9	7	7.5	0.2
Long-term deposits				
Households				
Time	4.6	18-28	24-30 6/	2.8
Housing	4.6	13	20	3.2
OALs and other	14.9	17	23	8.9
Total	100.0			58.0 7/

1/ Based on average of end-1982 and end-1983 estimated amounts outstanding; estimated by the National Bank of Yugoslavia, except that amount of interest-free credit is assumed to grow at same rate during 1983 as selective credits.

2/ New National Bank interest rates on credits are to be introduced by July 10, 1983; new commercial bank deposit rates will come into effect before the end of the year.

3/ On an annual basis.

4/ Organizations of Associated Labor.

5/ Credits to exporters, 18 per cent; for agriculture, 20 per cent; imports and other, 22 per cent.

6/ One-year deposits, 24 per cent; two-year deposits, 28 per cent; three-year deposits, 30 per cent.

7/ On the basis of average stock figures for 1983-84 calculated by the Yugoslav authorities it is estimated that the increase in bank costs will amount to around Din 66 billion.

Fund Relations with Yugoslavia 1/

Membership:	Yugoslavia is an original member of the Fund. It continues to avail itself of the transitional arrangements under Article XIV.
Quota:	SDR 415.5 million.
Use of Fund credit:	Total outstanding purchases of SDR 1,858.0 million (447.2 per cent of quota), including SDR 190.4 million under the compensatory financing facility (45.8 per cent of quota), SDR 413.9 million (or 99.6 per cent of quota) under the credit tranches, and SDR 1,253.7 million under the supplementary financing facility. Outstanding purchases excluding those under the compensatory financing facility are equivalent to 401 per cent of quota.
Fund holdings of dinars:	SDR 2,270.3 million, or 546.4 per cent of quota.
Current arrangement:	Stand-by program covering the period from January 30, 1981 to December 31, 1983 in the amount of SDR 1,662 million (400 per cent of quota), of which SDR 1,357.8 million is being provided under the supplementary financing facility. (SDR 1,433 million had been purchased by the end of June.)
SDR position:	Net cumulative allocations amount to SDR 155.2 million. Holdings amount to SDR 0.04 million.
Gold distribution:	Received 177,144 fine ounces of gold in the four phases. Received profits amounting to US$32.9 million in the three distributions; US$11.0 million has been transferred to the Trust Fund.
Last consultation:	The staff report for the 1982 Article IV consultation and review under stand-by arrangement with Yugoslavia (EBS/83/46, 2/24/83) was considered by the Executive Board at EBM/83/47 (3/11/83). The Executive Board's decision on the 1982 consultation with Yugoslavia (*Decision No. 7362-(83/47), adopted March 11, 1983*) was as follows:

1. The Fund takes this decision in relation to Yugoslavia's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1982 Article XIV consultation with Yugoslavia in the light of the 1982 Article IV consultation with Yugoslavia

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1/ Position as of June 30, 1983.

conducted under Decision No. 5392-(77/63) adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

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

The Executive Board's decision on the review under stand-by arrangement with Yugoslavia, Decision No. 7363-(83/47), was also adopted on March 11, 1983.

A memorandum reviewing Yugoslavia's economic performance and the external financing package (EBS/83/88, 5/4/83) was issued prior to the May drawing under the stand-by arrangement.

Exchange rate system:

The currency of Yugoslavia is the Yugoslav dinar. The authorities do not maintain the exchange rate of the dinar within announced margins and, therefore, all transactions, with the exception of those effected under the procedures set forth for certain countries with which Yugoslavia has bilateral payments agreements, take place at a fluctuating exchange rate. However, the authorities intervene in the foreign exchange markets, when necessary, to ensure orderly conditions and to smooth out fluctuations in exchange rates. The buying and selling rates for the U.S. dollar in the foreign exchange market in Belgrade on June 30, 1983 were Din 96.3672 and Din 96.6387 per U.S. dollar, respectively. Rates are quoted for certain other currencies.

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FͻR AGENDA

EBS/83/227
Supplement 3

CONFIDENTIAL

November 21, 1983

To: Members of the Executive Board

From: The Secretary

Subject: Brazil - Staff Report for the Consultation Under Extended Arrangement, and Request for Waiver and Modification of Performance Criteria

Attachment for consideration by the Executive Directors is a revised proposed decision on Brazil's request for an extended arrangement, and a table summarizing quantitative performance criteria through the first quarter of 1984.

This subject has been placed on the agenda for discussion at a meeting scheduled for 12:00 noon tomorrow, Tuesday, November 22, 1983.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

BRAZIL

Revised Proposed Decision and Supplementary Information

Prepared by the Western Hemisphere, Exchange and Trade Relations, and Legal Departments

Approved by S. T. Beza, W. A. Beveridge, and G. Nicoletopoulos

November 21, 1983

Introduction

This paper presents a revised proposed decision. This proposed decision, which contains no change of substance, includes a complete and simplified presentation of the quantitative aims and other understandings reached, as set forth in the communications from the Brazilian authorities dated September 15, 1983 and November 14, 1983, and which are to apply as performance criteria. For the convenience of Executive Directors, the full text of the decisions contained in EBS/83/227, Sup. 2, as amended, is reproduced here. This paper also summarizes, in Table 1, quantitative performance criteria through the first quarter of 1984.

Proposed Decisions

A. Extended Arrangement

1. Brazil has consulted with the Fund in accordance with paragraph 29 of the letter dated January 6, 1983 from the Minister of Finance and the President of the Central Bank of Brazil and paragraph 4 of the extended arrangement for Brazil (EBS/83/33, Sup. 4, 3/3/83), in order to review progress made by Brazil in implementing its program, reach understandings with the Fund regarding the circumstances in which

purchases may be resumed by Brazil under the arrangement, and reach understandings with the Fund regarding policies, measures and performance clauses for the first calendar quarter of the second year of the arrangement.

2. The letter dated September 15, together with the annexed memorandum, and the letter dated November 14, 1983 from the Minister of Planning, the Minister of Finance, and the President of the Central Bank of Brazil, and the letter dated September 5, 1983 from the Minister of Planning and the Minister of Finance shall be attached to the extended arrangement for Brazil; and the letter with the attached memorandum dated January 6, 1983, together with the communication dated February 24, 1983, shall be read as modified and supplemented by these communications.

3. (a) Purchases under the extended arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 2,743.125 million, provided that purchases shall not exceed the equivalent of SDR 1,246.875 until March 1, 1984, the equivalent of SDR 1,620.875 million until June 1, 1984, the equivalent of SDR 1,994.875 million until September 1, 1984, and the equivalent of SDR 2,368.875 million until December 1, 1984;

(b) Paragraph 4 of the extended arrangement shall be amended to read as follows:

"Brazil will not make purchases under this arrangement:

(a) (i) during any period in which the data at the end of the preceding period indicate that the target for the net international reserves of the Brazilian Monetary Authorities, as specified in paragraph 1 of the Technical

Memorandum of Understanding dated September 15, 1983 and in paragraph 7, third sentence, of the letter dated November 14, 1983, is not observed, or

(ii) during any period in which the limit on the public sector borrowing requirement, as specified in paragraph 2 of the Technical Memorandum of Understanding dated September 15, 1983 and in paragraph 6, third sentence, of the letter dated November 14, 1983, is not observed, or

(iii) during any period in which the limit on the operational deficit of the public sector, as specified in paragraph 6, fourth sentence, of the letter dated November 14, 1983, is not observed, or

(iv) during any period in which the limit on the net domestic assets of the Brazilian Monetary Authorities, as specified in paragraph 4 of the Technical Memorandum of Understanding dated September 15, 1983 and paragraph 3, fifth sentence, of the letter dated November 14, 1983, is not observed, or

(v) during any period in which the data at the end of the preceding period indicate that the limit on the use of external credit, as specified in paragraph 5 of the Technical Memorandum of Understanding dated September 15, 1983 and in paragraph 7, third sentence, of the letter dated November 14, 1983, is not observed, or

(vi) during any period in which the cumulative quarterly target on the depreciation of the cruzeiro, as specified in paragraph 6 of the Technical Memorandum of Understanding dated September 15, 1983 and paragraph 7, second sentence, of the letter dated November 14, 1983, is not observed, or

(vii) if the intentions to eliminate certain exchange restrictions, including bilateral payments arrangements and payments arrears, and multiple currency practices that are specified in paragraphs 7 and 8 of the Technical Memorandum of Understanding dated September 15, 1983 and paragraph 7, fifth sentence, of the letter of November 14, 1983, are not carried out before December 31, 1983; or

(viii) if the intensifications of exchange restrictions that took place on September 14, 1983 and arose from reduced limits on foreign exchange allotments for travel abroad, as specified on page 24 of EBS/83/227 (10/19/83), are not be eliminated by December 31, 1984; or

(b) if the reviews with the Fund contemplated in paragraph 2 of the letter dated November 14, 1983 have not been completed in accordance with the following schedule:

(i) The "February" review, including the specification of performance clauses for calendar quarters ending June and September 1984, shall be completed before June 1, 1984;

(ii) The "August" review, including the specification of performance clauses for calendar quarter ending December 1984, shall be completed before December 1, 1984;

(iii) The "November" review shall be completed before March 1, 1985; or

(c) for the third year of this arrangement, if before March 1, 1985 suitable performance clauses have not been established in consultation with the Fund, or if any such clauses, having been established, are not observed, or

(d) if Brazil

(i) imposes new or intensifies existing restrictions on payments and transfers for current international transactions, or

(ii) introduces or modifies multiple currency practices, or

(iii) concludes bilateral payments agreements which are inconsistent with Article VIII, or

(iv) imposes new or intensifies existing restrictions on imports for balance of payments reasons.

When Brazil is prevented from purchases under this extended arrangement because of this paragraph 4, purchases will be resumed only after consultation has taken place between the Fund and Brazil and understandings have been reached regarding the circumstances in which such purchases can be resumed."

4. The Fund finds that no other understandings are necessary regarding the circumstances in which Brazil can resume purchases under the extended arrangement.

B. Exchange Measures

In view of the circumstances of Brazil, the Fund grants approval of the multiple currency practices and exchange restrictions that are described under points (1), (3)(a), (3)(b), (3)(d), and (5) on page 25 in EBS/83/227, until December 31, 1983; and of those that are described under points (2), (3)(c), (3)(e), (3)(f), (4), and (6) on page 25 in EBS/83/227, until April 30, 1984 or the conclusion of the 1983 Article IV consultation with Brazil, whichever is earlier. The Fund urges Brazil to eliminate at the earliest possible date the discriminatory aspects of its exchange system that are described under points (7) and (8) on page 25 in EBS/83/227 and paragraph 7 of letter dated on November 14, 1983 and contained in EBS/83/227, Supplement 1.

Table 1. Brazil: Quantitative Performance Criteria

	Ceiling 1/	
	4th Qtr 1983	1st Qtr 1984
(In billions of cruzeiros)		
Borrowing requirement of non-financial public sector 2/	24,600	11,750
Operational deficit of the public sector 2/	3,600	1,300
Net domestic assets of monetary authorities	3,540	3,300
(In millions of U.S. dollars)		
Change in net international reserves of the monetary authorities 2/	--	100
Net disbursements of medium- and long-term, and selected short-term, external debt of public and private sectors 2/	9,000	2,500
External payments arrears	None	None

1/ Floor in case of the net international reserves.
2/ Cumulative change in each calendar year.

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EBS/83/235

CONFIDENTIAL

November 2, 1983

To: Members of the Executive Board

From: The Secretary

Subject: Madagascar - Staff Report for the 1983 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1983 Article IV consultation with Madagascar. A draft decision appears on page 33.

This subject will be brought to the agenda for discussion on a date to be announced.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Stillson, ext. 72917.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

DEMOCRATIC REPUBLIC OF MADAGASCAR

Staff Report for the 1983 Article IV Consultation

Prepared by the African Department and the Exchange and Trade Relations Department

(In consultation with the Fiscal Affairs, Legal, and Treasurer's Departments)

Approved by J.B. Zulu and S. Kanesa-Thasan

November 1, 1983

I. Introduction

The 1983 Article IV consultation discussions with Madagascar were held in Antananarivo during the period of July 19-August 4, 1983. The representatives of Madagascar included Mr. P. Rakotomavo, Minister of Finance; Mr. J. Robiarivony, Director General of the Plan; and Ms. R. Razafintsalama, Director General of the Central Bank. The mission also met with representatives of the Ministries of Agriculture, Industry and Commerce, and the three commercial banks. The staff representatives were Mr. R. Bhatia (head-AFR), Mr. R. Stillson (AFR), Mrs. M. Tyler (ETR), Messrs. S. Schiavo-Campo and M. Gilman (both AFR), Ms. Z. Abdallah (AFR-secretary). Ms. C. Kimes (IBRD) also participated fully in the mission. Mr. B. Tshishimbi, Alternate Executive Director for Madagascar, attended the discussions during the last week of the mission.

Since June 1980 Madagascar has made extensive use of Fund resources under three successive stand-by arrangements, the latest of which was approved by the Executive Board on July 9, 1982 in an amount of SDR 51 million (100 per cent of quota). Although progress was achieved, especially under the last program, none of the three stand-by arrangements remained operative through the expiration date, owing to nonobservance of various performance criteria. As of September 31, 1983 Fund holdings of Malagasy francs were equivalent to 368.1 per cent of quota, including gross purchases under the compensatory finance facility equivalent to 100 per cent of quota; as a ratio of the proposed quota, under the eight general review of quotas, Fund holdings of Malagasy francs were 282.7 per cent, or 205.9 per cent if purchases under the CFF are excluded. Appendix I contains additional information on Fund relations. Appendix II contains selected economic and financial indicators.

As of end-June 1983 Madagascar's total debt outstanding (including undisbursed) under IDA credits and IBRD loans amounted to US$419 million, in addition to IFC investments of US$20 million. Two major IDA credits were approved in 1983, for assistance to rice production and for road rehabilitation, in amounts of US$18 million and US$45 million, respectively. Sector lending for agriculture and for industry is under active consideration. The Bank, in cooperation with the Fund, organized a consultative group meeting in Paris on April 27-29, 1983, to help mobilize the additional financial support for the Malagasy authorities' investment program. Madagascar's relations with the World Bank Group are summarized in Appendix III. Fund and Bank staff have cooperated closely and constructively in major issues of concern to Madagascar's adjustment and development effort.

II. Background and Long-Term Trends in the Economy

Agriculture dominates Madagascar's economy, accounting for 41 percent of GDP at current prices in 1982, employing 85 per cent of the workforce, and providing 90 per cent of exports (including processed agricultural products). The most important agricultural commodity is rice, the basic food staple of the country, which accounted for about one half the total area under cultivation in 1982. Madagascar has one of the highest per capita consumption of rice in the world, and government policy has put a high priority on ensuring ample rice supplies, including importing large quantities of rice (equivalent to 20 per cent of total imports in 1982). 1/ Madagascar's exports are dominated by coffee, cloves, and vanilla, which represented about 69 per cent of total exports in 1982, but Madagascar has the potential to produce substantial amounts of other agriculturally based exports, including cotton cloth, meat, fish and shellfish, pepper, and cocoa.

The services sector is the second largest in the economy (41 percent of GDP), a fourth of which consists of public wages and salaries. The industrial sector accounted for about 15 per cent of GDP in 1982 and is dominated by the food processing and textiles industries. The country is characterized by sharp economic disparities between regions, which are, in part, caused by relatively long distances between agricultural and industrial producing areas and their major markets and shipping points, and insufficient transportation links between those areas. In principle, prices, imports and credit are controlled by the Government, although in 1983 there have been substantial moves to liberalize prices, particularly in the rice sector.

The public enterprise sector grew rapidly in the 1970s, and by the end of the decade comprised the nationalized banks and insurance companies, about 90 parastatal organizations active in agriculture, and

1/ Rice importing policy is based on the provision of about 1 pound of rice per person per day, an amount almost three times the world average.

virtually all large industrial enterprises, in addition to transport and public utilities. There are indications that by 1980 the public enterprise sector was on balance having an adverse effect on the efficiency of allocation of resources, especially in agriculture, as well as being a serious drain on the budget. From 1981, however, an effort was begun by the authorities to supervise more closely the activities of these enterprises (particularly in the area of investment), to allow substantial price increases for their output, and to rationalize the financial and economic structure of the sector.

From 1971 through 1978 Madagascar experienced no real overall growth, although private consumption and gross investment grew by about 5 percent in real terms while public consumption fell. The percentage distribution of consumption and investment in GDP along with the resource gap is shown in Chart 1. Chart 2 shows the percentage distribution of the fiscal and external deficit in GDP, along with an index of GDP. In 1978 Madagascar embarked on a major investment program concentrated on education and transportation equipment 1/, financed primarily by foreign borrowing. Real GDP increased by just over 10 percent in the two-year period 1979-80, pushed up by an unsustainable level of investment and foreign borrowing. In 1979 gross investment more than doubled, and it increased by a further 7 percent in 1980; in SDR terms, imports increased by 76 percent in 1979 and by a further 14 per cent in 1980. The current account deficit of the balance of payments increased four fold in 1979 and increased again by 27 percent in 1980. To finance this large increase in the current account deficit, outstanding and disbursed external debt in SDR terms more than tripled between end-1978 and end-1980, to over one third of GDP, with the largest increases in 1979 coming from suppliers and financial institutions on relatively onerous commercial terms. 2/ This borrowing was still insufficient to finance the current account deficit in 1980, and arrears were incurred, estimated at SDR 174 million, equivalent to 28 per cent of imports in that year.

The large increases in investment and foreign borrowing in 1979 and 1980 were reflected in the fiscal and monetary outturns. Government capital expenditures increased threefold in 1979 and

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1/ Actual investment during this period was more heavily concentrated on education and transportation equipment than was indicated in the 1978-80 plan. An example of the startling increases in education in only two years is the fact that in 1980 the number of university students was around 30,000, compared to 11,000 in 1978. The investment in transportation equipment included purchase of a Boeing 747 aircraft and a number of ships.

2/ In 1979 new foreign loans contracted are estimated at SDR 379.7 million, of which SDR 235.3 million were from suppliers and financial institutions; in 1980 drawings on foreign loans totaled SDR 320.7 million. These magnitudes compare to total exports in 1979 of SDR 304.9 million and in 1980 of SDR 335.3 million.

by another 32 percent in 1980; and the overall central government deficit increased fourfold in 1979, to 13 percent of GDP, and by another 59 percent in 1980, to 18 percent of GDP. Even with the substantial foreign financing, the greater part of these deficits was financed by the domestic banking system, whose outstanding claims on Government increased almost fourfold between end-1978 and end-1980. This increase in bank finance to the Government is likely to have crowded out some nongovernment bank credits, as the proportion of nongovernment credit in total outstanding bank credit fell from 68 percent at end-1978 to 46 percent at end-1980. The money supply, however, increased by only about 20 percent in each of these years, the increase being moderated by the sharp drop in net foreign assets.

In view of the deteriorating external position, Madagascar requested assistance from the Fund, which, in June 1980, approved a two-year stand-by arrangement for an amount equivalent to SDR 64.45 million (EBS/80/136). The core of the financial program supported by the stand-by arrangement was a reversal of the expansionary fiscal policy, control over external borrowing, and elimination of arrears. However, key elements of the program were not observed, and no purchases were made after an initial purchase of SDR 10 million.

In 1981, with debt service payments estimated at SDR 146.2 million, or 43 percent of exports of goods and services, and prospects of a further substantial deficit in the external accounts, Madagascar entered into a new 14-month stand-by arrangement with the Fund in an amount equivalent to SDR 109 million (EBS/81/77). Also, a Paris Club rescheduling was organized, which in 1981 provided SDR 64.3 million in debt service relief, and there was a consolidation of SDR 9.0 million of arrears. The major policy elements of the financial program supported by this stand-by arrangement were, as in the 1980 program, a reduction of the central government deficit, to 9 percent of GDP; a reduction in external arrears through cash repayment of SDR 36.4 million; and a limitation on the contracting of new external debt. Performance criteria and program targets on the budget and arrears were not observed, despite a substantial reduction in public investment, and purchases of only SDR 39 million were made under the arrangement. As a result of the shortage of foreign exchange in 1981, import restrictions were severely tightened, and nominal imports fell by 26 percent, in spite of a 48 percent increase in rice imports, and real GDP declined by over 9 percent.

III. Performance Under the 1982 Program and Developments in 1982 and the First Half of 1983

1. Performance under the 1982 stand-by arrangement

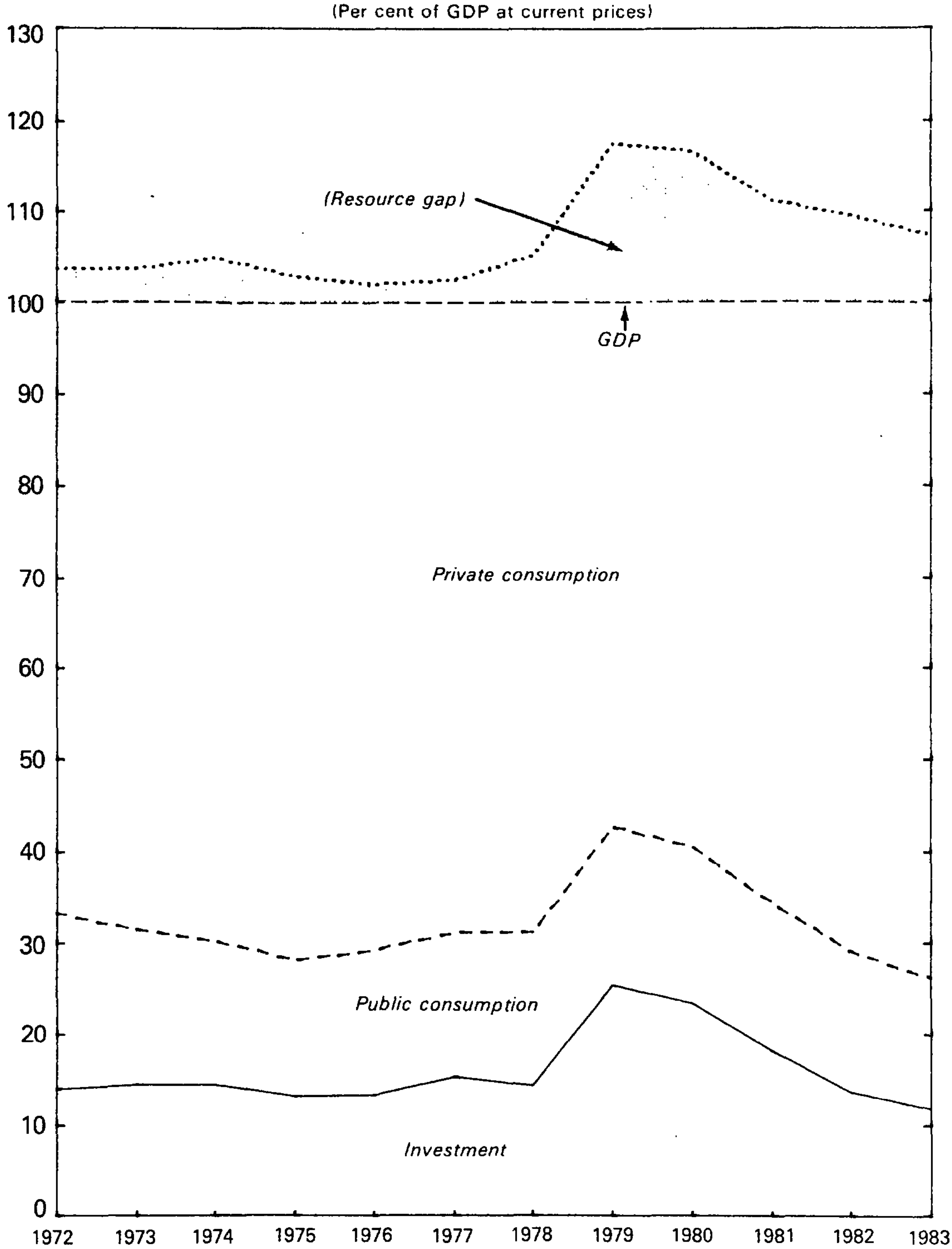
On July 9, 1982 the Fund approved Madagascar's request for another one-year stand-by arrangement (EBS/82/103, June 11, 1982), for an amount equivalent to SDR 51 million. The program's principal objectives

CHART 1

MADAGASCAR

DISTRIBUTION OF USES OF RESOURCES, 1972-83

(Per cent of GDP at current prices)



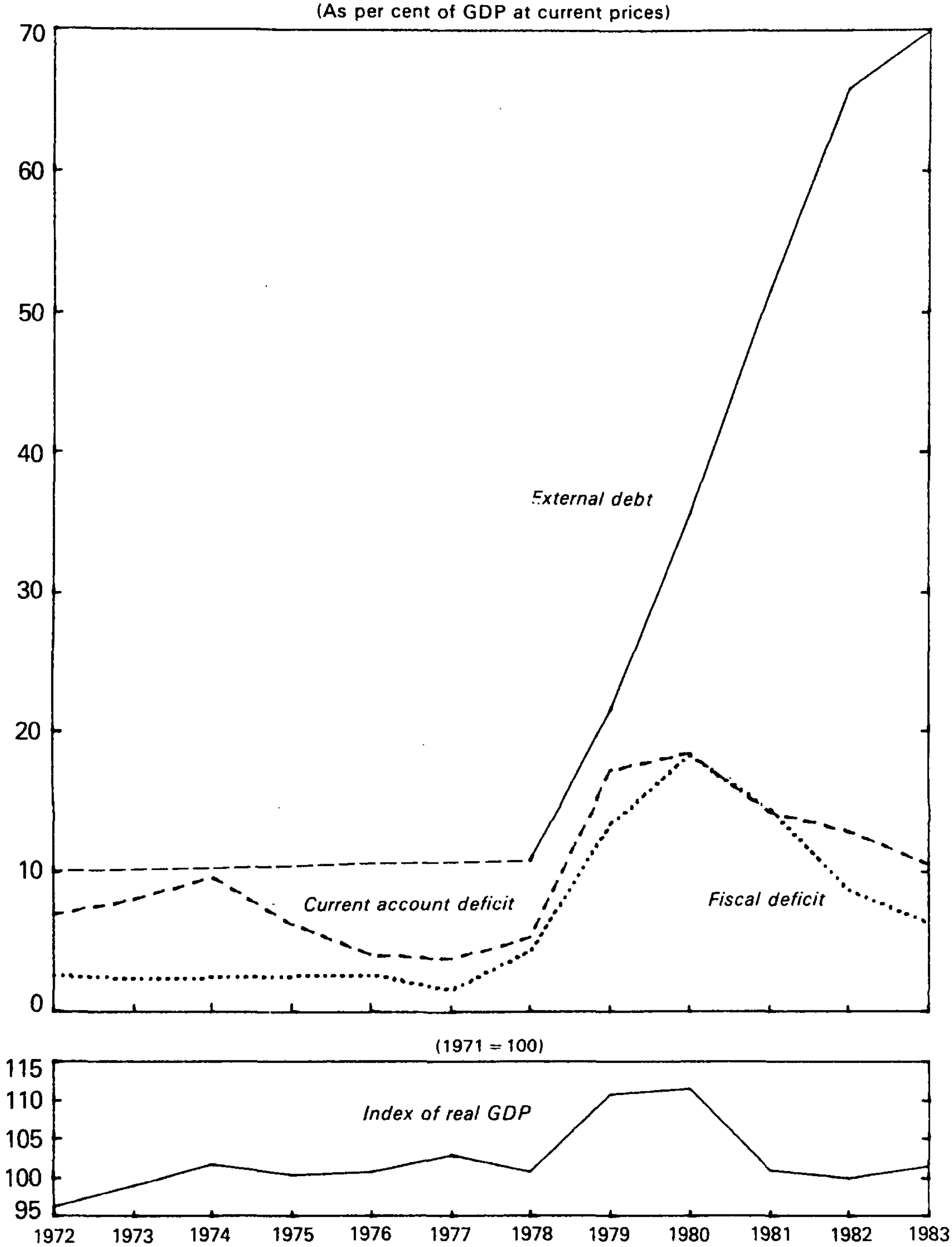
Source: Data supplied by the Malagassy authorities.

CHART 2

MADAGASCAR

MAJOR FINANCIAL INDICATORS, 1972-83

(As per cent of GDP at current prices)



Source: Data supplied by the Malagassy authorities.

were to limit the 1982 current account deficit of the balance of payments to 14.9 percent of GDP, with a reduction in external arrears by cash payments of SDR 30.0 million in that year, and to permit a modest resumption of economic growth, of about 1 percent. The primary policy instruments were substantial changes in pricing policy, particularly for rice, so as to eliminate consumer subsidies on rice, a relaxation of industrial price controls, a devaluation of 15 percent in local currency terms, and a reduction in the overall government deficit to 10.8 percent of GDP.

All performance criteria, except the arrears reduction, and most program targets were observed at end-December 1982. The program was substantially revised, and the Executive Board granted a waiver of the performance criterion on reduction of arrears (EBS/83/55, March 8, 1983) on the basis of new adjustment measures, including a tighter budget policy for 1983 (with the overall deficit to equal no more than 6 percent of GDP), a further depreciation (of 6 percent) of the exchange rate, an increase in deposit rates (by an average of 2.5 percentage points), and further progress on price liberalization. New ceilings were established through June 1983, including that for reduction in arrears on a net cash payment basis, and indicative fiscal targets were agreed for the whole of 1983. Again, while the end-March performance criteria were observed, the end-April performance criterion on the net cash reduction in arrears was not respected and the final purchase under the stand-by arrangement was not made. Tables 1 and 2 give the performance criteria and policy targets, along with actual performance, for both the original and revised program.

2. Principal economic developments and policies during 1982 and the first half of 1983

a. Production and demand

In 1982 real GDP declined by about 1 percent in contrast to the modest growth projected in the program. The national accounts show a 4 percent real growth in the agricultural sector, but this was more than offset by a 12 percent decline in the industrial sector, where a lack of foreign exchange for inputs and raw material caused many companies to curtail or cease operations. 1/ Investment fell by 30 percent in real terms in 1982, with a further notable decrease in

1/ National account estimates for 1982 are provisional and are not completely consistent with the production figures of individual sectors. Data on agricultural production gathered by the Ministry of Agriculture extension staff show declines in 1982 in rice and the major industrial and export crops, and only slight increases in other food crops. However, the general trends shown in the national accounts (an overall fall in output, with industry declining much more than agriculture) should reflect actual trends in 1982.

Table 1. Madagascar: Quantitative Performance Criteria, 1982-83

	1981	1982						1983			
		June		September		December		March/April		June	
	Dec.	Program	Actual	Program	Actual	Program	Actual	Program	Actual	Program 1/	Actual
Total domestic credit of banking system (FMG billion)	391.8	429.0	415.3	453.0	431.9	471.0	457.4	477.8	457.2	497.4	477.2
Net credit to Government by banking system (FMG billion)	215.0	235.2	234.8	242.2	239.0	249.2	248.8	266.7	260.7	276.4	258.3
Cumulative reduction by net cash payments of external arrears other than dividends (SDR million) 2/ (reduction -)		--	-6.1	-19.1	-24.7	-49.1	-4.8 3/	-9.0	28.6	-15.0	30.4
Cumulative reduction in external arrears with respect to dividends (FMG billion) (reduction -)		-0.1	-0.1	-0.5	-0.5	-1.0	-1.0	-0.2	-0.2	-0.4	-0.4
New external borrowing of 1-10 years' maturity (French franc million) 4/		167.6	--	167.6	33.2	167.6	97.9	167.6	118.4	167.6	(...)
Of which: 1-5 years' maturity		(167.6)	(--)	(167.6)	(33.2)	(167.6)	(97.9)	(167.6)	(118.4)	(167.6)	(...)

1/ Indicative targets only.
2/ From the level of end-March 1982; stock at that date estimated at SDR 144.8 million under program; revised estimate of stock outstanding at that date is SDR 116 million.
3/ A waiver was granted by the Executive Board, (EBS/83/55, March 8, 1983).
4/ Represents an overall loan agreement denominated in French francs signed in 1981; individual contracts for utilization for the loan were signed were signed in 1982.

Table 2. Madagascar: Principal Policy Measures and Their Implementation, 1982-83

1. Production and prices	
a. Increase in the producer (28 per cent) and consumer (87 per cent) prices of rice, so as to eliminate all subsidies on both domestic and imported rice.	Implemented prior to Executive Board discussion.
b. Increases in producer prices for crops other than rice.	Partial implementation.
c. Reorientation of 1983-85 investment program toward emphasis on quick-yielding projects in agriculture sector and rehabilitation of existing infrastructure.	An investment program along these lines was been prepared, with World Bank technical assistance.
d. Relaxation of price controls, with enterprises allowed to adjust prices by up to a certain percentage without prior government approval.	A significant number of prices charged by state enterprises, particularly for transport and utilities, have been substantially increased. Nevertheless, the government price control was maintained on a case-by-case basis. In 1983 there appeared to be some de facto liberalization but no decree establishing more liberal procedures.
2. Fiscal measures 1/	
a. Cost-of-living increases for public sector employees to be limited to 4.5 per cent in 1982 and elimi ated in 1983.	Implemented.
b. Growth of central government labor force to be limited to 4 per cent in 1982 and to 127,500 persons (1.1 percent) in 1983. Limit in 1983 of FMG 84 billion on wages and salaries.	Implemented.
c. Limit of FMG 47.4 billion for nonpersonnel expenditure other than external interest payments in 1982.	Implemented.
d. An inventory of all internal arrears to be compiled and FMG 8 billion of such arrears to be paid in 1982.	Implemented; program established in 1983 to eliminate internal arrears by 1984.
e. Value-added tax to rise from 10 per cent to 15 per cent and scope widened in 1983.	Implemented.
f. Petroleum prices to be raised by 18 per cent in 1982. In 1983 specific taxes and duties replaced by an ad valorem import duty.	Implemented.
3. Money and credit policies	
a. Reintroduction of quantitative credit controls with quarterly global ceilings in 1982.	Implemented.
b. Increase in central bank base rate from 8 to 12.5 per cent, with corresponding increases for lending and deposit rates. Further increase in deposit rates by 2.5 percentage points in 1983.	Implemented.
4. External sector policies	
a. Devaluation of 15 per cent (local currency terms) and move to a trade-weighted basket for exchange rate peg. Further devaluation by 6 percent in local currency terms in 1983.	Implemented.
b. Automatic licensing of priority imports.	Not implemented.

1/ 1983 measures for full fiscal year were indicative targets; these are marked as implemented if current budget projections (September 1983) show that the targets will be attained.

the transport sector, investment in which fell to 7 percent of gross investment from 14 percent in 1980. Private consumption, on the other hand, increased by about 5 percent in real terms, largely insulated from the overall decline by a relative increase in imports of consumer goods, and a large absolute increase in rice imports. Non-government saving fell in 1982 to 4 percent of GDP from 8 percent in 1981.

Consumer price information is gathered for both low-income and high-income market baskets established in 1973 and represents prices in the Antananarivo urban area. During 1982 both price indices increased by about 31 percent, accelerating slightly from a weighted average increase during 1981 of 29 percent. The increases were large in all categories and reflected the combination of the expansionary policies of 1980 and 1981 and increases in administered prices of state enterprises in 1981 and 1982. In the first half of 1983 substantially tightened fiscal and monetary policies began to relieve demand pressures, and, after a 6 percent rise in the first quarter, price increases slowed to only 3 percent in the second quarter.

Production of rice declined in 1982, in part because of a severe cyclone in the early part of the year, which is estimated to have lowered output by about 8 percent. Official marketing of domestically produced rice fell sharply in 1982, to only about 5 percent of the estimated crop. About one half of officially marketed rice is produced in two areas in which large, intensive irrigation investments have been made and in which two agricultural development agencies, SOMALAC and FIFABE, have monopolies on the purchasing, collection, distribution, and processing of rice. These organizations, along with another large publicly owned rice marketing agency (SINPA), experienced serious financial and management problems in 1982, which, along with the controls on the producer price, affected their efficiency and largely account for the continuous drop in officially marketed production in recent years.

In 1982 the Government of Madagascar began a process of liberalization of rice prices and marketing designed to increase production and efficiency. In May 1982 the consumer price of rice, which had been subsidized, was nearly doubled, to FMG 140/kg. for ordinary rice, and the producer price of paddy was raised 28 percent to FMG 60/kg., thus eliminating subsidies on consumption of rice. 1/ In February 1983 the producer price was raised again, to FMG 65/kg. In the spring of 1983 a decree and implementing regulations were promulgated, which allowed for competition in the purchasing, processing, and marketing

1/ In 1980 direct rice subsidies totaled FMG 6.7 billion, 6 percent of current budgetary revenue, and, in addition, parastatal losses on rice marketing are estimated at FMG 4 billion, financed from profits of other activities, notably export activities. Estimates are that subsidies in 1981 were at about the same level.

of domestic rice in most areas of the country and freed from controls the producer price of paddy and the consumer price of domestic rice, subject to a floor producer price for paddy of FMG 65/kg. and a ceiling consumer price for domestic rice of FMG 300/kg. 1/ In the areas served by SOMALAC and FIFABE (called "reserved" areas), their monopoly on the purchase of paddy and the distribution, processing, and marketing of rice has been maintained.

Production of the other main agricultural crops was roughly maintained or increased in 1982, with coffee and cloves increasing from 1981 levels and vanilla slightly down. Trends were also mixed for the most important industrial crops, with sugarcane and groundnuts slightly higher but cotton down. With the exception of vanilla there has been no significant growth in output since 1979. Cotton producer prices were raised substantially in early 1983, and the Government launched a national cotton development program aimed at removing supply constraints. Cotton production in 1983 is expected to show considerable improvement. Sugarcane and groundnuts production have been adversely affected by low producer incentives; ex-factory prices of sugar have not been changed since January 1982, resulting in a decline of about 25 percent in real terms, and nominal producer prices of groundnuts also remained constant during 1982 and the first half of 1983.

b. Government finance

In 1982 there was a substantial reduction in the overall deficit, from 14.6 percent of GDP in 1981 to 8.8 percent, primarily as a result of restraints on expenditure (Table 3). The deficit was FMG 21.5 billion less than programmed in the 1982 stand-by arrangement. Total expenditure declined by 6 percentage points of GDP, with the largest fall in capital expenditure, which declined by FMG 12.0 billion. The proportion of the overall deficit financed by domestic resources fell from 52 percent in 1981 to 42 percent in 1982, and domestic bank finance was well within the program target. This was due in part to the counterpart of concessional loans (FMG 50.6 billion) received from the aid donors' conference in June 1982, part of which was exceptional balance of payments support channeled through the Treasury.

Budgetary revenue increased in 1982 by 17 percent, implying an elasticity of 0.65, and was considerably less than the amount envisaged in the program. This was attributable to shortfalls in import taxes, in line with a lower volume of imports, and in indirect taxes, in line with the lower level of economic activity. Nonbudgetary revenue,

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1/ Previously state marketing agencies had a monopoly on all official purchasing, processing, distribution, and marketing of rice, and prices for the intermediate steps in production, and the consumer price were fixed by the Government.

Table 3. Madagascar: Overall Government Operations, 1979-83

(In billions of Malagasy francs)

	1979	1980	1981	1982 Prog.	1982 Est.	1983 Prog.	1983 Est.
Total revenue	114.4	123.3	119.6	157.8	151.9	189.4	185.8
Budgetary receipts	90.7	100.4	104.4	127.6	121.9	139.5	138.4
Direct taxes	(15.4)	(19.9)	(23.5)	(24.2)	(22.1)	(25.2)	(25.8)
Indirect taxes	(70.6)	(77.3)	(76.9)	(100.3)	(96.7)	(110.8)	(108.1)
Nontax revenue	(4.7)	(3.2)	(4.0)	(3.1)	(3.1)	(3.5)	(3.5)
Other	23.7	22.9	15.2	30.2	30.0	49.9	47.4
Of which:							
FNUP receipts	(19.3)	(15.6)	(15.2)	(26.6)	(26.4)	(34.7)	(36.0)
grants	(...)	(...)	(...)	(3.6)	(3.6)	(9.3)	(11.4)
Total expenditure	-194.3	-250.1	-234.8	-266.5	-238.9	-265.5	-267.7
Current budgetary expenditure	-97.7	-112.9	-112.2	-134.1	-127.4	-144.5	-147.0
Wages and salaries	(-50.8)	(-60.9)	(-68.6)	(-77.4)	(-80.7)	(-84.0)	(-82.0)
Interest on external debt	(-1.5)	(-2.8)	(-4.5)	(-9.3)	(-9.1)	(-9.6)	(-11.9)
Interest on domestic debt	(-0.4)	(-1.2)	(-2.2)	(-0.4)	(-1.8)	(-2.1)	(-3.1)
Other current expenditure	(-45.0)	(-48.0)	(-36.9)	(-47.0)	(-35.8)	(-48.8)	(-50.0)
Capital expenditure	-65.7	-89.6	-84.1	-99.8	-72.1	-78.3	-70.6
Development budget	(-56.4)	(-74.4)	(-62.1)	(-70.8)	(-44.1)	(-51.3)	(-45.8)
On-lending	(-9.3)	(-15.2)	(-22.0)	(-28.0)	(-28.0)	(-27.0)	(-24.8)
Other	-30.9	-47.6	-38.5	-32.6	-39.4	-42.7	-50.1
Of which:							
deferred payments 1/	(-12.7)	(-12.9)	(-14.6)	(-16.8)	(-13.6)	(-16.0)	(-22.1)
Overall deficit	-79.9	-126.8	-115.3	-108.7	-87.2	-76.1	-81.9
Of which: Treasury deficit	(-81.7)	(-108.0)	(-107.5)	(-120.8)	(-95.3)	(-107.8)	(-101.2)
Foreign (net)	35.3	47.9	55.6	68.8	50.4	40.6	45.0
Domestic (net)	44.6	78.9	59.7	39.9	36.8	35.5	36.9
Banking system	(41.9)	(78.2)	(57.8)	(35.0)	(33.9)	(36.6)	(37.6)
Non-bank	(2.7)	(0.7)	(1.9)	(4.9)	(2.9)	(-1.1)	(-0.7)
Memorandum items:			(In percent of GDP)				
Budgetary receipts	15.2	14.5	13.2	12.8	12.2	11.5	11.4
FNUP receipts	3.2	2.3	1.9	2.7	2.7	2.9	3.0
Total receipts	19.2	17.8	15.2	15.8	15.3	15.6	15.3
Current budgetary expenditure	-16.4	-16.3	-14.2	-13.5	-12.8	-11.9	-12.1
Capital expenditure	-11.0	-13.0	-10.7	-10.0	-7.2	-6.4	-5.8
Total expenditure	-32.7	-36.2	-29.8	-26.7	-24.0	-21.8	-22.0
Overall deficit	-13.4	-18.4	-14.6	-10.9	-8.7	-6.2	-6.7
Banking system	7.0	11.3	7.3	3.5	3.4	3.0	3.1

Sources: Ministry of Finance and Economy; Central Bank of Madagascar; and staff estimates.

1/ Including payments of domestic arrears. It is not possible to separate out net payments of domestic arrears from deferred payments.

consisting primarily of receipts from the Fonds National Unique de Péréquation (FNUP), 1/ increased substantially over 1981, as envisaged in the program, in large part because of the devaluation in May 1982, which increased the local currency counterpart of export receipts.

Current budgetary expenditure was kept below programmed targets, primarily because of restraint on expenditure other than wages or interest payments. The authorities have reinforced the monitoring and control of these expenditures, which succeeded in reducing them from a high of FMG 48 billion in 1980 (43 percent of total current expenditure) to FMG 35.8 billion in 1982 (28 percent of total current expenditure). Wages and salaries increased by 18 percent in 1982 over 1981, a significant decrease in real terms. Capital expenditure was sharply curtailed, continuing its downward trend since the investment boom of 1979-80; in 1982 this category of expenditure was only 80 percent (in nominal terms) of its peak level in 1980. Expenditure financed from FNUP receipts declined substantially in 1982, reflecting a policy agreed in the 1982 program not to undertake investment expenditure from the FNUP account.

The 1983 fiscal program continued the trend toward restraint. Total revenue was projected to increase 25 percent from the 1982 outturn, while expenditures were programmed to increase by 11 percent. The overall deficit was programmed to fall by FMG 11.1 billion to 6.2 percent of revised GDP. Domestic bank finance of the Government was projected to rise slightly from the level in 1982, to FMG 36.6 billion, or 15 percent of the beginning period money supply. Foreign financed capital expenditure was projected to fall in line with reductions in capital expenditure and imports.

In the first half of 1983 the budgetary outturn was even more restrictive than the program envisaged. Total revenue was 32 percent higher than in the first half of 1982, while total expenditure was only 5 percent higher than the similar period in 1982. The overall deficit was much lower than envisaged in the program and outstanding claims on government by the domestic banking system rose by FMG 6.5 billion as against a ceiling of FMG 20 billion. The higher revenue reflected new discretionary measures, including a new unified import duty on petroleum products, increased excise taxes and extension of the value added tax

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1/ This fund receives most of its money from the export commodity stabilization funds which, in turn, receive money from the difference between the fixed price paid to domestic producers, processors and distributors of exports and the actual domestic currency counterpart of export receipts. This price difference represents an implicit export tax, which on some commodities is extremely high (74 percent in the case of vanilla). FNUP expenditures are related to export crop collection, storage, and marketing. In previous years rice subsidies and some capital expenditures were made from this account. Net receipts of the FNUP finance other budgetary expenditure.

to professional activities and the retail trade, 1/ and increased company taxes and a new bi-monthly withholding scheme for company taxes. FNUP receipts increased sharply, reflecting in part, a 6 percent devaluation in February 1983. Expenditures were lower than expected, in part due to a new expenditure control system implemented in January 1983, which is likely to have accentuated the normal seasonality where the majority of expenditures come in the second half of the year. An inventory of domestic arrears was completed for end-1982 showing a level of FMG 19.1 billion (about 8 percent of total expenditure in 1982). Payments on these and other deferred payments are expected to amount to FMG 22.1 billion in 1983.

c. Monetary and credit developments

Monetary statistics over the past three years have been distorted because arrears and other foreign liabilities of the Central Bank were accounted for at their original exchange rates and not adjusted for subsequent exchange rate changes. For most items this led to a considerable undervaluation by the end of 1982. With technical assistance from the Fund, and in accordance with a provision in the 1982/83 stand-by arrangement, the authorities have revalued their foreign liabilities at current exchange rates for end-December 1982 and end-June 1983. In the future these data will be kept current.

Monetary developments in 1982 show a decelerating credit expansion (17 percent) and monetary expansion (10 percent) (Appendix II). Monetary expansion was moderated by the growth in arrears and other foreign liabilities of the central bank. 2/ In the first half of 1983 credit expansion slowed even more and nominal money balances fell. To a certain extent this reflects seasonality in the government accounts, and credit to Government is estimated to expand 14 percent by the end of 1983 and total credit to expand by 17 percent. These projections imply a large increase in velocity of broad money, from 3.8 in 1982 to 4.2 in 1983, after a period of relative stability in velocity, ranging from 3.5 to 3.8, from 1979 to 1982.

Real interest rates turned sharply negative in 1981, as the inflation rate increased (6-12 months real deposit rates were -25 percent). Interest rates were increased in June 1982, by about 4 percentage points, and raised again by up to 2.5 percentage points in February 1983, but the real rates remained sharply negative as the increase in the CPI stayed above 30 percent during 1982. The negative real rates of interest may have been a contributing factor in the rise in velocity in 1983 because of a lagged effect on the demand for money.

1/ The full effect of this measure will be delayed, as the full implementation of this tax requires a census of retail establishments, which will not be completed until the end of 1983.

2/ The domestic counterpart of external arrears are deposited in a blocked account at the Central Bank.

d. The external sector

The balance of payments in 1982 (Table 4) was burdened by the growing debt service, which, prior to the reschedulings obtained from the Paris Club and other official creditors increased 55 percent, after more than doubling in 1981 (Table 5). 1/ Also, drawings on new foreign loans were reduced by SDR 87.1 million to SDR 190.1 million. After the two reschedulings with the Paris Club and with other official creditors, the overall balance remained in deficit by SDR 42 million. Since the Central Bank had virtually run out of foreign exchange (gross foreign assets were only SDR 20.5 million at the end of 1981), the deficit was reflected in a further net accumulation of arrears, and the balance was financed by drawings under the Fund stand-by arrangement and the CFF.

(1) The current account excluding interest payments

In 1982 exports increased by 9 percent in SDR terms to SDR 298 million stimulated particularly by a large price and volume increase in vanilla, the SDR value of which more than doubled. However, export earnings in 1982 were still less than their value in 1979. In 1983 exports are projected to decline slightly to SDR 296 million, reflecting mainly a sharp drop in clove exports.

Exports of the three major crops have been constrained in large part by marketing considerations. Madagascar's coffee quota under the ICO is 45,000 tons/year, whereas marketed production has varied from a high of 65,000 tons in 1980 to a low of 50,000 tons (in 1982) over the past five years. In 1982 8,000 tons were sold to nonquota markets and for 1983 contracts have been signed for about the same volume to nonquota markets. These marketing constraints have been exacerbated in recent year by declines in average quality of exported coffee. In 1983 year, the clove market has been severely constrained because the major part of world demand comes from one country, Indonesia, which is also increasing its own production. As a result, cloves exports are expected to be substantially lower in 1983, following increases in these exports over the past two years. 2/ For vanilla, Madagascar, the Comoros,

1/ The debt service before rescheduling shown on Table 5, does not exactly match the balance of payments presentation since it includes payments on debt (including arrears) rescheduled in previous years and IMF repurchases.

2/ Export projections for 1983 assumes a sale of 4.5 thousand tons of cloves to Indonesia based on a contract which was expected to be signed in February 1983; however, at the end of August 1983 the contract had not been signed. If these exports are not made in time to receive payment during 1983, exports would be SDR 32 million less than projected, and total exports would be 12 percent less than in 1982.

Table 4. Madagascar: Balance of Payments, 1979-83

(In millions of SDRs) 1/

	1979	1980	1981	1982	1983 Proj.
Exports, f.o.b.	304.9	335.3	274.3	298.1	295.7
Imports, f.o.b.	-512.7	-587.3	-433.2	-409.0	-371.1
Trade balance	-207.8	-252.0	-158.9	-110.9	-75.4
Service receipts	58.9	62.9	55.6	49.7	44.0
Service payments	-219.8	-274.2	-268.1	-272.0	-268.6
Freight	-99.3	-113.5	-66.2	-68.1	-58.8
Transport and travel	-45.1	-58.2	-59.3	-55.7	-54.3
Investment income 2/	-13.5	-35.6	-78.3	-90.7	-101.0
Other services	-61.9	-66.9	-63.7	-57.5	-54.5
Services (net)	-160.9	-211.3	-212.5	-222.3	-224.6
Private unrequited transfers, net	5.5	2.9	3.4	-1.3	-1.1
Current account	-363.2	-460.4	-368.0	-334.5	-301.1
(Excluding interest)	(353 3)	(-428.4)	(-292.8)	(-246.4)	(-202.3)
Public unrequited transfers	27.3	32.7	53.1	65.5	59.2
Nonmonetary capital (net)	234.3	288.0	274.8	171.1	175.8
Drawings	248.9	320.7	277.2	190.1	186.2
Amortization 2/	-14.6	-32.7	-66.8	-100.1	-170.7
Rescheduled debt service 3/	--	--	64.4	81.1	160.3
Principal on regular maturities (net of payments on reschedulings)	(--)	(--)	(44.4)	(57.1)	(134.2)
Interest	(--)	(--)	(20.0)	(24.0)	(26.1)
National banks (net)	4.7	5.1	-18.1	-23.8	--
Allocation of SDRs	3.5	3.5	3.5	--	--
Other 4/	-10.2	-41.6	9.6	79.9	-12.6 5/
Overall balance	-103.6	-176.2	-45.1	-41.8	-78.7
Financing	103.6	176.2	45.1	41.8	78.7
IMF (net)	-3.7	37.7	31.6	47.0	6.5
Changes in arrears (decrease -)	--	174.5	-65.2	55.0	-88.7
due to: Consolidations	(--)	(-44.7)	(-124.2)	(-8.8)	(-119.1)
Accumulations	(--)	)	)	(221.0)	(79.5) 6/
Repayments	(--)	)(219.2))	(59.0)	(-157.2)	(-49.1) 6/
Arrears consolidated into medium-term liabilities (decrease -)	--	44.7	87.1	-52.4	102.7
New consolidations	(--)	(44.7)	(124.2)	(8.8)	(119.1)
Repayments	(--)	(--)	(-35.0)	(-14.3)	-16.4 7/
Repayments due but not made	(--)	(--)	(-2.1)	(-46.9)	(...)
Other Central Bank reserves, (net) (increase -)	107.3	-80.7	-8.4	-7.8	10.5
Assets (increase -)	(43.3)	(-13.8)	(-7.8)	(-7.3)	(0.2)
Liabilities (decrease -)	(64.0)	(-66.9)	(-0.6)	(-0.5)	(10.3)
Remaining gap	--	--	--	--	47.7

Sources: Data provided by the Malagasy authorities; and staff estimates.

1/ Converted at the following rates per SDR 1: FMG 274.83 (1979), FMG 275.01 (1980), FMG 320.41 (1981), FMG 386.08 (1982), and FMG 445.8 (1983).
2/ Before debt rescheduling.
3/ Debt reschedulings obtained thus far under Paris Club I and II through June 1983, from certain other official creditors, and from the London Club group of banks under agreement reached in principle.
4/ Includes valuation adjustment, short-term capital, and errors and omissions.
5/ Represents delays in export proceeds assumed at 5 percent of export value except for exports of cloves.
6/ Estimates for January-June 1983.
7/ Scheduled total repayments in 1983; differs from previous years where actual repayments are shown.

Table 5. Madagascar: Impact of Rescheduling on External Debt Service 1/

(In millions of SDRs) 2/

	1981	1982	1983
A. Debt service before rescheduling	135.6	210.2	280.6
Interest (incl. moratorium interest on debt rescheduled on previous years)	61.4	87.5	96.4
Principal on regular maturities 3/	66.8	100.1	170.7 4/
Payments on previously rescheduled regular maturities	--	2.9	3.9
Payments on arrears consolidated in previous years	--	14.3	6.0
IMF repurchases	7.4	5.4	3.6
B. Amounts rescheduled 5/	-68.3	-84.6	-167.4
Interest	-20.0	-24.0	-26.1
Principal (gross)	48.3	-60.6	-141.3
Paris Club I (1981)	(-31.4)	(--)	(--)
Paris Club I (Jan-June 1982)	(--)	(-19.3)	(--)
Paris Club II (July-Dec. 1982)	(--)	(-24.2)	(--)
Paris Club II (Jan-June 1983)	(--)	(--)	(-25.2)
Other countries 6/	(-13.7)	(-15.2)	(-50.8)
Private	(-3.2)	(-1.9)	(-65.3)
C. Payments on reschedulings during any given year	52.6	1.3	15.9
Moratorium interest	13.7	0.7	2.4
Payments on rescheduled regular maturities	3.9	0.6	3.1
Payments on consolidated arrears	35.0	--	10.4
D. Debt service after rescheduling of any given year (A - B + C)	119.9	126.9	129.1
E. Exports of goods and services	329.9	147.9	339.7
A/E ratio	41.1	60.4	82.6
D/E ratio	36.3	36.5	38.0

Source: Data provided by the Malagasy authorities; and staff estimates.

1/ Includes reschedulings obtained thus far from Paris Club through June 30, 1983, from certain other official creditors through September 1983 and from the London Club group of banks based on an agreement in principl expected to be signed in November 1983.

2/ Converted at the following rates for SDR 1: FMG 320.41 (1981), FMG 386.08 (1982), and FMG 445.8 (1983).

3/ Excluding unconsolidated arrears.

4/ Includes FMG 29.11 billion (SDR 65.3 million) of regular principal due to banks in 1983 on debt not in arrears. The counterpart is added to amounts rescheduled (under category "private") in accordance with the agreement reached in principle and expected to be signed in November 1983.

5/ Excluding arrears.

6/ Certain Arab and COMECON countries.

and La Réunion have almost a world monopoly, and the world market could not absorb substantial increases in supply without greatly affecting the price. Other agriculturally based exports include cotton cloth, meat, fish, pepper and sugar, which have substantial potential for expansion, but which accounted for only about 10 percent of exports in 1982.

Imports in 1982 declined by about 6 percent in SDR terms and are expected to decline again in 1983 by another 7 percent. They have declined in each year beginning 1981 and are expected to be 29 percent less in 1983 than their value in 1979. However, rice imports grew sharply in 1982, to 356 thousand tons (from 192 thousand tons in 1981), 75 percent of which was paid for with Madagascar's own foreign exchange. For 1983, rice imports are expected to be kept to 183 thousand tons, and the volume of nonrice imports is expected to drop to less than the level of 1978.

Given these trends in the trade accounts, and the reduction in the noninterest services account from the high level in 1980, the current account excluding interest payments has shown a steady improvement since 1980, with the deficit being reduced by more than half, from SDR 428.4 million in 1980 to a projected SDR 202.3 million in 1983.

Public transfers and drawings on loans declined sharply in 1982, from SDR 330.3 million in 1981 to SDR 255.6 million in 1982, and are expected to remain at about this level in 1983. The decline was the result of a reduction in 1981 and elimination in 1982 of exceptional balance of payments financing, which in 1980 amounted to SDR 57.2 million, and of the reduction in investment noted above. Amounts drawn from Donors Club commitments (in 1982 and 1983) partially made up for the above loss.

(2) External debt service

Debt service before rescheduling reached SDR 210 million, 60 percent of exports of goods and services in 1982, and is projected at SDR 280 million in 1983, 83 percent of exports of goods and services.

In 1981 a Paris Club rescheduling was arranged, followed by a second rescheduling in 1982. The impact of these reschedulings, along with rescheduling obtained in 1981-83 from other creditors and from the London Club group of banks (under an agreement reached in principle) is shown in Table 5. The amounts rescheduled amounted to SDR 320.3 million during the three years, about 50 percent of the regularly scheduled debt service due in those years. However, net debt relief was slightly less, due to downpayments on the rescheduled amounts and moratorium interest due on these reschedulings and on arrears consoli-

dations (a total of SDR 1.3 million in 1982 and SDR 15.9 million in 1983). Net debt relief in the three years amounted to SDR 240 million, or about 40 percent of the regularly scheduled debt service in those years.

Debt service payments to banks are an important part of scheduled debt service, although not the majority of it. In 1982 and 1983 interest owed to banks, including on short term lines of credit, was 30 percent and 35 percent, respectively, of interest payments, after rescheduling, in spite of the fact that bank debt is only 10 percent of total debt in 1982. Negotiations with the London Club group of banks began in June 1982 to reschedule the whole of outstanding bank debt (US$195 million, out of which US$70 million was arrears on principal payments). An agreement with the group's steering committee was reached in March 1983, with the proposals to be forwarded to individual banks. A further agreement in principal was reached in September 1983 to provide for a grace period for principal payments during 1983 and 1984.

Consolidations of arrears (see below) and reschedulings have given rise to moratorium interest payments on the amounts rescheduled and consolidated, which in 1982 amounted to SDR 19.8 million, or 31 percent of total interest payments after rescheduling. In 1983 moratorium interest payments are expected to be SDR 32.9 million or 45 percent of total interest payments after rescheduling. In 1983 interest payments after rescheduling are estimated to amount to 56 percent of total debt service and 21 percent of exports goods and services. There are substantial arrears on the moratorium interest payments and on payments in respect of rescheduling and consolidations of arrears.

(3) Arrears

Since 1980 the buildup of arrears has represented a major element in the balance of payments. In 1981 new accumulations on a net cash basis are estimated at SDR 59 million (compared to a current account deficit of SDR 368 million) and in 1982 at SDR 63.8 (compared to a current account deficit of SDR 334.5 million). In the first six months of 1983, SDR 30.4 million in new arrears were accumulated on a net cash basis. 1/ Through the first half of 1983, SDR 206 million in

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1/ The estimates for stocks of and changes in arrears before June 1983 are mainly based on valuations at original exchange rates, unadjusted for changes in rates after the date the arrears were incurred. Some revaluations of changes in arrears were made during 1982 and the stock of arrears was partially revalued at the end of 1982. The stock was further readjusted at June 1983, at which time it amounted to SDR 107 million, and will be adjusted monthly on the basis of current exchange rates.

arrears have been consolidated into medium-term loans; since then SDR 29 million has been rescheduled with other official creditors and agreement has been reached in principle for the consolidation of arrears outstanding to commercial banks at the end of 1982.

e. Exchange rate

The Malagasy franc continued to be pegged to a basket of several currencies, a system adopted on April 2, 1982. The weight assigned to each currency in the basket is based on the distribution of Madagascar's trade during 1973-80. A devaluation on May 17, 1982, by 15.0 percent (in local currency terms) against the currency basket was followed by further devaluations by 6 percent, 2 percent and 10.5 percent on January 31, July 8, and October 3, 1983, respectively. As a result, the real effective exchange rate has been roughly maintained at the May 1982 level.

IV. Report on the Discussions

The discussions centered on the new policies promulgated in 1983, particularly in rice pricing and marketing, and on prospects for the whole of 1983 and the medium term. The policies governing the allocation of resources (pricing, marketing, import controls, credit controls, and the exchange rate) will be the primary instruments to guide medium term developments. The discussions on medium term prospects focused on the external debt servicing, since it is clear that financing this debt service would cut deeply into foreign exchange earnings and would provide the most important single constraint on economic developments in the coming three to four years. Apart from debt service, the discussions on medium-term prospects focused on the potential of the economy over a three- to four-year horizon to increase production, primarily of agriculturally based exports and import substitutes.

1. Agricultural policies and prospects

a. Rice

The Malagasy authorities explained that rice output in 1983 was expected to be about 9 percent above output in 1982 and that officially marketed production would be well above the amount marketed in 1982, as the weather conditions were favorable and output was recovering from the cyclone-induced low level in 1982 but was still 36 percent less than the amount marketed in 1980. They also felt that part of the explanation of the increase in production and marketing was due to an improvement in the efficiency of SOMALAC and FIFABE, which were expected to show improved financial results in 1983. The authorities felt that, under ideal conditions, large increases in production should be possible (with perhaps up to a 10 percent annual increase in yield and a 10 per-

cent annual increase in area under cultivation), particularly in the three main producing areas (two of which are served by SOMALAC and FIFABE). This would require substantial expansion of extension services including technical advice, inputs, credit, and marketing.

The authorities recognize that pricing and marketing policies are also likely to be crucial in supporting any sustained increase in output, and for this reason promulgated the liberalization reform in May 1983. However, the authorities still wanted to protect producers and consumers from extreme price fluctuations with a minimum producer price and a maximum consumer price. The maximum consumer price has been set substantially above free market prices during most of the year but may still constrain consumer prices in the period of relative scarcity right before the harvest. The staff was concerned that some provisions in the new regulations, such as licensing requirements for rice traders and the exclusion of the areas served by SOMALAC and FIFABE from free competition, would continue to affect adversely the incentives for paddy farmers and distributors to expand. The authorities explained that the licensing provisions were not intended to restrict competition; licensing fees were small, the number of licenses was not restricted, and the issuance of the license was dependent only on the honesty and reliability of the applicant. The reserved areas were necessary to ensure the financial stability of the two agricultural development agencies and to finance their provision of irrigation and extension services to producers in these areas. Quantitative information on the results of the new pricing and marketing measures was not yet available, but the authorities felt that the large price differences between parallel and official markets that existed prior to May 1983 had disappeared.

b. Other agricultural products

The production of coffee has stagnated in recent years, and the quality has deteriorated on average. A program to provide productivity improvements over about 70 percent of the coffee-growing area, primarily through improvements in extension services, called Opération café, has been in operation for several years, but it is unlikely that output will increase, and, in any event, an increase in output would be difficult to market. For cotton, the new cotton development program was likely to achieve short- and medium-term results. For other agricultural products, the emphasis has been on overcoming marketing difficulties and solving industry-specific problems. For example, there is a program to improve the sanitary conditions in the slaughterhouses for export quality meat and a possible joint venture with foreign partners to improve technical and financial performance in fishing.

2. The non-agricultural sectors

The current primary objective of industrial policy is increased utilization of existing capacity and the rehabilitation and maintenance of this capacity. In general the authorities view the primary role of industry as a processor of agricultural products and a provider of inputs and incentive goods for agriculture. Industrial activity is generally directed through import and price controls, with decisions on both being made on a case-by-case basis by an interministerial committee. In 1983 priorities were ordered such as to maintaining capacity utilization in higher-priority enterprises while letting others cut back substantially or close. This policy has resulted in some improvement in foreign exchange allocation and, after a fall of 11 percent in 1982, industrial activity is expected to be maintained or to increase slightly in 1983 in spite of lower foreign exchange availability in the latter year.

The transportation sector has been given priority by the authorities in terms of allocations of investment and imports, with about one fifth of the total public investment program for 1982-85 (about US$950 million) allocated to this sector. Energy consumption has been over 60 percent dependent on wood, and efforts have been made toward diversifying energy resources. Hydroelectric power generation rose by about 50 percent in 1982 with the completion of a power project. Also, oil exploration by several foreign corporations has been proceeding, both in the Mozambique channel and on the land, but, so far, there have been no significant exploitable discoveries.

A significant degree of rationalization, employment reduction, and contraction of the activities of the public enterprise sector took place in 1982 and 1983. In particular, the activities and staffing of the state marketing agencies active in agriculture have been curtailed since the May 1983 decree liberalizing rice marketing. Industrial public enterprises appeared to have improved their financial performance, even in the midst of the economic downturn of 1981 and 1982, and in spite of the relatively restrictive foreign exchange allocation, because the price control administration has allowed substantially greater price increases for state enterprises than in previous years. The only major instruments of state intervention in public enterprise operations are import and price controls, in keeping with the stated rationale of preventing abuses of monopoly power, and government policy in 1982 and 1983 has been for public enterprises to be on the same footing as any private company. In keeping with this orientation, public enterprises are generally subject to the same customs and tax treatment as private companies; subsidies on the current operations of commercial activities were sharply reduced in 1982 in the aggregate and were eliminated in 1983. The Government has also begun a case-by-case evaluation of enterprises' financial, managerial, and economic structure.

3. The budget

Budgetary outlays for the whole of 1983 are expected to be slightly higher than the targets set at the time of the mid-term review of the 1982/83 stand-by arrangement (Table 3). Thus, without further measures, the overall deficit is expected to be about FMG 81.9 billion (6.7 percent of estimated GDP), compared to a program target of FMG 76.1 billion (6.2 percent of GDP), and bank finance to the Government to be FMG 37.6 billion (14 percent of the beginning period money supply), compared to a program target of FMG 36.6 billion (13 percent of the beginning period money supply).

With the introduction in January 1983 of a new, centralized expenditure control system, expenditures in the first half of the year were unduly low but are expected to recover in the second half of the year. Under the new system all nonsalary current expenditure commitments and billing are being monitored at the level of the Treasury, and payments are not allowed by the spending ministry until Treasury approval is obtained. This has slowed some legitimate payments but will result in better expenditure control.

Overall revenue is expected to increase 22 percent for the full year (3 percentage points less than programmed), and tax revenue is currently estimated to increase by only 13 percent, with most of the increase coming from indirect taxes. However, there is some uncertainty with regard to the full-year outcome, due to the uncertain timing of the impact of the new indirect taxes, the delays in extending the new system of withholding of company taxes, and the extension of the domestic sales tax to retail establishments. Thirty-one percent of tax revenue stems from import-related taxes, which are expected to rise 21 percent over 1982 as increased tax rates and expanded coverage should make up for declining import levels. Other indirect taxes are expected to increase 21 percent, with 60 percent of the increase coming from increased profits of the state monopoly on the sale of tobacco and alcohol. FNUP receipts are expected to increase by 36 percent over 1982, reflecting the devaluations of May 1982, and February and July 1983. Another source of net nontax revenue or expenditure stems from the Central Bank's rice import operations, whereby the trading profit or loss on imported rice is surrendered to the Government. This operation is expected to continue its record of losses in 1983, despite the cancellation of some shipments of imported rice and large sales from stocks, due to losses on the sale of luxury rice at the price of ordinary rice.

Current budgetary expenditures for the whole of 1983 are expected to increase by 15 percent, declining to about 12 percent of GDP. Personnel and other current expenditures should be held to about the program target, but interest expense will be higher than forecast due to the greater-than-anticipated level of moratorium interest payments

on the rescheduling of external debt. Capital expenditures will be about 11 percent under the program target and only 2 percent over 1982, as this item has borne the major part of the budgetary adjustment. Capital expenditures are expected to be about 21 percent lower in nominal terms than their peak in 1980.

The inventory of domestic arrears as at end-1982 showed that there were no domestic arrears at the level of the Treasury; the arrears were due to spending ministries not presenting bills for payment. The new expenditure control system, which will match bills sent by suppliers with expenditure commitments by spending ministries, should prevent the reaccumulation of domestic arrears. The authorities stated that they would be able to reduce the level of domestic arrears by FMG 10 billion in 1983 and to eliminate them by the end of 1984.

The staff emphasized the importance of achieving the budget targets for 1983 if the momentum of the stabilization policies is to be maintained. This should not require additional tax or expenditure measures but will require maintaining pricing policies to ensure that subsidies to state enterprises do not arise and that the price of imported rice is raised to approximate domestic market levels. This policy would also be desirable so as not to encourage the consumption of imported rice. The staff also suggested that the FNUP and rice operations be separated from the budget, as they are not strictly fiscal operations. The commodity stabilization funds could then be operated outside of the budget to reduce the variance in producer incomes. The rice-import operations cause fluctuations in government net receipts due to changes in ricestocking policy, which is not based on budgetary considerations. Together, the two types of operations are expected to contribute 10 percent of total revenue in 1983.

4. Monetary and credit policy

Since 1982 monetary policy has become more restrictive, accommodating only small increases in economic activity compared to the previous two years. This more restrictive stance was a reflection of and a response to the deterioration in the balance of payments. Even though real economic activity declined and monetary velocity increased, the financial system became highly constrained and increasingly illiquid by the end of 1982.

In the first half of 1983 the liquidity problems of the banking system increased, as deposits declined by almost 7 percent while credit rose by 2 percent. The decline in the availability of financial resources reflected the unexpected worsening in the external arrears situation (domestic deposits are debited by the Central Bank according to the original maturities of external loans) and the strong improvement in the government finances. The reduction in the deposit base and the lack of access to central bank rediscount facilities for all but one

of the commercial banks, when viewed in combination with the relatively illiquid situation of the banks' balance sheets due to the financing of large stocks of cloves, severely limited the ability of the banks to expand credit to the nongovernment economy. In June 1983 the aggregated bank liquid reserves to deposits ratio had declined to 2.8 percent from 5.9 percent at end-1982 and 14.3 percent at end-1981.

The liquidity problems of the banking system were putting in jeopardy the financing of the major summer rice harvest. In April 1983 the Central Bank allowed the agricultural commercial bank to use its rediscount facilities, given the inability of the other banks to supply excess funds in the interbank market. The authorities stated that further borrowing from the Central Bank would be allowed, as well as the reactivation of the interbank market, to meet the temporary credit needs of individual banks. The monetary authorities are currently reassessing the adequacy of institutional arrangements and policy instruments in allocating credit. They will endeavor to expand credit in the second half of 1983 consistent with the need for greater flexibility and taking into account the external situation.

5. The external sector

Discussions on the external sector centered on the difficulties with regard to external debt service, the continued increase in arrears, the potential for exports, and the import program required to support expansion in exports and other economic development. The conclusion of these discussions, which were held within a medium-term perspective of the economy, was that Madagascar would not be able to pay its debt service over the next four years, and provide support for any economic development, without considerable increases in new foreign resources and further debt rescheduling on terms more favorable than those provided in the past.

a. External debt and debt service

The stock of external debt outstanding at end-1982, including arrears was SDR 1.7 billion, or about 66 percent of 1982 GDP. The principal creditors are OECD countries (34 percent of the total), international institutions including the IMF (25 percent), other countries (19 percent) and banks (14 percent). By the end of 1983 this stock is projected to increase to about SDR 2 billion.

Debt service in 1983-87 is shown in Table 6, based on loans contracted through April 1983, after debt reschedulings from the Paris Club through June 1983 and from other official creditors through September 1983, and on the basis of an agreement reached in principle with the London Club group of banks in September 1983. Total debt service on this basis amounts to SDR 129.1 million in 1983, about 38 percent of projected exports of goods and services, and increases by 88 percent to SDR 243.3 million in 1984, about 62 percent of projected exports of goods and services.

Table 6. Madagascar: Projected External Debt Service Payments, 1983-87 1/

(In millions of SDRs) 2/

	1983		1984		1985		1986		1987	
	Am.	Int.	Am.	Int.	Am.	Int.	Am.	Int.	Am.	Int.
OECD countries	30.2	22.9	67.7	39.3	64.6	35.9	65.9	33.2	80.9	26.8
Other countries (including loans for the exceptional financing of the balance of payments) 3/4/	--	--	--	30.5	--	30.5	--	30.5	41.5	30.5
Banks 4/	--	25.4	--	21.8	34.9	19.8	34.9	15.2	34.9	11.5
International organizations	7.9	14.8	31.5	15.4	44.9	14.4	51.9	12.1	44.8	9.2
Of which: IMF 5/	(3.6)	(9.9)	(23.5)	(10.2)	(32.4)	(8.3)	(35.4)	(5.8)	(27.6)	(3.3)
Private non-guaranteed	2.0	0.7	1.8	0.5	1.0	0.4	0.5	0.3	0.8	--
Consolidated arrears	16.4	2.4	22.2	6.2	22.7	3.6	12.9	1.8	3.5	0.4
Short term	--	6.4	--	6.4	--	6.4	--	6.4	--	6.4
Total	56.5	72.6	123.2	120.1	168.1	111.0	166.1	99.5	206.4	84.8
Total debt service	129.1		243.3		279.1		265.6		291.2	

Sources: Data provided by the Malagasy authorities; and staff estimates.

1/ Data cover loans contracted through April 1983, after debt reschedulings from the Paris Club through June 1983, from other official creditors in respect of the total debt outstanding at the end of 1982, and from the London Club group of banks based on an agreement reached in principle and expected to be signed by end-1983.

2/ SDR 1 = FMG 445.8.

3/ Certain Arab and COMECON countries.

4/ Repayments on the basis of rescheduling of total debt (including arrears) outstanding at the end of 1982 referred to in footnote 1.

5/ On the basis of purchases outstanding at present.

b. Other items in the balance of payments

The foreign exchange necessary to pay debt service must be generated from a positive current account balance (excluding interest) and new foreign exchange inflows. In 1983 the projected current account balance, excluding interest, shows a deficit of about SDR 200 million, and new inflows of capital are expected to be SDR 245 million, leaving only about SDR 31 million for debt service. 1/ This compares with scheduled debt service payments in 1983, after rescheduling already obtained, of SDR 129.1 million, of which interest payments are SDR 72.6 million, leaving a gap of SDR 98.6 million.

(1) Exports

In 1983 exports of the three major commodities (coffee, cloves, and vanilla) have been primarily constrained by marketing considerations. The output of those commodities has been maintained over the past three years at levels in excess of exports, and substantial stocks have been accumulated. For coffee, Madagascar is facing the well-known marketing problems of all coffee producers, and substantial growth in exports of coffee is unlikely. Clove production has been maintained, but the authorities indicated that marketing problems in Indonesia, their principal market, will provide the main constraint in the future. In the coming three years the authorities expect that clove sales will decline substantially. Projections of 1983 exports assume 4.5 thousand tons (valued at SDR 32 million) of clove exports to Indonesia, but delays in the agreement may result in these shipments not being completed by the end of the year. Current Indonesian development plans call for virtual self-sufficiency in cloves by 1987. Vanilla, Madagascar's third largest export crop, is also constrained by marketing considerations, and the authorities feel that exports should stabilize around the current level (900-1,000 tons) over the next several years.

Madagascar also produces a variety of other crops with potential for increased exports, among them cotton cloth, meat, and fish. With each of these crops, specific problems have resulted in stagnant or declining exports. In the case of cotton, exports remained about 3,400 tons annually from 1977 through 1982. However, an increase in production, which should lead to a substantial increase in exports, was stimulated in 1983 by an increase in producer prices of over 40 percent over the last two years. The authorities feel that 1984 production could reach 37,000 tons (from 25,000 in 1982), which would save substantially on cotton imports and boost exports of cotton cloth. Another product with great export potential is shrimp, which in 1983 is expected to be the fourth largest agriculturally based export. However, the catch has not increased substantially in the last five

1/ This assumes SDR 12.6 million as negative other items, which are due to delays in surrender of export receipts.

years, in spite of the fact that a larger catch would be within ecological limits, because, at current prices and costs, expansion is not profitable. Meat exports have declined to negligible amounts in 1982 and 1983, from over 5 thousand tons in 1980, as health conditions in the livestock herd and difficulties in the slaughterhouses did not allow production of export standard meat; also, the profitability of exports was not as high as for production for local markets.

The staff felt it was clear that Madagascar had considerable potential for diversified exports, but for this to be achieved more attention should be paid to pricing policies, along with the development policies under way. For meat and fish, inadequate export prices were an impediment to increases in export volume, and in the three traditional export crops, inadequate producer prices were an impediment to improvements in quality. In addition, the timely provision of inputs was crucial and should receive the highest priority in the import program.

(2) Imports

Import policy is aimed primarily at supporting the productive sectors and the consumption of rice. In 1983, in spite of the planned reduction in rice imports, they will amount to about SDR 51.4 million or about 12 percent of total imports. The largest portion of these imports are expected to be on commercial terms. Edible oil is the second largest consumer import in 1983, representing about 5 percent of total imports. The structure of other imports in 1983 is expected to be similar to previous years.

Given the extreme difficulties in the balance of payments over the next two years, imports have had to be cut to the minimum necessary to support production. In this regard, the authorities were commended for the reduction in rice imports in 1983. Given the already high per capita consumption of rice and the likely increase in domestic production due to the liberalization program, further cuts should be possible; the authorities are planning for self-sufficiency in rice within three to four years. Cuts in edible oil and other consumer goods imports should be considered to provide more resources for productive inputs, particularly for the agricultural sector. Also, it would improve the ability of firms and other producers to plan output if import licensing could be done within broad quotas, allowing automatic licensing within the quotas and assuring automatic credit lines for approved imports.

6. The exchange rate

In response to staff suggestions that the exchange rate be used as an active instrument of economic policy, because in certain industries, particularly meat and cotton cloth, there was at present a bias against exports, the Malagasy representatives observed that in the traditional

export industries profitability is adequate in spite of the high implicit rates of taxation of exports. They further felt that improvements in infrastructure, particularly in transportation, along with other investments in export industries and the increased efficiency resulting from the liberalization program, should result in increased profitability of the export sector. Nevertheless the authorities intend to maintain their flexible approach to exchange rate policy as part of their commitment to pricing reform.

V. The Medium Term

The medium term outlook will be dominated by the balance of payments, particularly the likely difficulties of servicing the foreign debt. A projection was made of external debt servicing capacity through 1987 (Table 7). It is clear from the table that there are large balance of payments gaps in each year through 1987. Even in the hypothetical case of rescheduling each year on conventional terms, the debt service ratio increases from 44 percent in 1984 to 57 percent in 1987. The primary reason is that the net impact of rescheduling on conventional terms weakens after consecutive reschedulings as reschedulable amounts decline while moratorium interest payments increase, and repayments of previously rescheduled amounts become due.

VI. Exchange Restrictions

Madagascar avails itself of the transitional arrangements of Article IV, but maintains exchange restrictions under Article VIII, Sections 2 and 3 of the Articles of Agreement. In 1982 and 1983 Madagascar has continued to apply comprehensive exchange restrictions and, as noted above, to build up arrears on current payments. All payments of foreign exchange are controlled through foreign exchange budgets administered by an interministerial committee, the Central Bank and representatives of national banks. Specified limits apply on the sale of foreign exchange for certain invisible payments, such as foreign travel and educational expenses. Foreign workers in Madagascar are allowed to repatriate only fixed percentages of their pay, and there are restrictions on the repatriation of dividends of foreign companies. In addition to the external payment arrears on goods and services and principal on foreign debt, there are arrears on the transfer of dividends abroad and on payments of compensation to foreign firms that have been nationalized.

Regarding the transfer of dividends of foreign companies, the Malagasy representatives said that considerable progress had been made to reduce the backlog of applications which had developed since 1981 and to ensure that future requests will not encounter administrative delays. The transfer of additional amounts of bona fide dividends up to a specified limit will be authorized and effected during the remainder

Table 7. Madagascar: External Debt Servicing Capacity, 1983-87

(In millions of SDRs)

	1983	1984	1985	1986	1987
Exports, f.o.b.	295.7	346.5	363.3	395.9	435.5
Imports, f.o.b.	-371.1	-371.0	-375.2	-393.6	-412.8
A. Trade balance	-75.4	-24.5	-11.9	2.3	22.7
Services and private transfers net (excl. interest)	-126.9	-126.1	-127.1	-133.5	-140.1
B. Current account (excl. interest)	-202.3	-150.6	-139.0	-131.2	-117.4
Public transfers	59.2	62.0	62.0	62.0	62.0
Drawings 1/	186.2	171.4	180.0	189.0	198.4
Other items	-12.6	-2.5	--	--	--
C. Balance available for debt service	30.5	80.3	103.0	119.8	143.0
D. Debt service on basis of current reschedulings thus far obtained	-129.1	-243.3	-279.1	-265.6	-291.2
Amortization	(56.5)	(123.2)	(168.1)	(166.1)	(206.4)
Interest	(72.6)	(120.1)	(111.0)	(99.5)	(84.8)
Remaining gap after D	-98.6	-163.0	-176.1	-145.8	-148.2
E. Debt service if future reschedulings obtained in every year 2/	-94.3	-173.0	-220.3	-232.1	-276.1
Amortization	(33.1)	(70.6)	(95.0)	(105.7)	(152.4)
Interest	(61.2)	(102.4)	(125.3)	(126.4)	(123.7)
Remaining gap after E	-63.8	-92.7	-117.3	-112.3	-133.1
F. Debt service ratio on basis of D	38.0	62.3	68.0	66.0	59.7
G. Debt service ratio on basis of E	27.8	44.3	53.6	52.1	56.6

Source: Data supplied by the Malagasy authorities; and staff estimates.

1/ For 1983 after Donors Club; for subsequent years before Donors Club.
2/ On terms obtained thus far from Paris Club.

of 1983 and in 1984. With respect to other external payment arrears, the Malagasy representatives said that no increase on a net cash basis would be permitted during the last quarter of 1983 and during 1984. At the same time, the authorities would attempt to regularize outstanding external arrears through consolidations to the maximum extent possible. Regarding the approval of foreign exchange in payment for specified essential imports, the Malagasy representatives stated that an automatic allocation of foreign exchange would be put in place before the end of 1983. Moreover, the Malagasy representatives stated that the existing restrictions would continue to be kept under close review and further gradual relaxations would be undertaken as soon as feasible.

In light of the difficult external situation of Madagascar the staff does not feel that it will be possible to eliminate these restrictions before the next consultation with Madagascar.

VII. Staff Appraisal

In 1982, for the second year in succession, Madagascar's real GDP declined and consumer price increases continued at a high level, notwithstanding the fact that the budgetary deficit (a major element of excess demand in the earlier years) as a proportion of GDP was reduced by nearly 40 percent, credit expansion decelerated, and monetary expansion was moderated. The decline in domestic product, and the increase in prices, reflected the continuing serious balance of payments situation that forced the authorities into a further substantial increase in external arrears. The overall balance of payments registered a deficit of SDR 42 million in 1982, or about the same as in 1981, despite a 30 percent reduction in the deficit on the trade balance. Debt service continued to dominate the external payments accounts; despite the second debt rescheduling obtained under the Paris Club and from other official creditors, actual debt servicing (principal and interest) amounted to SDR 127 million, or 37 percent of exports of goods and services in 1982. Prospects are that 1983 would show little progress in terms of growth, although there has been a substantial deceleration in inflation and a further reduction in the budgetary deficit.

Viewed in isolation, therefore, the economic and financial situation in 1982 (and so far in 1983) must be regarded as extremely worrisome. However, when compared with the immediate past, the developments could be viewed with some guarded satisfaction. In the first place, although the authorities had embarked upon an adjustment program since 1980, real progress in implementing those policies was made only in 1982, when the exchange rate was adjusted within the framework of a flexible exchange policy, producer and (subsidized) consumer prices were raised, the domestic pricing and marketing system was liberalized to a degree, budgetary deficits were reduced, and credit expansion was restrained. Although real GDP declined in 1982, the rate of decline was considerably lower than in the previous year, and may be reversed in 1983. The rate of inflation for 1982, although still high, also turned out to be lower than anticipated in the program supported by the stand-by arrangement approved in July 1982, and is expected to be nearly halved in 1983. As mentioned earlier, the trade deficit in 1982 was less than half that in 1980, and is projected to be reduced further by one third in 1983; a similar improvement was also registered in the current account deficit other than interest payments, which in 1982 was two fifths lower than its peak in 1980, and is expected to be reduced further, by nearly one fifth in 1983.

This favorable reversal in trend is attributable to the commendable reorientation of policy embarked upon by the authorities in the context of the 1982/83 stand-by arrangement with the Fund, and with the support and encouragement of the World Bank. The fact that the overall balance of payments has not shown a corresponding improvement is due to the fact that, as a result of the rapid increase in indebtedness in 1979-81,

debt service has increased to the point where it preempts an insupportably large share of the country's foreign exchange earnings. The medium-term outlook for the balance of payments is also overwhelmed by debt service. Even under relatively optimistic projections for exports and the assumption of self-sufficiency in rice by 1987, and assuming debt rescheduling in every year on terms similar to those obtained in the past two years, the debt service ratio would rise to above 50 percent of exports of goods and services, and the balance of payments gap would increase to over SDR 133 million in 1987.

In this situation, the options open to the authorities are extremely limited. The staff feels that two complementary approaches must be made: (1) the policy reforms introduced in 1982 and 1983 should be continued and extended to provide for as much expansion of exports and import-substitution as is practicable, and (2) creditors and donors should be approached for extraordinary help and understanding in resolving the debt problem and in supporting the adjustment efforts of the authorities. The two approaches are complementary in that creditors and donors must be assured of the continued and reinforced implementation of the recently reoriented policy, and that the authorities may not be able to continue this policy reorientation over the medium term without a resolution of the debt problem and without continued exceptional balance of payments financing.

The staff welcomes, as an essential part of the stabilization efforts, the recent liberalization of the pricing and marketing system for domestically produced rice. While the staff recognizes the importance of considerations that initially prompted the authorities not to extend this liberalization to two of the main rice producing areas (the "reserved" areas), it feels that maintaining the marketing monopoly of SOMALAC and FIFABE in these areas is injurious to providing adequate incentives to producers in those areas. The authorities should, therefore, consider extending the marketing reform to these areas, while ensuring that the agricultural development agencies are adequately remunerated for the irrigation and extension services provided by them through user fees and budgetary transfers. This policy should aid in raising domestic production and reducing rice imports. Pricing and marketing liberalization should also be extended to other products, particularly groundnuts, cotton, fish, and meat. This could begin by raising the producer returns for those products and allowing competitive purchasing and distribution without ceilings on prices. The pace of decontrol of industrial prices should also be accelerated and formalized, although prices of specific commodities on a relatively small "negative list" would continue to be controlled.

The recent progress in bringing the budgetary deficits under control must also be maintained. In this context, the staff welcomes the recent tightening of expenditure controls, as well as the compiling of an inventory of domestic arrears and the intention to eliminate these arrears by end-1984, as a further step toward budgetary discipline. Were the authorities to continue to exercise the restraint shown in 1982 and 1983, the budgetary deficit, as a proportion of GDP, could well be reduced by a further 25 percent in 1984--a target the staff would recommend for the preparation of the fiscal targets for that year.

The authorities should also review the existing banking system, where banks are specialized to undertake operations primarily in specified sectors, as to its adequacy in the context of more liberal production and marketing systems. In the meantime, the monetary authorities must ensure that the credit needs of the revived private commercial and productive sectors are adequately met; the insufficient liquidity of the agricultural commercial bank at the beginning of the 1983 rice marketing season (the first season under liberalized marketing and no fixed producer and consumer prices) is indicative of the risks that the system could be subjected to if proper vigilance is not exercised. The present shortage of liquidity of the banking system as a whole is largely attributable to the large deficit in the balance of payments, but it could be in part alleviated by a further substantial increase in interest rates, which remain highly negative in real terms. Finally, in the monetary sector, large inaccuracies in the statistical base have recently been identified for the foreign liabilities, including arrears, and a corrected base established for the monetary data. The authorities should endeavor to keep the series accurate and, in that respect, the system of reporting from commercial banks should be improved and better coordinated with the import and foreign payments system.

The recent improvement in the financial situation is at least partially attributable to the pragmatic policy adopted by the authorities in respect of the exchange rate. The staff believes that, given the magnitude of the balance of payments problem, and given that Madagascar has a potential in developing several nontraditional exports, the exchange rate should be used as an active policy to maintain the country's competitiveness in the international markets and to provide adequate incentives for producers to expand in those markets.

The continued maintenance of comprehensive exchange restrictions has been necessitated by the critical balance of payments situation. Nevertheless, a modest liberalization of payments for essential imports is being effected before the end of 1983. Moreover, the authorities have indicated their intention to keep the restrictive system under review and to reduce dependence on these restrictions progressively. In view of the above, the staff recommends approval of the restrictions maintained by Madagascar on payments and transfers for current international transactions.

VIII. Proposed Decision

The following draft decision is proposed for adoption by the Executive Board:

1. The Fund takes this decision in concluding the 1983 Article XIV consultation with Madagascar in light of the 1983 Article IV consultation with Madagascar conducted under Decision No. 5392-(77/63), adopted April 29, 1977 ("Surveillance over Exchange Rate Policies").

2. Madagascar maintains restrictions on payments and transfers for current international transactions as described in EBS/83/235 and in SM/83/ . The Fund notes the intention of the authorities to remove these restrictions as soon as possible. In the meantime, the Fund grants approval for their retention until October 31, 1984 or the completion of the 1984 Article IV consultation with Madagascar, whichever is earlier.

MADAGASCAR - Relations with the Fund

(As of September 31, 1983)

Date of membership:	September 23, 1963
Quota:	SDR 51 million
Proposed quota 8th review:	SDR 66.4 million. Madagascar has consented to the increase in its quota and made arrangements, for paying the increase at subscription.
Fund holdings of Malagasy francs.	SDR 187.7 million, or 368.1 percent of quota, including compensatory financing purchases of SDR 51.0 million (100 percent of quota) and purchases under tranche policies, including supplementary financing of SDR 22.2 million and enlarged access of SDR 20.5 million. Excluding holdings under the CFF, the Fund's holdings are the equivalent of 268.1 percent of quota .
SDR position:	Holdings amount to SDR 24,622 (or 0.13 percent of net cumulative allocation of SDR 19.27 million).
Trust Fund loan disbursements:	
First period:	SDR 10.78 million
Second period:	SDR 14.63 million
Direct distribution of profits from gold sales:	
First period:	US$1.16 million
Second period:	US$2.97 million
Gold distribution:	22,252.0 fine ounces

Exchange rate system:	The Malagasy franc is pegged to a basket of currencies with weights based on the pattern of trade. SDR 1 = FMG 461.8 (August 31, 1983).
Intervention currency:	There is no single intervention currency.
Staff contacts:	The mid-term review (EBS/83/55) of the stand-by arrangement that expired on July 8, 1983 was completed on April 8, 1983. Staff visits to Antananarivo took place in mid-May and late-August 1983, and the 1983 Article IV consultation discussions were held from mid-July to early August 1983. A Malagasy delegation visited headquarters in early September 1983 for a financial program to be supported by a new stand-by arrangement.

Table 1. Madagascar: Selected Economic and Financial Indicators, 1980-83

	1980	1981	1982		1983	
	Actual	Actual	Prog.	Actual	Prog.	Est.
	(Annual per cent changes, unless otherwise specified)					
National income and prices						
GDP at constant prices	0.8	-9.2	0.9	-1.1	1.0	1.6
GDP deflator	15.1	25.2	35.2	28.3	24.7	20.3
Consumer prices 1/	17.1	29.0	51.0	31.2	25.1	23.0
External sector (on the basis of SDRs)						
Exports, f.o.b.	9.8	-18.2	10.1	8.8	6.3	-0.7
Imports, c.i.f.	14.5	-28.8	10.9	-4.4	-4.6	-9.9
Non-oil imports, c.i.f.	8.6	-29.1	11.8	-16.1	-9.8	-15.0
Export volume	-1.6	-26.6	3.0	2.3	3.9	-0.6
Import volume	-1.0	-39.5	8.7	-6.5	-2.7	-5.3
Terms of trade (deterioration -)	-6.9	-3.7	6.0	3.8	2.0	3.7
Nominal effective exchange rate (depreciation -)	-5.6	-8.8	-15.5	-18.1	...	...
Real effective exchange rate (depreciation -)	4.1	4.7	...	-0.8	...	...
Government finance						
Total revenue and grants	7.8	-3.0	31.8	27.0	18.6	22.3
Total expenditure	28.7	-6.0	13.4	1.7	7.2	12.1
Money and credit						
Domestic credit	48.2	22.5	20.1	16.6	16.3	17.0
Government	77.4	34.1	14.9	14.4	13.6	14.0
Private sector	25.1	9.0	27.5	19.8	20.1	22.0
Money and quasi-money (M_2)	19.0	21.4	26.2	10.2	23.3	14.0
Velocity (GDP relative to M_2)	3.3	3.1	3.5	3.8	3.7	4.1
Interest rate (annual rate, one-year savings deposit)	5.65	6.75	10.50	10.50	12.50	12.50
	(In per cent of GDP)					
Overall government savings	-2.8	-3.1	-0.9	-1.4	0.2	-0.7
Overall government financial deficit	-18.4	-14.7	-10.8	-8.8	-6.0	-6.7
Domestic bank financing	11.4	7.4	3.5	3.4	2.9	3.1
Foreign financing (net)	6.9	7.1	6.8	5.1	3.2	3.6
Gross domestic investment	23.4	18.1	18.3	13.7	12.9	11.8
Gross domestic savings	6.9	7.0	7.2	4.3	6.0	4.5
Current account deficit	-18.5	-14.4*	-14.9*	-12.2*	-9.0* 3/	10.4* 3/
External debt						
Inclusive of use of Fund credit	35.6	53.3 4/	50.1 5/	58.5 5/	...	69.2
Debt service ratio (in per cent of exports of goods and services)	14.5	36.3 4/	54.3 5/	36.5 4/	...	37.9 6/
Interest payments (in per cent of exports of goods and services)	7.9	15.7 4/	18.4 5/	17.2 4/	...	21.3 6/

1/ CPI index for Antananarivo, including officially controlled prices.
2/ * indicates severe constraint on foreign exchange availability.
3/ After debt rescheduling already obtained from the Paris Club through June 1983 and excluding penalty interest on arrears outstanding to banks, which are in the process of being rescheduled.
4/ After debt rescheduling, but excluding arrears.
5/ After debt rescheduling already obtained from the Paris Club, through June 1982, but excluding arrears.
6/ On the basis of debt relief thus far obtained in 1983 from Paris Club I and II, the London Club and other creditors.

MADAGASCAR - Relations with the World Bank Group

(In millions of U.S. dollars)

Amounts outstanding as of June 30, 1983	Disbursed	Undis- bursed	Total commitments
Completed projects	112.1	--	112.1
IBRD	32.6		32.6
IDA	79.5		79.5
Projects in execution (IDA)	122.98	193.28	316.10
Forestry	2.09	17.91	20.00
Agriculture and rural development	19.98	54.12	74.10
Education	14.27	11.23	25.50
Energy, power, and utilities	50.37	37.13	87.50
Transportation	34.15	69.85	104.00
Industry and tourism	1.96	3.04	5.00
Total	234.92	193.28	428.20
IBRD	32.6	--	32.6
IDA	202.32	193.28	395.60
Repayments			10.77
IBRD			2.53
IDA			8.24
Debt outstanding (including undisbursed)			419.25
IBRD			30.04
IDA			389.21
IFC investments			19.98

Source: World Bank.