Files

NOT FOR PUBLIC USE

#12

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 71/79

10:00 a.m., July 30, 1971

P.-P. Schweitzer, Chairman

Executive Directors	Alternate Executive Directors
L. B. Brand	P. van S. Smit
E. Brofoss	
W. B. Dale	C. R. Harley
	M. Al-Atrash
	N. H. Hanh
R. Johnstone	D. O. Mills
	E. da S. Gomes
B. Kharmawan	
P. Lieftinck	T. de Vries
	R. H. Arriazu
	R. H. Gilchrist
M. P. Omwony	
F. Palamenghi-Crispi	
P. S. N. Prasad	S. S. Marathe
	L. Fuenfgelt
H. Suzuki	K. Satow
L. Ugueto	
A. van Campenhout	H. G. Schneider
M. Viénot	C. Beaurain
	L. M. Rajaobelina

W. L. Hebbard, Secretary
A. R. Helm, Assistant

1. Approval of Minutes . . . . Page 3
2. Yugoslavia - 1971 Article XIV Consultation and Stand-By Arrangement . . . . Page 3
3. Malaysia - 1971 Article VIII Consultation; Purchase Transaction - Tin Buffer Stock Financing . . . . Page 18
4. Exchange Rate Flexibility . . . . Page 33

Also Present

V. Ceric, Alternate Executive Director, IBRD. Administration Department: T. Cole. African Department: M. Touré, Director. Asian Department: D. S. Savkar, Director; W. J. R. Woodley, Deputy Director; A. G. Chandavarkar, R. J. Niebuhr, S. A. Pandit, K. Suzuki, M. Yoshitomi. European Department: L. A. Whittome, Director; P. Høst-Madsen, Deputy Director; R. Evensen, C.-H. Trettner, G. Tyler. Exchange and Trade Relations Department: E. Sturc, Director; D. K. Palmer, Deputy Director; G. H. Jewayni, S. Makdisi, S. Mookerjee, M. O. Tyler. Fiscal Affairs Department: J. Saper, Deputy Director; W. A. Beveridge. Legal Department: J. Gold, General Counsel and Director; G. P. Nicoletopoulos, Deputy General Counsel; N. S. N. Chari, J. G. Evans, P. R. Lachman, J. V. Surr. Research Department: J. J. Polak, Economic Counsellor and Director; J. M. Fleming, Deputy Director; C. F. Schwartz, Deputy Director; C. M. Browne, F. Hirsch, N. M. Kaibni, R. R. Rhomberg, P. Salin, S. S. Tarapore. Treasurer's Department: W. O. Habermeier, Treasurer. Western Hemisphere Department: S. T. Beza. Information Office: D. Armour, L. R. Azócar. Personal Assistant to the Managing Director: L. F. T. Smith. Technical Assistants to Executive Directors: V. Barattieri, J. M. Chona, A. Doizé, B. P. Eap, F. García-Palacios, L. Halfmann, P. C. Hayward, B. M. F. Hazenberg, F. K. Hussein, E. Leung, R. W. Ley, H. Oyarzábal, A. Pipino, H. Rudloff, A. Seminario, E. W. Shann, N. Tsukagoshi, J. R. Vallet.

1. APPROVAL OF MINUTES

The draft minutes of Meetings 71/68 and 71/71 were approved.

2. YUGOSLAVIA - 1971 ARTICLE XIV CONSULTATION AND STAND-BY ARRANGEMENT

The Executive Board discussed the staff report and a proposed decision for the 1971 Article XIV consultation with Yugoslavia (SM/71/186, 7/16/71) and a request from Yugoslavia for a stand-by arrangement in an amount equivalent to $83.5 million for a period of one year, together with the staff's analysis and recommendation that the Fund agree to the request and grant any necessary waiver of the conditions of Article V, Section 3(a)(iii) of the Articles of Agreement (EBS/71/196, 7/16/71). It also had before it a report on recent economic developments in Yugoslavia (SM/71/183, 7/19/71).

The Chairman said that Mr. Vladimir Ceric, the Alternate Executive Director representing Yugoslavia in the IBRD, would be present for the discussion on Yugoslavia.

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

> The following additional information regarding the new measures recently introduced in Yugoslavia has been gleaned from a press report:
>
> a. A tax of 30 per cent is being imposed on all investment other than by productive enterprises.
>
> b. Consumer credits, which are based on savings deposits of households, are not to exceed 60 per cent of the total of such deposits. Previously, this ratio was 80 per cent. No consumer credits can be given for the purchase of construction materials for building villas or imported automobiles.
>
> c. Imports of consumer goods by enterprises are to be cut by 50 per cent. It also appears that imports of consumer goods will be linked to export performance. Imports of passenger cars by economic organizations and institutions are to be banned.
>
> The latest data on international reserves shows that at the end of June they totaled $203 million, which represents an increase of $30 million during the month.

Continuing, the staff representative said that a new Yugoslav Government had recently been formally installed and at that time the Prime Minister had announced measures which had been aimed at correcting the economic situation and which had made provision for sanctions to be applied to those who did not follow the regulations. It was not clear whether the additional information concerned measures supplementary to those that had been announced a few days previously, or whether it merely gave publicity to them.

Mr. Lieftinck made the following statement:

The Yugoslav authorities are most grateful to the Fund mission for their excellent report and concur with the proposed decision.

Economic conditions in Yugoslavia were dominated in 1970 mainly by four factors: (1) a sharp decline in agricultural output of 8 per cent depressing exports and requiring unusually large imports of food products; (2) a large increase in industrial production of 9 per cent led by an acceleration of fixed investments to 18 per cent in real terms; (3) a continued sharp rise in personal incomes in the socialized sector by 21 per cent, resulting in an increase of private consumption of 6.5 per cent in real terms and a rise in unit labor cost in industry by 11-12 per cent; (4) increasing devaluation expectations (in the second half of the year) which added to the demand for imports and caused some holding back of exports.

The unbalance that developed is demonstrated by the fact that whereas total output increased by 5.1 per cent, real domestic expenditure (excluding inventory investment which on the whole declined) rose by 10 per cent. Producers' prices of agricultural goods and of industrial goods rose by 15 and 10.2 per cent, respectively, and retail prices by 9.6 per cent. Exports increased by almost 14 per cent (in value) but imports by an unprecedented 35 per cent. The trade deficit widened from $660 million in 1969 to almost $1.2 billion in 1970. The impressive performance of services and transfers leaving a net income of over $800 million, together with net capital imports of $290 million, kept the overall balance of payments deficit down to about $100 million.

Following the "holding" measures taken in October 1970, the authorities decided in January of this year to devalue the dinar and introduced a stabilization program in support of which a stand-by in the first credit tranche was granted by the Fund last February. For a brief summary of the action taken I may refer to the first paragraph on page 2 of the present consultation report (SM/71/186), together with my introductory statements made in the Executive Board meetings of January 2 and February 19, 1971. Although the measures taken constituted a reasonable effort to contain the inflationary pressures that prevailed and were building up in 1970, the staff is right that in early 1971 developments turned out to be less favorable than the authorities had hoped, and at this time the need for additional action is fully recognized.

According to the latest information, the main indices of economic developments in the first six months of 1971 compared with the first six months of last year are the following. Industrial production increased by 12 per cent; fixed investments, however, declined by 1 per cent at constant prices. Personal incomes rose by 26 per cent, even more than in 1970. The money supply increased by 14 per cent (in the course of the first five months) and retail prices rose by 13 per cent. Exports declined by 1 per cent and imports rose by 33 per cent. The trade deficit climbed to almost $850 million (compared to $440 million in the first half of last year). It should be noted, however, that the import figure is inflated by large agricultural imports continuing in early 1971 and intense speculation preceding the devaluation.

All available evidence indicates a record agricultural crop for both wheat and corn this year which should not fail to have a favorable effect on the balance of trade and a stabilizing impact on food prices. Also encouraging is the apparent decrease in investment expenditures, particularly pronounced in the last two months and likely to continue. In the field of personal consumption no deceleration is yet discernible, but the authorities expect that the implementation of new measures will have positive effects. On July 23 the Federal Executive Council adopted a further extensive program of measures aiming at slowing down production and most forms of consumption. These measures include restrictions on new investments in nonproductive and noneconomic activities, a substantial decrease of consumer credits and new taxes on certain consumption goods. Further measures are aiming at more credit restraint and savings of foreign exchange to improve the balance of payments. Legal procedures for implementing this program are underway.

Against this background I warmly recommend Board approval of Yugoslavia's request for the cancellation of the current stand-by arrangement under which $21.75 million is still available, and the granting of a new stand-by in the amount of $83.50 million covering the remaining part of the first, and the second credit tranche. The letter of intent attached to the request describes the monetary, fiscal, and incomes policies which the authorities have decided to implement, the measures that have been taken in the field of foreign debt management and their commitments with respect to restrictions on trade and payments for current international transactions, multiple currency practices, and bilateralism. The proposed stand-by arrangement contains a number of safeguards in the form of performance criteria and phasing. I share the view of the staff that in conjunction with the recent devaluation the program described in the letter of intent should help to restore equilibrium in the balance of payments within the stand-by period and meets the conditions for Fund assistance reaching in the higher credit tranches.

Mr. Dale said that the evolutionary process through which Yugoslavia was moving was complex and involved great changes, which extended into institutional and legal spheres, as well as into economic areas. Those factors made it difficult to evaluate the present and the prospective situation, but they also made it appropriate--in part because of the past record of the authorities--to view events with some sympathy. Clearly, until recently the strength of the boom conditions in the country had been much greater than the authorities had recognized and as a result it was appropriate to establish a new, more detailed, and strengthened program for stabilization. Thus, there was a justification for cancelling the existing stand-by arrangement and replacing it by a larger one extending into the second credit tranche. He agreed with the general tone of urgency about the economic situation set forth in the staff appraisal, for it indicated the importance of cooling off the economy, of moderating the very rapid rate of advance in incomes, and of bringing about a lasting improvement in the balance of payments. With respect to the external sector, it was welcome that the most recent information indicated that improvement in the trade field had at last begun to occur.

The staff's view that monetary policy was the most important single element in the stabilization program was correct, Mr. Dale noted. The very tight monetary policy that the authorities were going to follow would do much to slow the economy down and to improve the allocation of resources. Mr. Lieftinck had indicated that there had been a clear downturn in fixed investment in the first half of 1971, following a very rapid expansion in 1970. That downturn provided evidence that monetary policy was becoming effective. The registration and control of foreign debt was another area of considerable importance. The actions of the authorities in that field were very helpful. Paragraph 11 of the letter of intent contained some qualifying phrases that conveyed the impression that there was room for increasing the level of foreign debt because some categories would be carefully controlled. That was important because, in support of the Yugoslav stabilization effort, some countries--among them the United States--were ready to offer debt relief if they were satisfied that their offers would be adequately protected by new debt controls. It was important to strengthen the reporting and control mechanisms in the light of the authorities' assumption that foreign indebtedness would increase in 1972. That was one of several areas in which the mid-term review under the stand-by arrangement, scheduled for December 1971, was of special importance. The need to strengthen policies in 1972 would of course depend upon the results obtained in the second half of 1971.

In conclusion, Mr. Dale welcomed the plans for further import liberalization. The staff had indicated that it was confident that the authorities would take action in that respect by the beginning of 1972. Liberalization was another matter that would be discussed no doubt, at the time of the mid-term review. He fully supported the proposed decision and the stand-by arrangement, and conveyed good wishes to the Yugoslav authorities.

Mr. Gilchrist said that he fully supported the proposed stand-by arrangement and the proposed decision in SM/71/186. Events, particularly those concerning foreign trade, prices, and wages in 1970 and in the first half of 1971, had been disappointing to the Yugoslav authorities. With respect to visible trade, it was not so much the higher level of imports which was disquieting, because there had been special agricultural reasons; rather it was the stagnation of exports in the first half of 1971. In 1970 there had been a decline in net tourist receipts and he hoped that that occurrence would not be repeated; it was a most unfortunate development which had come after the great efforts which the Yugoslav authorities had made in promoting their tourist industry. Taking the most optimistic balance of payments forecasts for 1971, it was clear that an increase in external borrowing would be necessary.

Turning to the structure of the Yugoslav economy, Mr. Gilchrist said that the deterrents against increases in incomes did not seem to have worked very well. The picture seemed somewhat involved: on the one hand, direct control did not appear to work and on the other hand, indirect levers did not seem to have enough effect. He wondered whether the time had come to impose a more progressive form of direct taxation on incomes. While he was not sure what the effects of such a tax would be, it might help deter excessive wage awards. There was also the problem of the growing volume of emigrants' remittances. A direct tax on incomes might help to deal with additions to household incomes in the form of remittances. However, there were perhaps strong social and political reasons why direct taxation could only be a small, and not an important, element in government revenues. Another structural difficulty seemed to exist in the banking system. Page 49 of SM/71/183 indicated that the banking system had been under very heavy pressure and it looked as though that would continue. The business banks had been able to borrow heavily from the National Bank, though he was not sure whether that borrowing had been excessive in the light of recent circumstances. At the same time, it had to be recognized that economic enterprises had also been able to borrow from the business banks. Many of the authorities' new economic measures depended upon the responsibility of the banking system for their success. Those measures concerned not only the current attempt to implement a restrictive monetary policy but also, in certain detailed aspects, the attempt to hold down excessive wage awards by a new system of regimentation in which the enterprises would not be allowed to offer wage awards unless they possessed the necessary resources, which were also the responsibility of the business banks. In addition, as the importance of the republics and the local governments increased through their rising command over extrabudgetary funds, the responsibilities of the local banking system would increase. The credit machinery that existed between the banking system and the republics and the local governments would require a good deal of attention during the period of institutional change. In SM/71/183 the staff had made the comment that it was possible that some of the monetary controls might no longer be a federal matter.

Perhpas what the staff had meant by that was that the responsibility would still be on a federal level but that the implementation of controls would be at a local level. If that was so, it was somewhat alarming.

With respect to the new stand-by program, Mr. Gilchrist particularly welcomed the proposed attempts to curb excessive investment expenditure, as well as to obtain a better control over external borrowing. Those measures were very important and required vigorous implementation. It would also be useful to know whether measures were being taken to regulate the volume of export credits which the authorities were granting. While that point had been raised in the past, he was mindful of the basic dilemma that a country could be in: borrowing expensively in the short term and medium term and lending at relatively cheap interest rates in the longer term. It had to be asked whether such a policy was sensible in the light of a poor overall balance of payments position. Though the net outflow of export credits had been reduced to $50 million in 1970, it was forecast to rise to $116 million in 1971. Therefore, he asked whether the measures that were being implemented to control external borrowing were likely to be matched by any system of control over the volume of export credits which were being granted. The performance criteria, as set forth in EBS/71/196, had been very well chosen and concerned areas in which the Yugoslav authorities could have an active influence. He shared Mr. Dale's view that the mid-term review at the end of 1971 would be useful and that there would then be a possibility of adapting old or introducing new policies to ensure the success of the stabilization program in 1972. The mid-term review was an important feature of the stand-by arrangement.

In conclusion, Mr. Gilchrist paid tribute to two encouraging aspects of policies adopted by the Yugoslav authorities. In the first place, progress had been made in the area of trade liberalization and in the authorities' determination to continue that policy. In the second place, progress in terminating bilateral payments agreements was useful and, although the termination of those agreements had been receiving less attention in the Executive Board than it had done in previous years, it was, nevertheless, important for Fund members to continue efforts in that direction.

Miss Fuenfgelt felt that post-devaluation developments in Yugoslavia had generally been rather disappointing. In comparison with 1970, personal incomes and prices had further increased at an alarming rate in the first half of 1971, and there was little evidence of an improvement in the situation. The Government had firmly declared its willingness to cope with inflationary tendencies and with balance of payments problems, which had at least been partly the direct result of excess demand and the inflationary expansion in the country. Thus, the balance of payments problems could only be solved by tackling the internal sector. There was not much evidence that the effects of either past or prospective stabilization measures would show beneficial effects in the very near future and that by the end of 1971 the stance of economic policy could be turned around.

The new stabilization program would, therefore, be the start of a somewhat longer-term effort aimed at attaining stability. The targets of the stabilization programs had been well chosen by the Yugoslav authorities. They aimed at putting a brake on the continuing fast rate of increases in wages and personal incomes and bringing credit expansion under better control than it had been in the past. In the incomes field, the authorities had taken legal measures both on the federal and on the republic levels to set limits on expansion. The staff had not passed a very clear judgment as to whether it agreed or not with the Yugoslav view that the limitation of 11 per cent, by which personal incomes during the first four months of 1971 should not exceed the average level of 1970, had been broadly observed. The latest figures contained in Mr. Lieftinck's statement indicated that, with a rise of 26 per cent in personal incomes during the first six months of 1971, the intentions of the Yugoslav Government had not met with very much success. To a large extent, difficulties were the result of the fact that autonomous regional entities tended to follow their own interests. As the republics had their own legal procedures, it was to be hoped that the enforcement of the laws governing the incomes policy would be made more effective. The formula under which personal incomes during 1970 had not been supposed to increase by more than the increase in the net receipts per employee in an organization was an interesting one. She was not entirely clear as to what that formula in fact implied. She asked what was the meaning of the term "net receipts per employee" and especially what was the extent to which provisions for investment needs were net under that formula? She also asked whether net receipts were net of any depreciation allowance, if not, what percentage was allowable as depreciation.

Continuing, Miss Fuenfgelt said that she had been puzzled by the very heavy cuts envisaged in the stabilization program in the field of investment expenditure. The reduction in the increase in real fixed investment in the economy, from 18 per cent in 1970 to an estimated 7 per cent in 1971, was somewhat surprising in a country that still had much room for the development of productive capacity and for diversification. Even if unproductive investment had been made in the past, it was to be wondered whether the burden of economic adjustment had not been placed too much on investment instaed of on consumption. She had the impression that more should and could be done by the authorities to restrain consumption. The new measures that had been taken to limit consumer credits might improve the situation, but it was to be doubted whether they would completely solve the problem because there were difficulties, in enforcing a coordinated policy in the incomes field, and with respect to the decentralization of fiscal matters. She agreed with the staff's judgment that the success of the authorities' stabilization efforts would depend mainly upon monetary and credit policies. The assurances given in the letter of intent that the authorities wished to restrain credit expansion, both on short-term and on investment credits, were encouraging. But it would not be easy to fulfill those assurances. The increase in money supply during the first five months of 1971 had been 14 per cent compared with the same period in 1970, a figure well above the target of 10 per cent for 1971 as a whole. Investment credits as of March 1971 had been 27 per cent higher than a year previously while the target for 1971 as a whole was only 15 per cent. In appraising the effectiveness of monetary policy, the staff seemed to have given little attention to the impact of the increases in the foreign indebtedness of banks and nonbanks on domestic monetary expansion. That indebtedness might completely neutralize any restrictive measures imposed by the National Bank; in effect that indebtedness had largely done just that in the past. The intention of the National Bank to improve the mechanism of debt reporting and control of foreign credits was welcome from that point of view, as well as from the point of view of foreign indebtedness itself.

Finally, Miss Fuenfgelt said that, in spite of all the questions she had raised, she was prepared fully to support the proposed stand-by arrangement because the performance targets were reasonable and because, it was to be hoped, the Government's stabilization efforts would be helped by financial assistance and by the setting of performance criteria. She extended her best wishes to the Yugoslav authorities and hoped that they would be able to implement the new program and meet the performance criteria.

Mr. Viénot indicated that his authorities fully supported the Yugoslav request for a new stand-by arrangement. On the assumption that the policies and the intentions which had been described in the letter of intent were firmly implemented, there was little doubt that the proposed program would bring about the needed improvement in the economy, especially in the balance of payments. He was looking forward to the mid-term review of the economic situation which was to occur before the end of 1971. In the meantime, he asked Mr. Lieftinck to convey to the Yugoslav authorities his best wishes in their endeavors.

Mr. Smit noted that both the staff report and particularly Mr. Lieftinck's statement made it clear that the Yugoslav authorities were facing a very difficult situation. Those of his authorities who had expressed their views supported the proposed stand-by arrangement. His authorities had the impression that the Yugoslav authorities had taken additional measures on or before July 29, among which had been the freeing of the exchange rate for the dinar, which subsequently was to have been established on the basis of international market rates. His authorities wondered what that meant in terms of the movement of the exchange rate for the dinar in relation to margins around parity. While the staff had indicated that they had no immediate information, he would be grateful if it could find out what had occurred. He conveyed the best wishes of his authorities to the Yugoslav authorities in their efforts to improve their situation.

The staff representative from the European Department noted that Mr. Gilchrist had asked a question concerning tourism. It was certainly true that in 1970, for the first time, net receipts from tourism had declined. Table 49 on page 80 of SM/70/183 set forth gross receipts and expenditures from tourism for the years 1967 to 1971 inclusive, and it was evident from that table that the main element that had caused a decline in 1970 had been a very substantial rise in expenditures on foreign tourism by Yugoslavs. That situation was not expected to be repeated in 1971. It had seemed to the staff that that large increase in expenditure might have been associated with a certain degree of speculation against the dinar because in the second half of 1970 it had been widely believed in Yugoslavia that a devaluation might occur in the not too distant future. The Yugoslav authorities had not fully agreed with the staff's view; they had thought that some of those expenditures might have been related to capital outflows, but they had felt that the increase was a once-and-for-all change and that it was mainly due to easier access to foreign exchange on the part of Yugoslavs travelling outside the country. Therefore, the authorities thought that, despite the large increase between 1969 and 1970, tourist expenditure abroad would tend to stabilize at about the 1971 level.

With regard to the question concerning taxation of personal incomes, the staff representative explained that the present situation was that although there was no direct income tax in the strict sense paid by workers in the socialized sector, there was a tax on income payments by enterprises, paid directly by the latter. This was not, however, a progressive tax. As far as changing the taxation system was concerned, most people would probably agree that a degree of progression, whether in the form of a direct tax or in the existing form of a tax paid by enterprises, would be desirable. But the Yugoslav authorities did not feel that it was politically possible to institute a new tax system at the present time. The staff certainly agreed with Mr. Gilchrist that the banking system faced a very difficult task indeed. Not only did Yugoslavia have a semi-federal system of banking, but also, to a large extent, economic management, by necessity, rested in the hands of the banking system. The fact that budgets were seldom used to any extent to provide anticyclical measures meant that there was a burden on the banking system, as did the inefficacity of incomes policy.

Concerning Mr. Gilchrist's question about access to the National Bank by business banks, the staff representative said that during the past 12 months, a period in which monetary policy should have been tight, to quite a large extent the business banks had been able to gain access to the resources of the National Bank. There were two main reasons why that had occurred. In the first place, special forms of rediscounting, which related, for example, to export credits and to agriculture, lay outside the normal ceilings established by the National Bank. In the second place, during 1970 and at the beginning of 1971 the National Bank had provided resources to the banking system in connection with earthquake and flood relief.

Turning to the question of the decentralization of the banking system, the staff representative observed that in the formal sense the new system, as described in SM/71/183, would be based upon independent national banks in each of the six republics and in each of the two autonomous regions. Those banks would replace the existing branches of the Federal National Bank and they would formally become national banks in their own right. However, the general determination of monetary policy would continue to lie in the hands of the Federal National Bank, and its policymaking would be under the control of a Board, which would consist of the chairmen of the individual national banks in the six republics and in the two autonomous provinces and of the Governor of the Federal National Bank. Thus, it would certainly be true to say, at least in the formal sense, that the individual national banks would have a say in overall monetary policymaking. The extent to which that would make life more difficult for the Federal National Bank would of course be a matter for the future. The individual republics had always been able to make known their wishes in the field of monetary policy, even though that policy had strictly been under the control of the Federal National Bank and the Federal Government. The extent to which the change to the new monetary system would strengthen the hands of the individual republics and the extent to which they would use that additional power to influence matters to their own interest as against the national interest could only be determined in the future. Clearly, the position of the federal authorities would be made more difficult.

Turning to the question of export credits extended by Yugoslavia, the staff representative noted that Table 51 on page 82 of SM/71/183 set forth data concerning new credits, repayments, and net outflows. Repayments had been relatively stable in recent years and were expected to be similar in 1971. The main change in the net outflow trend had occurred in 1970 due to a decline in new credits granted. The attitude of the Yugoslav authorities with respect to export credits had been discussed in the Board on previous occasions. Basically, they believed that by extending those credits, Yugoslavia would obtain a foothold in markets, many of which were in developing countries, which would become important to it in the future. That policy allowed Yugoslavia to establish abroad its construction industry, which was quite efficient, and to export a large number of ships. It was certainly true that net capital inflows were lessened because of the supply of that amount of credit. On the other hand, the Yugoslav authorities might well argue that if they did not supply credit their exports would diminish correspondingly. Steps had been taken to try to obtain cash payments, but the fact remained that Yugoslavia had to provide credit, otherwise exports to those areas would not be made at all.

Miss Fuenfgelt had asked whether the 11 per cent limitation on personal incomes which had been established for the first four months of 1971 had been observed, the staff representative recalled. When the staff had been in Yugoslavia, information regarding personal incomes had not been available and therefore there had been no indication whether or not there had been a precise observance of that limit. The Yugoslav officials had believed that the 11 per cent limitation had been broadly observed. The view of the staff was that if a judgment had to be made on the basis of trends in the months for which information was available, increases in personal incomes had exceeded the 11 per cent level. With regard to the new system of determining the permissible increases in personal income payments, under the new Constitution there were provisions setting out broad principles, but, as might be expected, they were expressed quite generally and it was not as yet possible to know how they would be interpreted in detail. Further, the laws of the republics which would govern that area had not yet all been passed; but, as the staff understood it, the main mechanism would broadly be that first of all it would be necessary for an economic enterprise to pay specific amounts of money from its gross receipts into various funds, such as reserve funds and deprecation allowance funds. Once those payments had been determined, some money would remain which could either be distributed into funds for investment purposes, other than depreciation funds, or distributed in the form of personal incomes. The authorities apparently believed that if it were not possible to increase personal income payments at a rate greater than the amount of money available after other payments had been determined, a limit would be set on the extent to which economic organizations could increase wages. In the past, those organizations had been increasing personal income payments at a rate greater than the level currently envisaged. Obviously, economic organizations had been able to do so either by increasing their debt or by limiting the amount that they had put aside for future investment. It was clear that the new mechanism would only be effective if there were stable prices inside the country and its effectiveness would therefore depend upon appropriate demand management. The staff had found it rather disappointing that the explicit connection between productivity and wage increases was not included in the basic constitutional provisions.

Turning to the question concerning the rate of investment, the staff representative said that there was expected to be a smaller increase in real gross fixed investment in 1971 than had occurred in previous years. However, Table 1 on page 3 of SM/71/186 indicated that there had been a very substantial increase in investment in the past three years. In 1968 gross fixed investment in real terms had been more than 19 per cent higher than it had been in 1967. In 1969 the increase had been 10 per cent higher than in 1968, and in 1970 the increase had been 18 per cent higher than in 1969. In each of those years, except 1967, the rate of increase of fixed investment had been considerably higher than had been the rate of increase in either public consumption or personal consumption. Of course, it was true that the large increase in investment in 1968 had taken place after a very depressed level had been recorded in 1967. Nevertheless, there had been a fairly substantial amount of investment between 1967 and 1970. If the 7 per cent rate were reached in 1971, it would be matched by a similar increase in personal consumption but by no increase at all in public consumption. The Yugoslav authorities believed that the past rate of increase in fixed investment had been a very strong factor contributing to the inflationary domestic situation, and they felt that it was essential at least to slow down the increase in the rate of investment to 7 per cent.

With regard to the question of the interaction between foreign borrowing and monetary policy, the staff representative said that it was certainly true, as Miss Fuenfgelt had noted, that to the extent that enterprises were able to borrow abroad they could escape any domestic liquidity squeeze that the National Bank introduced by its credit policies. At the same time, while enterprises had borrowed significant amounts from abroad, the balance of payments for 1970 as a whole had been in deficit; to that extent, there had been a decrease in net foreign assets of the banking system during the course of 1970. Nevertheless, there would have been a much larger reduction in liquidity if those enterprises had not been able to borrow from abroad. It was also true that reserves would have fallen by much more than they had if enterprises had not resorted to foreign borrowing. The monetary authorities were, however, concerned that enterprises had been escaping the full impact of domestic monetary policy by foreign borrowing and it was partly for that reason that controls had been introduced in October 1970. Those controls had changed the conditions under which certain categories of foreign borrowing could be made. For example, enterprises had been able to import foreign goods when they had had the automatic right to obtain foreign exchange. Borrowing had occurred so that enterprises could conserve their holdings of domestic dinars. Therefore, in October 1970, the authorities had changed the rules governing that category of borrowing so that it would become less profitable. They expected that during 1971 there would be no increase in that kind of borrowing. A similar case existed with respect to financial credits; the compulsory counterpart deposit of 10 per cent, which bore no interest, had been raised to 20 per cent and the National Bank was no longer willing to buy, for payment in dinars, the foreign exchange resulting from such credits. In consequence, the authorities did not expect that there would be any further borrowing of that kind during the remainder of 1971.

In conclusion, the staff representative, referring to Mr. Smit's question about the exchange rate, said that the staff had had no direct information from the Yugoslav authorities, but the authorities were, of course, aware of their obligations under the Articles of Agreement. The staff surmised that the Yugoslav authorities had allowed the dinar to fluctuate vis-à-vis the dollar within the 1 per cent margin on either side of parity. They had been maintaining a fixed exchange rate, which had given them less leeway than did the 1 per cent margin on either side of parity.

Mr. Lieftinck expressed his gratitude to Executive Directors who had participated in the discussion for the interest that they had shown both in Yugoslavia and in its stabilization efforts, as well as for the good wishes which they had expressed and which he would certainly convey to his Yugoslav authorities.

It was generally realized, Mr. Lieftinck thought, that Yugoslavia was in a period of constitutional and political transition. A large degree of decentralization and a new division of power between the Federal Government and the republics was occurring. The revised structure would take some time to become fully implemented and workable, even though the new Constitution had been instituted. Whether or not the new arrangements would operate satisfactorily depended, in his own opinion, on the way in which the Federal Government exercised its reserve powers and upon the self discipline exercised by the governments of the republics and by the institutions that were subject to decision at the republic level. Foreign affairs, the military, and monetary policy were among the reserve powers held by the Federal Government. In Yugoslavia, fiscal policy had not played an important role at the federal level in recent years because the federal budget was neither impressive in size nor in importance. However, the republics were highly dependent on the Federal Government for funds and the Federal Government continued, under pressure, to accommodate those republics, some of which were more in need of accommodation than others. Those arrangements would be radically changed in the sense that the republics would become very much more dependent on their own financial policies and operations. The Yugoslav authorities expected that once the republics became self-responsible they would also act more responsibly. There was reason, at least to a certain extent, to believe that that would happen.

It had been reported, Mr. Lieftinck noted, that the first test of the new federal system would be in the economic rather than in the political sphere. Whether or not that would be so he did not know, but he did feel that at least from the Fund's point of view, the text for the new institutions and the new Constitution would be whether they were successful in the economic and, particularly, the financial fields. It might be that the economic situation would be less difficult in 1971 than it had been in 1970 in view of the expected good harvest. There would, therefore, be an adequate supply of goods and commodities and also a lesser need for imports, while there would be a large margin for agricultural exports. At the same time, if the harvest turned out to be good, a problem of credit requirements might be created. Although it was the firm intention of the authorities to observe the credit limitations set forth in the letter of intent, personally he would not be surprised if in the second half of 1971 they found it difficult to observe those limitations in view of the somewhat unexpected and large credit requirements that would result from the harvest.

Turning to more specific points raised by previous speakers, Mr. Lieftinck observed that the staff representative had already answered Mr. Gilchrist's point concerning the decline in net tourist receipts during 1970. Although gross receipts had increased, they had been offset by the high level of foreign expenditures by Yugoslavs. He himself had referred to the measures that had been taken to save foreign exchange. One of those measures was that foreign exchange credits and net retention quotas could no longer be used for foreign travel. The effect might be substantial, as foreign travel had been largely financed by those means. A second measure that had been taken was that foreign exchange credits were no longer allowed between domestic banks and enterprises. That measure had an effect not only on the raising of foreign exchange credit but also on the total volume of internal credit. A third measure was that the allocation of foreign exchange to the Federation had been reduced by 20 per cent, which meant that the Federation at the central government level would have to adopt an austerity program with respect to the use of foreign exchange. It was to be hoped that the republics would do the same thing. A fourth measure was that the use of 20 per cent of the global foreign exchange quotas for the second half of 1971 had been deferred, and the same also applied to the use of 50 per cent of the consumer goods quotas. Finally, more rigid criteria had been introduced for the importation of machinery and investment goods. The last two measures were, under the circumstances, temporarily unavoidable.

With respect to the point made by Mr. Gilchrist concerning export credits, Mr. Lieftinck said that Yugoslav enterprises, and particularly the big trusts in the contracting sector and the sector concerned with the export of capital goods, were all becoming more successful in their bidding for large international contracts, especially in Africa, but also in other countries. The staff representative had already mentioned that the export of ships required the extension of credit. Other large contracts also required prefinancing and the extension of credit. The Yugoslav authorities were aware of the danger of extending the volume of foreign credits too greatly. When he had recently visited Yugoslavia, one of the subjects that had been raised over and over again was whether the World Bank could provide Yugoslavia with finance for export credits. The World Bank could of course, not do that, but the Yugoslav authorities' interest in that matter indicated the great need that they felt for promoting their exports by competing with other countries in the field of suppliers' credits.

In conclusion, Mr. Lieftinck believed that the increase in the federal turnover tax, which had just been implemented for cigarettes, imported goods, and certain services, would be a helpful measure. The yield was expected to be no less than Din 530 million on an annual basis. The revenue collected would be credit to a newly created compensatory fund to be used to finance the higher costs of certain basic foodstuffs. Therefore, the receipts from that tax were intended to be used as an instrument for stabilizing the internal prices of certain items in the household budget. While that was an interesting tax measure on the federal level, it also indicated that the authorities were very seriously concerned with the increase in the cost of living and its repercussions on the wage front.

The Executive Board then turned to consider the proposed decisions, which were adopted.

The decisions were:

a. <u>1971 Article XIV Consultation</u>

1. This decision is taken by the Executive Directors in concluding the 1971 consultation with Yugoslavia pursuant to Article XIV, Section 4, of the Articles of Agreement.

2. The strong expansion in economic activity continued during 1970. Aside from agriculture, where there was a poor harvest, real social product increased by more than 9 per cent. Demand pressures intensified, particularly in the field of fixed investment. Personal incomes again increased by much more than productivity and the rate of increase of costs and prices accelerated.

3. The combined effect of excess demand and a deteriorating relative price position led to a very large increase in imports. Despite a substantial improvement in net invisible receipts and a further increase in exports and net capital inflow, there was a sharp deterioration in the balance of payments. This was reflected in a deterioration of more than US$100 million in the convertible international reserves of the National Bank, and at the end of 1970 they totaled only US$140 million which is equivalent to less than one month's imports from the convertible currency area.

4. In October 1970, the Yugoslav authorities embarked on a comprehensive stabilization program, which included monetary and fiscal restraint, as well as a price freeze and measures to slow down the growth of personal incomes. In January 1971, the dinar was devalued by 16.7 per cent. When it became apparent in the first half of 1971 that the program was not working as quickly and effectively as had been hoped, the authorities strengthened and stepped up the implementation of the program.

5. With the large increase in the current account deficit, there was a large increase in new foreign borrowing in 1970, which will again be substantial in 1971. As a result, the level of outstanding foreign indebtedness has increased to a high level. The Yugoslav authorities are introducing a comprehensive recording and registration system and have tightened controls on certain categories of foreign debt. The Fund shares the view of the authorities that careful attention should continue to be given to the foreign debt position.

6. Despite the balance of payments difficulties, Yugoslavia has continued to reduce restrictions on payments and trade, and further improvement is expected over the next 12 months. The Fund welcomes the progress made in this area and in terminating bilateral payments agreements with Fund members. In view of the circumstances, the Fund approves the multiple currency practice arising from a bilateral payments agreement with a Fund member until August 31, 1972.

Decision No. 3380-(71/79), adopted
July 30, 1971

b. Stand-by Arrangement

The Government of Yugoslavia has notified the Fund of its desire to cancel the existing stand-by arrangement and has requested a new stand-by arrangement for a period of one year and for the equivalent of US$83.5 million. The Fund approves the stand-by arrangement attached to EBS/71/196, Supplement 1 and grants any necessary waiver of the conditions of Article V, Section 3(a)(iii) of the Articles of Agreement.

Decision No. 3381-(71/79), adopted
July 30, 1971

3. MALAYSIA - 1971 ARTICLE VIII CONSULTATION; PURCHASE TRANSACTION - TIN BUFFER STOCK FINANCING

The Executive Board considered the staff's report for the 1971 Article VIII consultation with Malaysia (SM/71/140, 6/8/71, and Cor. 1, 7/28/71). It also had before it a report on recent economic developments in Malaysia (SM/71/168, 7/8/71, and Cor. 1, 7/28/71). In addition, the Executive Board took up the request by Malaysia for a gold tranche purchase to be regarded as a purchase under the decision on the problem of stabilization of prices of primary products in connection with the financing of a compulsory contribution to the buffer stock established under the Fourth International Tin Agreement, together with the staff's analysis and recommendation (EBS/71/200, 7/22/71); and it considered a paper which examined the legal questions raised by the Malaysian request (SM/71/193, 7/22/71).

The staff representative from the Asian Department said that the staff had recently received a message from Malaysia advising it of some revision in the figures in SM/71/140. First, the last sentence of the first paragraph on page 2 of that document had been revised as follows: "Total public investment for 1966-70 was estimated at M$4,242 million, or 92.5 per cent of the revised Plan target of M$4,585 million." Second, the figures in column 3 of Table 1 of the staff report had been revised to read: "Current revenue M$2,394 million; Current expenditure M$2,154 million; Current surplus M$240 million; Development expenditure M$693 million; and the overall deficit M$453 million." Those revised figures for Table 1 were still provisional.

Mr. Suzuki made the following statement:

I would like first to express my appreciation to the staff for its well-balanced analysis of the Malaysian economy. The Malaysian authorities accept generally the staff appraisal on pages 15 and 16 of the report.

Malaysian economic developments since the last consultation continued to be generally favorable. Developments during the first half of 1971, however, have somewhat changed the expectation of the authorities for the year. First, the 1971 plan target for GNP growth rate of 7.2 per cent seems to be on the high side in view of the continuing low rubber prices. It is now estimated that for 1971, the average price of R.S.S. Grade I rubber would be around M$0.50 per pound instead of about M$0.55 per pound as estimated earlier. Second, as already fully discussed, the current account surplus of M$41 million in the second half of 1970 was displaced by an estimated deficit of M$41 million in the first half of 1971. With rubber prices presently at such a low level, partly due to renewed GSA sales, and with imports of investment-biased goods still increasing, the current account deficit might well increase further in the second half of 1971.

As is indicated in the staff report, the most serious, immediate problem facing the country is the steady deterioration in the employment situation associated with a rapidly increasing labor force and a relative decline in the demand for labor by the traditional export sectors. The present level of overall unemployment in West Malaysia is estimated at about 8 per cent of the labor force, compared to 6.6 per cent in 1967 and 6.0 per cent in 1962. The most significant feature of this problem is that the highest incidence of unemployment fell on the younger age groups, including school leavers.

The increasing concern over rising unemployment has thus led to various short-term policy responses. Apart from allocating more funds for vocational education and training, the authorities have taken measures to promote employment, such as restricting overtime work to 32 hours per month for workers both in public and private industry and requiring noncitizens to obtain work permits. The payroll tax was also abolished in January 1971. However, although these short-term measures do help, the only enduring remedy is a much faster rate of economic growth toward which the Second Malaysian Plan (1971-75) is expected to make an effective contribution.

The basic objectives of the Second Malaysian Plan (1971-75) which has just been passed by the Parliament are: (1) raising level of economic growth, (2) reducing income disparities, and (3) increasing employment opportunities for the growing labor force. The projected rate of growth of GNP at 1965 prices for the Second Plan is set at 6.8 per cent annually (6.5 per cent at current prices). The authorities hope to attain this growth rate during the plan period, if not to surpass it as they did in the case of the First Malaysian Plan (1966-70), when they achieved a 6 per cent real growth per year against the Plan target rate of 4.9 per cent per year. The role of the public sector under the Second Plan would be far more important than under the First Plan since its scope would be considerably extended in order to realize the above objectives. Public investment, which grew at only 1.9 per cent per annum under the First Malaysian Plan, will now have to grow at a much faster rate of about 5.9 per cent or more per year during the Second Malaysian Plan.

Although the authorities are at present concerned about the problem of accelerating public development expenditure to keep pace with the forecasts, greater demands on the public sector under the Second Malaysian Plan are anticipated. Under these circumstances the authorities agree with the staff that "all avenues for raising additional resources for the public sector through taxation and nonbank borrowing will need to be continually explored." However, I wish to add that, in implementing the Plan, the authorities also attach great importance to foreign assistance, which, including market borrowing, consists of around 15 per cent of the total public development expenditure under the Plan.

I would like to record the Malaysian authorities' gratitude for the many occasions when technical assistance has been provided by the Fund, particularly in the field of fiscal policy.

Mr. Gilchrist noted that at the beginning of its appraisal, the staff had rightly praised Malaysia's economic performance. Perhaps it was in tribute to that performance that the staff had not concerned itself very much with short-term financial policies and had concentrated on the less tractable structural problems. Clearly, the most important of those problems was the deterioration in the employment situation, which was, of course, much more than just a problem of economic management. The Malaysian authorities were tackling it in an imaginative way, judging by the approaches that were listed on page 6 of SM/71/140, and also by Mr. Suzuki's interesting opening statement. He was particularly interested in the staff's statement, which was reiterated in the staff appraisal, that the development of labor intensive techniques might sometimes have a more serious impact on efficiency, and hence on growth, than on employment. The choice of production techniques was a very difficult issue and could probably only be resolved on a case-by-case basis, and even then, largely by experience. Whatever the production techniques that were to be used, an expanded investment program, both in the public and in the private sectors, was of key importance in achieving a growth rate sufficiently large to absorb increases in the labor force. The private sector had responded very favorably in 1970, but it had to be admitted that public investment spending had fallen short of expectations. Obviously, it was important that the authorities renewed their efforts to overcome deficiencies in the identification, the preparation, and the carrying out of investment plans. Unless a breakthrough was achieved in that area, the high level of unemployment and the disparity between rural and urban incomes would remain. If and when success was achieved in the employment field, considerable efforts would have to be made in order to increase the level of savings. Impressive success had already been achieved on that front, but more remained to be done, and the rather large budgetary deficit expected for 1971 might make the need for solutions more acute. Certainly, a reorientation of the tax system, aimed at making it more growth elastic, would ease the problem. Attempts to expand domestic nonbank borrowing would also be welcome. Even though quite a large fiscal program had been financed in that way, more remained to be done.

Mr. Gilchrist said that he had been interested in the attempts that were being made to expand bank lending to the private sector. That was a matter which had been raised a number of times in the past. Both the collateral requirements for that type of lending and the traditional banking customs might perhaps need some adaptation. Therefore, the ideas that had been mentioned on page 10 of SM/71/140 were very much directed to the problem of expanding bank lending to the private sector, and it would be interesting to see how successful the policies implemented by the authorities would be.

With respect to the external sector, Mr. Gilchrist noted that in 1970 the balance of payments had been dominated by the decline in rubber prices and by the high level of imports of investment goods. Presumably, neither of those factors would be quite so important in 1971, although, of course, Malaysia would be dependent on its exports of primary products for many years. It was perhaps fortunate that Malaysia was not quite so limited in the number of commodities which it exported as was the case in some other countries. Nevertheless, he shared the staff's view that the manufacturing sector ought to be oriented more directly to foreign markets. Finally, the Malaysian authorities had shown themselves well capable of responding with imaginative solutions to problems and he was confident that they would be equally capable of doing so in the future.

Mr. Kharmawan said that, like Mexico in the Western Hemisphere, Malaysia was providing a shining example to neighboring countries in Asia that it was possible to achieve substantial economic growth under conditions of stability. That achievement was most encouraging indeed for all those countries that wished to follow the same path. It was an impressive achievement to be able to show that over the years a growth rate of over 6 per cent had been achieved, while prices had been kept relatively stable; for instance, in 1970 the price level had increased by only 1.5 per cent. At the same time, the problem of wage increases had not created very many difficulties because they had been contained by increases in productivity. Another achievement was that in spite of a certain deterioration in Malaysia's export revenues, its reserve position remained strong. That had been made possible by the use of a highly skilled personal and responsible budgetary and monetary policy. The Malaysian budgetary performance had been such that the current account had generated small surpluses in past years and a slight deficit in 1970. Naturally, the overall budgetary position was in deficit, but it did not compel the Malaysian authorities to resort to a high level of foreign borrowing. The deficit in the overall budget had been financed by internal borrowing from nonbank sources, which meant that there were no inflationary pressures emanating from budget financing. The money supply was also kept within reasonable bounds.

Naturally enough, the Malaysian authorities faced some problems, Mr. Kharmawan noted. One of those problems was of a structural, and possibly a social, nature--namely, how to involve all sections of Malaysian society in the process of economic development and in the distribution of wealth. That was a long-term problem and the Malaysian authorities were following a very cautious and reasonble policy in that regard. Another problem concerned the level of unemployment, which was serious and had increased from 6.6 per cent in 1967 to about 8.0 per cent at the present time. The Malaysian authorities were seeking a solution by further expanding the economy in order to create new jobs. It was in respect of the unemployment position that he wondered whether the educational system should be restructured--that point applied not only to Malaysia but also to other developing countries, including Indonesia. All those countries had inherited an educational system from the former colonial authorities. Perhaps it was now time for those countries to take responsibility and gear their educational systems to present domestic conditions. Developing countries ought not to pursue educational objectives with an eye on the long-term potentials of their economies; rather, they should pay attention to the more immediate possibilities for economic growth. He wondered whether there was too much emphasis on university education in developing countries; perhaps they should direct more attention to vocational training.

Mr. Kharmawan indicated that the staff, on page 3 of SM/71/140, had mentioned that the authorities had supported rubber prices by purchasing rubber when prices had been low and unrealistic. He wondered what the staff had meant by the words "unrealistic prices." He understood that if prices were low, the Government would be compelled to support them, in effect by creating a domestic stockpile. He asked whether the term "unrealistic" referred to low prices which would be caused by releases from the U.S. stockpile. Further, the second paragraph on page 3 of

SM/71/140 had indicated that the authorities had thought that there might be some firming in rubber prices in view of recent developments in other rubber producing countries in Asia. He was uncertain as to what the staff had meant in that paragraph: did it mean that in view of certain problems in other rubber producing countries the supply of rubber was expected to be smaller than it had been in the past? However, in SM/71/140, the staff had also said that there had been great concern expressed by the Malaysian authorities regarding the development of rubber prices in view of releases of rubber from the U.S. stockpile; even information which had been leaked about possible releases from the U.S. stockpile had had adverse effects on rubber prices. He asked the staff what its position was on the matter of future rubber prices. He wondered whether the Malaysian authorities expected rubber prices to increase or to be rather firm in view of developments in other Asian countries, or whether they expected a further deterioration in rubber prices in the light of probable releases from the U.S. stockpile. On page 5, the staff had noted that the authorities expected that the country would become nearly self-sufficient in rice in 1973, but they were concerned that domestic rice was produced at a higher cost than in other countries. He wondered whether a subsidy was involved in producing rice in Malaysia. Of course, that sort of problem was not only present in Malaysia but also in other developing countries.

Continuing, Mr. Kharmawan said that he understood the concern of the Malaysian authorities regarding their reserve position much better at the present time than he had in the past. An important fact was that the currency issue had to be covered by reserves. He asked whether that was a legal requirement and also whether the authorities had thought about changing that policy. It had to be wondered whether that legal provision might not prove to be an impediment for Malaysia's long-term economic development policies. If a country wished to develop, it had to be ready and willing to use reserves to meet that objective. But if reserves had a function other than for balance of payments and development purposes, such as to cover the currency issue, problems might be created. With the experience of a highly developed country in mind, he recalled that the link between gold reserves and money supply had become difficult at times.

In conclusion, Mr. Kharmawan said that the questions which he had raised did not imply any criticism. Rather, they were a reflection of his very deep interest in the events in Malaysia, with which Indonesia had the most friendly and pleasant relations. He asked Mr. Suzuki to accept his warm congratulations on the achievements of the Malaysian Government, and to extend his best wishes to the Malaysian authorities.

Mr. Dale said that the rate of growth in Malaysia had been commendably high, while prices had been extraordinarily stable by any standard, and wage increases had been very modest. The balance of payments had been consistently strong and financial policies had been prudent and successful. Clearly, as the staff had recognized and as Mr. Suzuki had stressed, unemployment was the most important problem to tackle and would doubtless yield only to a multi-sided program of both short-term and long-term measures. Of course, a still higher rate of real economic growth than at present, as was targeted under the Second Malaysian Plan, was of importance in respect of the unemployment problem. If the authorities were as successful in exceeding the target under the Second Malaysian Plan as they had been under the First Malaysian Plan, the unemployment problem would be even further alleviated. Given the much more vigorous and essential role that was to be played by the public sector in the Second Malaysian Plan, there was a continuing need to strengthen the receipts of the public sector.

With respect to rubber disposals from the U.S. stockpile, Mr. Dale noted that on page 4 of SM/71/140 the staff had said that "they [the Malaysian authorities] were interested in an enduring long-term solution to the problem of stockpile releases and expected that the Association of Natural Rubber Producing Countries would put forward specific proposals to the U.S. authorities before July 1971." However, the Association had not been successful in putting forward those specific proposals to the U.S. authorities before July 1971.

Mr. Arriazu said that SM/71/140 had indicated that Malaysia was a country in which good economic management had been exercised, the authorities had shown extreme caution, and there had been realism in recognizing economic problem areas. The year 1970 had been very good for Malaysia; the authorities had managed to obtain a very satisfactory rate of growth, to maintain price stability, and to increase workers' real wages. Although the external sector had registered a smaller surplus in 1970 than it had done in 1969, primarily as a consequence of the importation of investment goods, it continued to be strong. Obviously, unemployment was the most pressing problem faced by Malaysia. The authorities were very much aware of that fact and they had taken both long-term and short-term measures to solve the problem. Those measures should contribute solutions, although two or three measures might be working in the opposite direction. The staff had pointed out that unemployment had increased because of the use by the export sector of capital intensive techniques of production. He wondered whether the Investment Incentive Act of 1968 had contributed to the unemployment problem by providing incentives and subsidies for the use of capital, as against the use of labor, thus changing the wage/cost ratio. Another point of concern centered on the implementation of public sector projects. While Malaysia was growing at a very fast rate, there were reasons to believe that the potential rate of growth was not being attained. Three of the most important constraints to development were: the external sector, which included imports of capital (a surplus in the balance of payments was a substitute for domestic capital); the lack of specialized labor; and the absence of a labor surplus. Malaysia was strongly endowed in each of those three areas. Additional investment in the form of imports could easily be supplied by the external sector. The staff had not indicated the position as regards trained labor, but the measures which had been taken by the authorities in that field would contribute to dissolve any bottleneck. Finally, Malaysia had a sufficiently large labor surplus to supply any increased demand brought on by a rise in the level of economic activity.

The Malaysian authorities seemed to be overly cautious with respect to their fiscal and monetary policies, Mr. Arriazu observed. A more agressive monetary policy could perhaps be adopted; the planned increase in the money supply for the period 1971/75 seemed to be a little restrictive. In most countries, the demand for money increased at a faster rate than the growth of nominal income. Furthermore, Malaysia was still in the proces of monetizing its economy. Finally, there seemed to be room for a larger expansion in output. All those points led him to the view that a rate of growth in money supply of about 9-10 per cent would be more adequate than the one set forth in the Second Malaysian Plan. The last measure that might run counter to development needs concerned the proposed increase in the contribution to the Employees' Provident Fund.

With respect to longer-term policies, Mr. Arriazu felt that the authorities deserved praise for their policy of diversifying exports and the agricultural sector, in the light of the stagnation in the production of some traditional goods. He felt sure that the authorities were choosing which products to promote on the basis of economic and social returns, as well as on the basis of the impact on employment. Regarding rubber policies, he sympathized with the authorities' preoccupation with respect to releases from the U.S. stockpile. Those stocks were so large in comparison with the nature of trade that no effective planning could be achieved until clear policies in respect of the stockpile were established.

Mr. Brand said that the Malaysian economy had performed most impressively in recent years. The average rate of real growth in the period covered by the First Malaysian Plan, i.e., between 1966 and 1970, had been 6 per cent. That high growth rate had been combined with remarkable price stability; the staff had on page 1 of SM/71/140 said that Malaysia's gross national product at current market prices had risen by 6.3 per cent--about 6 per cent in constant prices. It was to be hoped that Malaysia maintained that price performance and that other Fund members would be able to copy that example. The Malaysian performance was even more impressive because 25 per cent of GNP originated from trade and because the economy was highly dependent upon the earnings from a small number of export products, such as rubber, tin, and timber. The major export product continued to be rubber, and rubber prices had declined by about 25 per cent during the last five years, i.e., from M$0.66 per pound in 1966 to M$0.50 per pound in 1970. Nevertheless, the Malaysian authorities had managed to diversify the economy to such an extent that economic growth had not been seriously disrupted. Production of manufactured goods, and exports in particular, had shown encouragingly strong growth; Table XV on page 83 of SM/71/168 made impressive reading. Although external receipts had declined in 1970, domestic demand had been able to provide a continued impetus for growth. Malaysia seemed to be favorably placed to reap a substantial benefit from the opportunities that would become available in 1971 under the generalized reduction of tariffs imposed by industrial countries on the imports of manufactured goods from developing countries. The ability of industries, which had been formally set up for import substitution purposes, to compete in the export field was a sign that Malaysian tariff policies were sound; the reliance on tariffs rather than on quantitative restrictions for protection was particularly satisfactory. The upsurge in private investment was also a sign of renewed confidence emerging after the problems that had been caused by civil disturbances in recent years. The Malaysian authorities' major problem was the existence of the high level of unemployment which persisted despite the excellent record of economic growth. The need seemed to be to provide both for additional employment at the present time and for measures to control population in the long term. The authorities expected that the growth rate of real GNP for the Second Malaysian Plan would be 6.8 per cent a year. He asked the staff whether that rate of growth was expected to absorb all persons who entered into the work force, or whether it might reduce the present level of unemployment.

The budget estimates for 1971 showed a substantial deficit, representing about 25 per cent of total expenditure, and to be financed as to 60 per cent by domestic borrowing, Mr. Brand observed. A large proportion of the planned increase in expenditure would result from a rise in the outlays for defense and internal security. As that rise primarily resulted from the withdrawal of British military forces and, as it would largely replace expenditure incurred by the U.K. Government, the real effect might be limited. Moreover, much of the remaining increase in expenditure would be caused by a rise in allocations to the development budget. The amount of money spent upon development in the 1970 budget had been 20 per cent lower than had originally been estimated. If that trend were to be repeated in 1971, and the increase in revenue had been underestimated, as it had been in 1970, the total impact of the deficit might well be less than would appear at first sight. He agreed with the Malaysian authorities who had stressed the importance of bringing forward public sector projects more quickly and of facilitating private investment to which they continued to provide an impressive array of incentives. But given his experience of the Australian federal structure, he had been rather surprised to learn of the apparent economic conservatism of the state authorities which appeared to have collected considerable reserves. Those reserves were continuing to rise, even though the governments themselves relied upon federal grants to meet deficits in state budgets. As Mr. Suzuki had pointed out in his opening statement, the faster rate of expansion which had been planned for public investment in the Second Malaysian Plan was certainly necessary. The rate of increase in public investment had only been 1.9 per cent during the First Malaysian Plan and that increase definitely appeared to have been on the low side. Official debt servicing payments had represented about 3 per cent of exports in 1970, by international standards a fairly low figure, Mr. Brand observed. He assumed that there were substantial private debt repayments because of Malaysia's "open-door" policy toward overseas investment and that might raise the debt servicing figure. As domestic savings amounted to 18 per cent of GNP and external financing only supplied 10 per cent of total investment requirements, there appeared to be room for far greater overseas borrowing by Malaysia. Such a course should lead to a more rapid rate of growth and help to overcome the present unemployment problem. Moreover, such borrowing could also provide a greater concentration of domestic resources on labor intensive projects without the overall growth rate declining. If properly directed, foreign financed projects could supply a more even income distribution throughout the states. Certainly, effective use of possible additional resources would be dependent upon a faster rate of project implementation and he hoped that considerable progress would be made in that area.

Turning to page 7 of SM/71/140, Mr. Brand agreed with the sentence which read: "As regards the possible scope for an incomes policy, the Malaysian representatives thought that this policy instrument was of little significance in the Malaysian context." In the area covered by incomes policies, Malaysia certainly faced a situation which was different from that faced by many other countries.

In conclusion, Mr. Brand said that, all in all, the outlook for the Malaysian economy was very bright. It had shown great resilience during 1970, despite falling rubber prices, and the authorities' policy of diversification had proved remarkably successful. He wished the Malaysian authorities continued success in the future for their sound and intelligent policies.

Mr. Prasad felt that SM/71/140 had indicated that Malaysia was a bright spot in an area where it was usually thought that the economic situation was rather gloomy. The Malaysian economy also represented a bright spot for the old dispirited colonial administrations. Malaysia had started off its independence by inheriting a well-organized and an increasingly developing economy. Since independence, Malaysia had continued the tempo of its development by pursuing some reasonably realistic, conservative policies, which had been fairly free from ideological preoccupations. Because of those policies, Malaysia had not suffered after detaching itself from the old colonial administration and its growth had continued in a quite remarkable way during the post-independence years. The present Prime Minister of Malaysia had at one time made the statement, "Our aim is not to level down from up, but, rather, to level up from down, toward higher living standards." That policy had been pursued in a variety of ways and had helped Malaysia to build a fairly strong economy. Nevertheless, the fact remained that the economic strength was, to some extent, uncertain in the sense that it could well be subject to sudden and large fluctuations because of the nature of the commodities involved in its trade. That fact also explained to a great extent the sometimes strange behavior of the Malaysian authorities, for example, the extremely conservative policies toward reserves. If the authorities had been rather reckless with their reserves, development might have been helped, but if there had been sudden reverses in their economic position, they would have suffered rather badly.

He agreed with Mr. Arriazu that the Malaysian economy was not growing to its full potential in spite of the very good record, Mr. Prasad noted. There seemed to be two limitations. In the first place, in spite of a very good educational system, the development of technical skills had been rather backward. Thus, there seemed to be room for a great deal of improvement in the educational system as a prerequisite for a more rapid advance in the planning and the development of the Malaysian economy. In the second place, with respect to fiscal matters, there appeared to be room for a considerable amount of improvement in the mobilization of resources. The assistance provided by the Fund and the World Bank to Malaysia in recent years had been of some significance, but it might wish to receive even more assistance. In respect of Malaysia's monetary policy, the authorities had pursued sound, conservative policies. Nevertheless, the time had probably come when the Malaysian authorities ought to take a second look at their reserve policies and, to a certain extent, their monetary policies. Perhaps they should diversify their reserves and use them in the service of economic development.

Malaysia, Mr. Prasad thought, had a serious population problem. The rate of growth of population seemed to be about 3.2 per cent per annum. SM/71/140 had not indicated where the concern of the Malaysian authorities lay in that particular matter, and had not said whether any action had been initiated. A certain amount of population restraint might occur once people began to taste higher standards of living, but it seemed sensible to consider whether, in a situation like the one in Malaysia where a reasonable growth rate was being eroded by a fast growing population, some action in the area of population control might be advisable. Further, Malaysia's unemployment level, which stood at 8 per cent, was very high. The problem was probably even greater if account was taken of the difficulty of assessing underemployment--something which was very common in developing countries. A solution to the unemployment and underemployment problem would not be easy to find and, possibly, Malaysia could do with a good deal of advice with respect to possible ways and means of diversifying the economy. He shared the staff's assessment that the Malaysian effort to produce more rice might not be particularly practical or sensible in the sense that it might lead to the production of a high-cost good.

It was to be hoped, Mr. Prasad said, that Malaysia, which had practiced some very sensible policies over the years, would also have the wisdom to be able to exploit to the fullest extent the contribution that its minority peoples could make to the growth of the economy as, for example, Thailand had been able to do. Recently, there had been some problems in that area and they had certainly affected, at least to a small extent, the Malaysian economy. He hoped that the authorities would be able to weld together the various ethnic groups in the country, thus building a strong basic structure on which the economy could grow.

In conclusion, Mr. Prasad wished to convey to the Malaysian authorities his appreciation for the sound and sensible policies they had adopted.

Mr. Hanh noted that the Malaysian economy was generally in a satisfactory condition. In 1970 the growth rate had marginally decreased in comparison with the average achieved during the First Malaysian Plan (1966-70); nevertheless, it had been very good. The authorities had to be congratulated for their significant achievement in maintaining stable prices. Another important achievement which deserved the Fund's attention was the maintenance of the external debt at a low level. In the past few years, debt service payments had been only slightly higher than 2 per cent of export receipts. In 1970, they had increased to just over 3 per cent, which was still very low in comparision with most developing countries. Problems, however, did exist, and one of them was the unemployment situation which was of major concern to the authorities. In 1970 the unemployment level had reached 8 per cent, which was relatively high. At the same time, the labor force was expected to increase at a rapid pace. Measures taken by the authorities had achieved some results, but they had not completely solved the problem. He agreed with the staff's view that the authorities should pursue a strategy of employment-generating growth and of exploiting the scope for labor intensive technology, both in industry and in agriculture. He also agreed with the staff's view, which was shared by the Malaysian authorities, that the choice of production techniques had to be assessed in terms of the optimum trade-off between increased output and efficiency on the one hand, and greater employment on the other.

With respect to the external sector, Mr. Hanh observed that Malaysia's export receipts depended to a large extent upon the export of primary products. The prices of some of those products fluctuated widely and the demand for some of them was subject to change. The price of rubber had dropped nearly 15 per cent in 1970 compared to 1969; the value of rubber exports had dropped by more than US$100 million accordingly. Iron ore was another of Malaysia's important foreign exchange earners; the export volume had dropped from over 5 million tons in 1969 to 4.8 million tons in 1970, so that receipts from iron ore exports had also declined. Most of the fluctuations in prices, volumes, and export receipts of primary products were beyond the control of the Malaysian authorities. In order to provide a cushion for such unforeseen fluctuations, it was necessary for the authorities to have a relatively high reserve position. Thus far, the balance of payments had been satisfactory, but in 1970 the value of imports had increased by more than 17 per cent while exports had increased by only 2 per cent. That might have been one of the reasons why the authorities had requested a drawing under the buffer stock financing facility.

In conclusion, Mr. Hanh thought that the Malaysian economy was healthy. He hoped that the authorities would be able to solve their problems; they were skillful and capable managers of their economy. He asked Mr. Suzuki to convey to the Malaysian authorities his best wishes for their continued success.

Mr. Lieftinck joined other Executive Directors in expressing his great admiration for the way in which the Malaysian authorities had conducted their affairs. It was true that problems existed. They were mainly of an internal nature: unemployment and perhaps an overly slow implementation of the development program brought on by the scarcity of skilled manpower and administrative difficulties. But there were also external factors which might possibly have adversely affected progress. Previous speakers had referred to the matter of the U.S. stockpile for rubber. In order to strike some balance, he wished to refer to what the staff had said on page 4 of SM/71/140 with respect to oil palm products. The staff had reported that the authorities had "expressed their concern at the possible loss of tariff preferences for palm oil in the U.K. market and the imposition of an added 6 per cent duty in the event of the United Kingdom's entry into the EEC." That specific example led to a more general observation: industrialized countries ought to take care not to create conditions which might adversely affect the efforts to developing countries. With respect to other aspects of the policies of the Malaysian authorities, they should perhaps review the tax system in order to create larger amounts of domestic resources for the development program. Direct taxes only constituted 30 per cent of total tax income, and he wondered whether some progress could be made in that respect. However, he was a little concerned about the idea expressed in the last sentence on page 8 of SM/71/140 which read: "A new directive, which allows government agencies to enter into contracts for development projects before appropriations have actually been made..."; the implementation of such an idea might weaken budgetary control, and treasury control in general, over such apparently important contracts.

The staff representative from the Asian Department, referring to Mr. Kharmawan's questions, noted that there was no publicly announced price at which the authorities intervened in the rubber market. All that could be said was that the authorities did intervene in the market, irrespective of internal or external factors, whenever rubber prices were low. Second, regarding recent developments in other rubber producing countries in Asia, the authorities had thought that events in Ceylon and in the Khmer Republic might have some effect on the exports of rubber from those countries. Third, in Malaysia, rice producers received no cash subsidy. However, the Government did regulate the volume of rice imports in keeping with domestic requirements. At the same time, a number of inputs, such as fertilizers and irrigation facilities, for rice cultivation were subsidized. Fourth, the position was that although there was no statutory obligation for currency cover, official policy was to maintain a 100 per cent cover for the total currency in circulation. In that context, it was worth bearing in mind that Malaysia, Singapore, and Brunei formed part of a common currency area, which meant that the three currencies were interchangeable. Although there was no statutory stipulation, the currency cover requirements were broadly the same for all three areas.

Mr. Brand had raised the question as to the expectations of the Malaysian authorities with regard to the likely impact on unemployment of future economic growth, the staff representative observed. The authorities had no firm view on that matter, although they did believe that the problem was not altogether unmanageable, provided that two aspects, namely, the shortage of labor in Sabah and the fact that unemployment mostly affected school-leavers because of their preference for white-collar occupations, were adequately taken care of. The authorities intended to rely chiefly on land settlement schemes and small-scale industries to tackle the unemployment problem. They realized that the growth of the industrial sector might not per se be an answer to that problem. Mr. Brand had also asked about the accumulating reserves of the state governments. The staff had been told by the Malaysian officials that the whole question of financial relations between the Federal Government and the states, including the subject of grants, was currently being studied by an expert committee and that it would probably take the matter of accumulating reserves into account in its deliberations.

Mr. Prasad had wondered what was the alternative occupation for marginal rice producers, the staff representative noted. The authorities believed that the cultivation of other crops, such as maize, or the transfer of some of the workers concerned in marginal rice production to other agricultural occupations, for example, rubber cultivation on small holdings, might be a feasible and an economic solution. Regarding Mr. Prasad's inquiry about family planning, according to the authorities, and judging by the number of persons seeking advice from family planning clinics, the response had been fairly encouraging.

Mr. Suzuki thanked speakers for their comments which he would convey to the Malaysian authorities. His own impression, gathered at the time of the consultations between the staff mission and the Malaysian authorities in April, was that the management of the economy was somewhat conservative, although the Second Malaysian Plan indicated that that attitude was changing. He agreed with the speakers who had thought that greater efforts could be made on the development front. Some Directors had also expressed the belief that the Malaysian authorities had adopted a too conservative management policy toward foreign exchange reserves. Of course, one reason for that attitude was that export receipts fluctuated quite markedly and beyond the control of the authorities. Besides that, and as the staff representative had indicated, there was a currency interchangeability arrangement between Malaysia and Singapore. There were no exchange rate margins between

Singapore dollars and Malaysian dollars, as page 66 of SM/71/168 pointed out. Moreover, before he had visited Malaysia in April, there had been some rumor in Singapore of a devaluation of the Malaysian dollar. Thus, the authorities had to be careful to maintain sound management of their foreign reserves. That was one reason why the authorities believed that a 100 per cent reserve cover on the local currency was quite reasonable. Finally, several speakers had wondered why Malaysia had not sought external assistance for its development program. Of course, Malaysia wished to borrow resources from abroad, but the real problem was that many countries thought that, because Malaysia had a favorable balance of payments position and a strong reserve position it should use its own resources. Thus, the problem concerned the supply side rather than the demand side.

The Executive Directors concluded their discussion of the 1971 Article VIII consultation report on Malaysia and turned to Malaysia's request for a gold tranche purchase to be handled under the buffer stock financing facility.

Mr. Suzuki said that he had informed his Malaysian authorities about the discussion which had taken place at EBM/71/76 and EBM/71/77. At the request of the Chairman and other Directors at those meetings, he had asked the Malaysian authorities whether they would change their position with respect to their request for a drawing. However, his Malaysian authorities had informed him that they wished to maintain their original position and had asked him to persuade the Board to approve their request.

The Chairman said that as the Malaysian authorities still wished the Fund to deal with their request for a gold tranche purchase to be handled under the buffer stock financing facility, the Board had to consider the most appropriate procedure for dealing with it. Whatever the Fund's final reaction to the request might be, it would involve taking a position on one or more questions of principle that had arisen and had already been discussed in connection with the buffer stock facility. If the Fund were to do nothing in connection with those questions of principle, a reaction to Malaysia's request might nevertheless implicitly involve positions on those questions. In his opinion, that would not be the most desirable course to follow. The Fund should make its policies on the use of its resources as clear as possible for the guidance of its members. Therefore, he recommended that within the next ten days and before the informal recess, the Executive Directors should reach conclusions on the questions of principle that were involved with respect to Malaysia's request in relation to the buffer stock facility. Very little more by way of staff preparation would be required as the issues were well known. The staff would produce a paper which would provide all the information which Executive Directors would need in order to reach conclusions on the questions involving the facility. That paper would probably be ready by about the middle of the week commencing August 2, and the Executive Directors would be able to take a decision in the week commencing August 9. On the basis of that decision on the matter of principle, the Executive Directors would be able to come to a conclusion about the Malaysian request for a drawing.

The Executive Directors agreed to take up both the question of principle and Malaysia's request for a gold tranche purchase to be handled under the buffer stock financing facility during the week commencing August 9.

4. EXCHANGE RATE FLEXIBILITY

Executive Directors continued from EBM/71/69 (7/19/71) their discussion of a paper on certain aspects of a possible amendment of the Articles of Agreement to widen exchange margins around parity (SM/71/104, 4/29/71, and Sup. 1, 7/14/71), a staff paper on drafts of possible amendments of the Articles of Agreement to permit temporary deviations from par value obligations and/or small changes in par values without the concurrence of the Fund (SM/71/132, 6/1/71), and a staff paper on legal aspects of Article XVI, Section 1, (SM/71/182, 7/14/71). It also had before it statements delivered by Mr. van Campenhout at EBM/71/51 and by Mr. Dale at EBM/71/68.

Mr. van Campenhout provided the following explanatory notes to his statement which had been delivered at EBM/71/51:

> The proposal described in my statement at EBM/71/51 is an outline and should be understood as such. A distinction should be made between those provisions which are essential to its underlying concept and those which are illustrative.
>
> I. In short, the existence of disruptive capital movements and the impracticability of other permissible measures than those which could be authorized under the amendment constitute the basis of the proposal.
>
> (a) The first of these conditions is expressed in the outline A.(a) by the clause "capital movements which might disrupt the proper functioning of the international monetary system." What these may be is a matter of ad hoc decisions. The character of the extended jurisdiction of the Fund is "jurisprudential." No reference is made to the nature of the disequilibria which call for correction: the provision could apply whether they are fundamental or not. However, in the case of fundamental disequilibrium the effect of capital movements should be such as to make the determination of a new parity (the "normal" adjustment measure under A.(a) an impracticable or hazardous task.

(b) This last comment is illustrative of the meaning of the clause "The Fund would have to be satisfied that other measures already provided for or permissible under the Articles of Agreement are not practicable in the circumstances". Other measures would of course include administrative capital controls, the establishment of a dual market, and the whole range of measures which belong to monetary and fiscal policies.

The clause "practicable in the circumstances" should be read as a whole. It means that the judgment of the Fund must be based on the situation as it has developed and not as it could have been, had other and more adequate policies been previously adopted.

The word "practicable" may not be the best. It is intended to allow room for judgment on an ad hoc basis and would include consideration of the adequacy of possible measures from the viewpoint of sufficient effectiveness and timeliness.

II. Therefore, once the authorization provided for by the proposed jurisdiction has been given, the task and indeed the duty of the member(s) concerned, of the Fund as an institution, and of the collectivity of members is obviously to correct the situation.

The fact that departures from a basic principle of the whole international monetary system can be authorized does not alter their anomalous character.

Safeguards against arbitrary requests and decisions and against abuse must therefore be provided for.

These considerations constitute the rationale of paragraphs (b) to (e) of the outline.

Paragraph (b) does not need an explanation. Similar provisions are common to all proposals aiming at expanding the jurisdiction of the Fund. It contains, however, an explicit reminder of the purposes which must generally direct the decisions of the Fund.

Paragraph (c) is illustrative. The imposition of a time limit and the necessity after a period of the authorization of the Board of Governors, a system inspired by the emergency provision, is clearly open to debate and is not of the essence of the outline. It is, however, worthy of consideration.

The prescription of some qualified majority is more important. Such a provision responds to the consideration that the exceptions provided for in the suggested amendment may affect the whole membership. A certain moderation of the normal rule based on the majority of the votes cast seems equitable from that viewpoint. It would have also the not negligible advantage of underlining that the departure from the parity rule provided for should be really exceptional.

Paragraph (d) responds to the same consideration. In addition, the obligation for the Executive Directors to justify fully, i.e., to make explicit the facts on which they base their decision, is an effective safeguard against arbitrariness.

Paragraph (e) is important. One may say that the Executive Directors may always call on the collaboration of other members pursuant to Article IV, Section 4(a). Paragraph (e) suggests that the Executive Directors would have the obligation to do so when appropriate. Clearly, situations arising out of disruptive capital movements and their correction do not necessarily involve only the member who would be led to request the dispensation of the par value obligation. Article IV, Section 4(a) is, in addition, drafted in very general terms and to make the right of the Fund more precise in the circumstances envisaged would be useful.

Mr. Gomes made the following statement on behalf of Mr. Kafka:

In our meeting of July 19, 1971, this chair commented on various aspects of the three sets of proposals regarding flexibility before us. In the light of the discussion at that meeting we should like to spell out our comments in somewhat greater detail.

I. General Considerations

1. To begin with, we should like to stress once more that our discussion is essentially on a procedural matter. Without prejudice to our dedication to the par value system, we have found it necessary and possible to tolerate temporary exceptions for short and sometimes for quite long periods. Moreover, we have found it possible to do so without withholding from the countries involved access to our resources and that irrespective of whether the countries were under Article XIV or Article VIII. Also, members in very different situations--industrialized or less developed, situated in Europe, the Western Hemisphere, as well as Asia--have in case of genuine need not hesitated to avail themselves of the IMF's tolerance. Furthermore, all those who have done so have scrupulously managed their affairs with regard to the interests of their fellow members in the international financial community. As it was in the past, so, no doubt, it will be in the future.

2. Thus, our discussion does not concern the question how much or under what conditions there shall be increased flexibility. It concerns rather the question whether this flexibility shall be available as a matter of law or, as hitherto, by ad hoc acquiescence.

3. In reality, the subject which we are discussing is even more narrowly defined. It is whether certain kinds of flexibility so far practiced in exceptional cases by ad hoc acquiescence or which could be practiced by ad hoc acquiescence, shall in future be practiced by virtue of statute, while other forms of flexibility hitherto also practiced by ad hoc acquiescence, shall remain under the shadow of illegality.

4. The procedural character of the discussion is underlined by the fact that it is hardly conceivable that legalization of certain forms of flexibility will permit any more control over the policies of countries practicing them than is presently possible. It is hard to see what conditions (not to speak of sanctions) except frequent consultations can realistically be imposed. Last year, when we discussed Canada's float and suggestions were made that we should "call on" Canada to observe certain conditions other than frequent consultations, two things became very clear. First, if we had found it practicable to devise conditions, we expected our "call" to be as effective as would have been an order; in the last analysis both are backed by the same sanctions in the Agreement or more relevantly by the same desire of members to cooperate with the international financial community. Second, we did not find it practicable to formulate conditions. It is sometimes claimed that if legal exceptions were available we could approve or disapprove their being invoked; today we cannot approve, but we can graduate the expression of our sympathy or of our antipathy, quite apart from invoking sanctions for the recalcitrant member.

5. The fact that the discussion is procedural does not rob it of very fundamental importance. Even those who favor legalization should have no doubt that the legalization of some but not of other departures from the Articles which are presently tolerated threatens to establish a new distinction between different types of situations, which will, overwhelmingly, mean distinguishing systematically between two groups of countries. The latter distinction between members can hardly fail sooner or later to reflect itself in differential substantive treatment. We should be recreating a danger which became evident to us in 1967 regarding stand-bys and which led to the adoption, in 1968 of an Executive Board decision designed to make explicit the dedication of this Board to equal treatment for all members. We should like to underline the reality of this danger.

II. Specific Considerations

6. Let us now examine the various proposals or rather sets of proposals before us in the light of their compatibility with the essentials of the Bretton Woods system, including the need to avoid introducing into the system differentiations between members which do not presently exist.

7. Of Mr. Dale's proposals, that on margins would be relatively least harmful if widening were limited to no more than 2 per cent. His proposal on transitional floats would open a very wide break in the system for certain countries, but not necessarily for others. Everything depends on the interpretation of "transitional." If it were accepted, as it should be, that all Fund members are *ipso facto* committed to the parity system and that, therefore, any flexibility they engage in must be considered transitional, Mr. Dale's proposal would at least be nondiscriminatory.

8. To the staff's proposals on margins and temporary floats the same applies which was said about Mr. Dale's, provided the margins are not widened beyond 2 per cent and "temporary" is interpreted appropriately.

9. We can agree with Mr. Dale that an amendment on "prompter parity changes" is unnecessary. We can also agree with the staff that if an amendment were proposed on wider margins it might be advisable to provide for the power to deal with the problem of cumulative margins by other means than by the Fund's jurisdiction over multiple rates.

10. Mr. van Campenhout's proposal would create as great difficulties as the others.

(a) It is particularly to be stressed that it cannot be justified by the claim that a reform of the Articles is needed in this case, but not in others because we are here facing a matter overlooked at Bretton Woods; viz., the size of short-term capital flows. There is one very clear reason why this argument does not apply, beside the fact that the Articles made quantitative controls and (with IMF authorization) also cost controls available for the purpose. The reason is that Mr. van Campenhout's proposal, like any other one, does not and cannot guarantee or even minimize the danger that the application of the proposal would be strictly confined to the case where there is simply no practicable alternative for controlling unbalancing short-term capital movements.

(b) In other words, the proposal is wide open to abuse. First, one could hardly impose on a country the adoption of other measures rather than a float if it claims it cannot handle the former. And an international organization cannot determine whether such a claim is justified or not. Second, unbalancing capital movements can occur or be made to occur in a multitide of situations; so that the proposal would permit considerable fluctuation--in accordance with or counter to its spirit--to any one of a certain group of countries which wished to fluctuate: not long enough for all cases which we consider legitimate today and not at all available to many countries because they are not in a condition to exhibit (and, thus, possibly, abuse) the fact that they have unbalancing capital flows. Third, in practice, it will not be possible to restrict the applicability of the amendment to the case where unbalancing flows have taken or are taking place, but it will be necessary to permit it to be applied also if there is an imminent threat of their occurring. This widens the scope for abuse even further. Fourth, the maximum period of the float, if it is to be realistic, must be rather long; but by the same token, it is not much of a safeguard.

(c) This leaves us an apparent procedural safeguard: a large majority. We would note that the majority proposed for the Executive Board would make it possible to approve a float which was so damaging to the LDCs that all the LDC Directors voted against it; and in the Board of Governors, three fifths of the LDC voting power would be insufficient to block the continuation of such a float. We do not mention this because we believe that higher voting percentages would be proper; this Board has always acted by consensus. Our problem is that, once again, the safeguard is apparent, not real. The fact remains that Mr. van Campenhout's proposal, gives, in effect, extreme latitude to certain countries but not to others.

III. Conclusion

11. The preceding considerations are not intended as criticisms of the specific proposals. We do not believe that proposals could be formulated which would provide better safeguards against abuse.

12. If, however, the only way to avoid abuse is to rely on the moral suasion of the international financial community and on the good faith of the countries which may be entitled to avail themselves of the above proposals, there could be no objection either to an amendment which would attend to all cases where in the past, greater flexibility has been found desirable, or, still less, to the safest solution from any point of view, which would be that of eschewing any amendment.

Mr. Gilchrist said that his authorities still had no final position on the exchange rate flexibility question. They did find Mr. Dale's proposals helpful. But if the proposal for wider margins were incorporated into the Articles of Agreement, the preference of the United Kingdom would be to make them generally available and his authorities would oppose making them conditional. As to the precise figure for wider margins, he confirmed what had previously been said from his chair: if any flexibility were to be introduced into the system at all, his authorities would favor a widening of the margins, but only as far as 2 per cent. If there were a consensus in favor of margins wider than that, his authorities would certainly oppose figures higher than 3 per cent. If 3 per cent margins were to be used in some way, his authorities would suggest that they were not immediately put into effect. Rather, some experience of the impact of a narrower margin, say, 2 per cent, on the various market elements ought first to be gained. His authorities had in mind the effects not only on capital flows but also on trade and foreign exchange markets. As Mr. Mitchell had outlined at EBM/71/69, the whole procedure could be accomplished in one movement. For instance, the Articles could be amended so as to incorporate 3 per cent margins, but Fund members could agree that they would start operating on 2 per cent margins and a later move to the authorized 3 per cent margins might occur after some particular procedure had been accomplished, which would already have been catered for in the Articles of Agreement. Thus, if the proposal for wider margins were to be implemented at all, the U.K. preference would be toward the conservative side.

With respect to transitional floats, Mr. Gilchrist said that Mr. Dale's proposal raised quite a number of issues which had so far been unresolved. His authorities had noted Mr. Dale's comments, which had been made at EBM/71/69, about the kind of cases his proposal would cover, and they were still not forgetful that that proposal would only apply to the so-called "1969 German case." It would not take account of the three recent cases of floating exchange rates. Another aspect of that proposal which still caused his authorities some difficulty was that it did not deal with the phenomenon of short-term capital movements, except under the assumption that they would always be associated with a fundamental disequilibrium or that they would be dealt with in some other way.

Regarding the proposal for temporary floats, Mr. Gilchrist emphasized that the way any such proposal would work would depend upon the arrangements involved. Therefore, his authorities attached a great deal of importance to devising the right kind of rules, to the appropriate conditions, and, indeed, to timing. In that respect, he looked forward to receiving the promised staff paper. If a provision for temporary floats were incorporated into the Articles, his authorities were inclined to feel that they should not be as "open-ended" in time as had been envisaged by Mr. Dale. On that point his position might be regarded as approaching Mr. van Campenhout's proposal. But with respect to all questions of substance, he could only reserve his position. As far as his authorities were concerned, it was still an open question whether temporary floats should be restricted to cases where fundamental disequilibrium existed or whether they should also be applied to cases where unmanageable capital flows existed or, for that matter, to any other circumstances.

Mr. Ugueto said that he would like to restate his belief in the present par value system. To what extent present difficulties would be ameliorated by a mere technical measure, such as a limited widening of the margins, was an open question. But he was certain that even if many of the countries which had elected him were given the authority to maintain intervention points wider than those that were presently incorporated in the Articles of Agreement, they would not avail themselves of such an authority because it would be of no advantage to them. On the other hand, the adoption of wider margins by industrial countries would have consequences on the external accounts of his own countries which would be difficult to measure. There would also be difficulties as regards the management of his countries' international assets and in the pursuit of their domestic aims. He would, therefore, find it hard to give his unqualified support to the proposal for wider margins unless prior consideration were given to the safeguards which his countries would receive. Nonetheless, he was prepared to discuss on a country-by-country basis the proposal for wider margins, as was incorporated into the proposals presented by both Mr. Dale and Mr. van Campenhout. In any case, if the Articles were to be amended so as to include the possibility of countries availing themselves of wider margins when they were subjected to disequilibrating flows of capital, the Fund, as representative of the international community, should at the same time be given the real opportunity of being able to ask a country to cease using wider margins, either when the Fund found that the conditions which had originally made wider margins necessary had disappeared, or when the Fund was satisfied that there was no longer a need for the provision for wider margins. That type of safeguard, i.e., an authority invested in the Fund, would have to be of the type that would make countries rely on the fact that the basic rules of the system were respected. He shared Mr. van Campenhout's view that any provision for wider margins should not have an a priori limit. Rather, the Fund's authority should be strengthened adequately, and conditions should be made progressively stiffer for a country as it moved from a slight widening of the margins to a full floating exchange rate. Whether or not progressive conditions should be made available for cases of speculative flows of capital or for cases of a structural nature was somewhat academic, as Mr. van Campenhout's statement, which had been made at EBM/71/51, clearly indicated, in the sense that it would be difficult at times to distinguish between one case and another.

Continuing, Mr. Ugueto said that the only protection against misuse of any proposal that was incorporated into the Articles of Agreement would be through the authority of the Fund and the willingness to use that authority. The devising of a framework within which such a mechanism could be used would be one of the more difficult exercises that the Fund would have to undertake. The problem centered on whether the interests of the international community would be best served by keeping countries within a legal framework, or whether "living in sin" would instill greater caution into the countries that would otherwise be affected by conditions. The question to be asked was whether a legal framework that provided for greater flexibility, as well as safeguards, would really make the Fund more capable of exerting its point of view when conflicts arose between itself and a member. On the other hand, if the Fund continued to rely on its capacity to dissuade, or, if it were to have the capacity to impose sanctions, but would not be willing to use them, his authorities did not believe that any extension of the Bretton Woods system to cope with anomalous situations would improve the present state of affairs.

Mr. Viénot said that he had to reiterate the very strong reservations which his authorities had about the whole flexibility exercise. Those reservations were as strong as ever. The reasons for their position had been repeatedly made clear. Moreover, they considered that the present discussions were more likely to increase than to alleviate the present instability in the international monetary system.

With respect to the U.S. proposals, Mr. Viénot confirmed what he had said at EBM/71/69. As regards the proposal for wider margins, his authorities did not share the view that such a device would offer a sufficient and an adequate response at times of speculative pressures. In such circumstances, the margin, whatever it might be, would be rapidly used up when persons operating in foreign exchange markets expected a change in a par value. Further, his authorities did not believe that a margin of 2.5 per cent or 3 per cent would represent a slight widening of the margins, because, for currencies other than the dollar, such margins would mean potential variations between currencies of 10-12 per cent. In addition, his authorities did not think that EEC members would find it in their own interests to allow their currencies to fluctuate more widely with respect to the dollar than they did at present, simply in order to accommodate countries which encountered difficulties due to capital inflows, and there was a risk of endangering the relative position of the EEC in world trade.

Turning to transitional floats, Mr. Viénot observed that it was difficult for his authorities to share the view that such a technique, which would mean following a pattern set by market forces, would permit a move from one par value to another in an orderly manner. Even when market forces gave a steady and clear indication, countries that floated their exchange rates did not always seem prepared to follow the lead. Moreover, the use of a floating exchange rate to correct an actual, not to mention an emerging, fundamental disequilibrium would not be in accordance with the Articles of Agreement. More broadly, the access by members to such facilities as proposed by the U.S. authorities appeared to be very open-ended, and the combination of the two U.S. proposals might very well open the door to some kind of generalized crawling peg system. Finally with respect to transitional floats, if the Articles were amended so as to introduce new rules, the Fund should also, at that time, be granted the necessary powers to have its views respected by member countries and, of course, that raised the problem of possible sanctions. Thus, he would welcome any staff study on sanctions.

Although Mr. van Campenhout's proposal raised difficulties of principle which prevented the French authorities from supporting it, Mr. Viénot indicated that they recognized that, in certain technical respects, the proposal had the merit of trying to make possible departures from the conditions of the present par value system conditional, temporary, and limited. From that point of view, and on purely technical grounds, Mr. van Campenhout's proposal as opposed to the U.S. proposals seemed to offer advantages. Both the proposals of Mr. van Campenhout and Mr. Dale deserved attention and should be studied further. In that connection, he was grateful to Mr. van Campenhout for providing explanatory notes.

In conclusion, Mr. Viénot said that given the basic position of his authorities on the whole issue of flexibility, he would refrain from commenting at the present time in a more detailed way on the different papers before the Executive Board.

Mr. Al-Atrash said that in the main he would confine his comments to the proposals for a slight widening of the margins and for temporary deviations from par value obligations. At EBM/71/69, Mr. Dale had indicated that the U.S. authorities were of the view that it was not necessary to envisage a specific provision in the Articles on the subject of small and more frequent changes in par values. The position of the U.S. authorities was exactly the same as his own position on that matter.

With respect to a slight widening of the margins, Mr. Al-Atrash observed that it was obvious that the strongest case that could be made for an amendment of the Articles of Agreement in that direction would be to enable a country to exercise control over short-term capital movements, which were mainly induced by interest rate differentials between financial centers. It could be argued, however, that the remedy for interest rate induced capital flows should lie not in a slight widening of the margins, but in trying to control such movements by harmonizing interest rates in the various financial centers. Of course, the latter procedure would require more emphasis to be placed on fiscal policy as opposed to monetary policy in overall demand management. His chair was, however, aware of the difficulties that might be encountered in attempts to harmonize interest rates, and it was also aware of the fact that those who advocated slightly wider margins were usually pessimistic as to the prospects of interest rate harmonization. At any rate, in the event that the harmonization of interest rates proved difficult, he wondered whether it would be possible to discourage movements of interest-induced short-term capital by the adoption of measures to sterilize the impact of capital inflows on domestic liquidity by the receiving country.

His chair felt that the strongest case against slightly wider margins was that such a regime might entail disadvantages for developing countries, Mr. Al-Atrash said. The possible disadvantages were threefold. In the first place, fluctuations in a destabilizing or disequilibrating manner in the exchange rates of developing countries vis-à-vis nonintervention currencies might occur. In the second place, difficulties might be created for developing countries that tried to form some sort of economic grouping among themselves. In the third place, problems for portfolio management might occur for those countries that maintained a multiple external reserve system. Despite those problems and despite the misgivings of some of the countries that had elected Mr. Deif, the statement delivered by himself on behalf of Mr. Deif at EBM/71/69 had indicated that his chair considered a widening of the margins to 2 per cent as the maximum measure that the Executive Board ought to be prepared to accept. He believed that if the 2 per cent widening of the margins was acceptable, it should be made available to all countries, and without stipulating conditions in any possible amendment of the Articles. A larger widening of the margins to 2.5-3 per cent as explicitly envisaged in Mr. Dale's proposal, or implied in Mr. van Campenhout's proposal, which also contained certain explicit conditions which would have to be satisfied, might entail the danger that had been referred to in Mr. Kafka's earlier statement, namely, "distinguishing systematically between two groups of countries."

As regards the question of legalizing temporary deviations from par value obligations, Mr. Al-Atrash said that there were three arguments in its favor. First, temporary deviations might be necessary in order to enable the authorities of a country that was suffering or was believed to be suffering from a fundamental disequilibrium to determine a realistic par value in accordance with market forces. When an exchange rate was determined in the market, a return to an effective par value would be made either at the old value or at a new one. Of course, the deutsche mark revaluation of 1969 fitted that argument. Second, temporary deviations might be necessary in order to enable a country to deal with speculative short-term capital flows that were motivated by the expectations of a change in par value. Third, since temporary deviations, in certain circumstances, were a fact of life, it would be better from the point of view of the credibility and the prestige of the Fund to legalize them. However, there were also three counterarguments. First, temporary deviations, in order to establish a more realistic par value via market forces, might not always prove to be temporary, as the present Canadian floating exchange rate exemplified. Second, there was a better method of dealing with speculative short-term capital flows: the Articles of Agrement made provision for countries to impose controls on such flows as an alternative to permitting temporary deviations from par value obligations. Third, legalization of temporary deviations from par value obligations might encourage further recourse to them. But that counterargument might not be particularly strong in view of the fact that if a country found that it was in its interest to deviate temporarily from the present Articles of Agreement, those Articles would unfortunately not constitute, from a practical point of view, a hindrance to it doing so. Mr. Dale's proposal to legalize temporary floats in the case of a country making a representation to the Fund that it had an actual or an emerging fundamental disequilibrium, had certain merits, but he wondered about the real contribution if such a proposal were incorporated into the Articles, because it ruled out a situation in which a country might suffer from speculative capital flows, while at the same time its external balance might not be suffering from a fundamental disequilibrium. In other words, under Mr. Dale's proposal, Germany would not have been permitted to float its exchange rate as it had done in May.

Mr. Schleiminger said that he was grateful to have another opportunity of discussing the exchange rate flexibility issue and he wished to make some general comments. Since the 1970 Annual Meeting in Copenhagen, the Fund had undertaken some extremely useful work on the matter of exchange rate flexibility even though a consensus had not yet been reached. At the present time, it was more widely accepted than it had been in 1970 that a problem existed and that it was in the common interest to find a constructive, reasonable, and generally acceptable solution to it. In the discussions which had occurred in 1971, the scope of possible solutions to the problem had been whittled down. Moreover, the Executive Board had had the opportunity of understanding better some of the legal and the policy implications of the proposals that were being discussed. The fact that there were only two official proposals before Executive Directors was perhaps rather indicative of the limitations regarding options that were politically feasible and desirable. Of course, that was not to say that other variations on themes similar to the ones on which the two official proposals were based ought to be excluded. He did not believe, however, as Mr. Kafka apparently did, that the whole exchange rate flexibility matter was essentially one of procedure and should be treated as such. The matter concerned reform, even if it were limited in scope, and even if it were not the answer to all the problems concerning international monetary management. The recent discussions which the Executive Directors had had on Chapters 1 and 2 of the 1971 Annual Report had shown that there were a great many other problems in existence and that they might have to be tackled in time.

Turning to the proposals before the Executive Board, Mr. Schleiminger expressed his gratitude to Mr. van Campenhout for the explanatory notes which had been provided; they were very helpful and provided food for further thought. He reiterated the interest of his German authorities in Mr. van Campenhout's proposal, and recommended that it be set aside for further examination by Executive Directors and also by the staff. Mr. Dale's proposal, as a whole, took a different approach, but it also sought important safeguards for the maintenance of the par value system. Those two proposals, in some ways, polarized the issues. Moreover, Mr. Kafka appeared to believe that, after all, the status quo did not offer too many difficulties. He, himself, agreed with Mr. Kafka that international cooperation had so far provided effective results, even in areas where no international treaties or articles were laid down. Nevertheless, he believed that rules of conduct had their advantage, and a reform of the international monetary system should, in all cases where it was possible, be set forth in an agreement. Therefore, Mr. Kafka's approach to the problem should only guide the Fund in the period of transition from the present system to a better one. Like Mr. Viénot, he would be very interested in hearing the views of other Executive Directors, and particularly learning of any possible trend that might indicate the chance of reaching a consensus, which his authorities were looking forward to.

Mr. Brand noted that there were two broad proposals before the Executive Board and that he would deal with them in turn. As he had said at previous Board discussions, all his authorities were strongly opposed to authorizing temporary deviations from par value obligations, even if strict conditions on the duration and on the size of fluctuations were imposed. They believed that to legalize any protracted deviations of that nature would be tantamount to throwing out the whole concept of the par value system. Legalization of such long floats would clearly contradict the fundamental nature of the par value system, and it would therefore weaken the Fund's credibility. The Fund was not ignoring departures from the Articles of Agreement by refusing to legalize temporary deviations; it was saying that it did not approve them. At present, the countries that had adopted temporary floats had to remain in close consultation with the Fund and, as he had suggested at EBM/71/69, the Fund should also give some thought to withdrawing some of the benefits of Fund membership from countries violating the Articles. Whatever the result of the Board's study of the staff paper currently being prepared on sanctions, the Board was, by not legalizing long floats, at least placing some pressure on the offending country to return to a par value. That pressure would surely be weakened in long floats, which were adopted for internal economic reasons, were legalized. Having said that, personally he had some sympathy with very "short transitional floats" that resulted from the difficulty of being able to immediately decide what new par value should be adopted. The case of Germany in 1969 was a good example of such floats. Some consideration might be given to legalizing short transitional floats of, say, six weeks or so, if there were severe restrictions on the duration and on the width of the float. Also, the availability of appropriately tough sanctions would be needed to discourage countries from abusing such a provision. In his opinion, short floats of that nature did not conflict with the fundamental principles of the par value system, or involve any great or prolonged disruption to international monetary affairs.

With respect to the question of a slight widening of the margins, which was the second broad proposal before the Executive Board, Mr. Brand observed that he had already pointed out some of the initial difficulties that would be faced by his countries if margins were widened. Those difficulties would center on links to the pound sterling and on trade transactions. However, on a personal basis, he had never ruled out wider margins in appropriate circumstances, subject to it being demonstrated to his satisfaction that the advantages of that proposal would outweigh its disadvantages. Naturally, he was unable to tell the Board which way his respective Governors would vote, if a vote on the wider margin proposal were called for, but he was able to provide an idea of how his authorities' views were developing at the present time. His Australian authorities believed that it was open to doubt whether exchange controls would be effective in stopping particular kinds of capital flows. They agreed with the use of some controls on capital inflows, and with attempts at obtaining better policy mixes, but they were under no illusion that such measures should be relied upon to prevent disruptive capital flows. They did not believe that short-term capital flows were the underlying cause of existing problems; those flows were simply a symptom of much deeper problems. Capital flows were in the nature of a preceipitating factor and their capacity for disruption had been increased by the operations of the Euro-currency market. The major underlying problem still remained unresolved, i.e., the failure of certain countries to take the necessary measures to put their balance of payments position on a more long-lasting and viable basis, or to adjust their exchange rates to realistic levels.

His Australian authorities felt that the par value system had been a major factor in facilitating the tremendous growth in world trade since 1945, Mr. Brand said. They maintained their strong support for that system as a whole. But that did not mean they would oppose outright any changes in the Bretton Woods system which were made to take account of changes in international conditions since the system had first been devised. The 1 per cent limit on the size of the margins, contained in the Articles, was not a sacrosanct figure that could never be varied. His authorities had, therefore, closely studied the possible costs and benefits of providing the exchange rate machinery with some greater flexibility above the amount already provided for in the Articles. They realized that many countries believed that a slight widening of the margins would have some beneficial effects. However, they had not been convinced that the various changes of the types presently being discussed would do much in practice to improve the present system. They believed that if the system was to work properly, countries ought to be prepared to adopt and maintain realistic par values. Governments were reluctant, for a whole host of reasons, to vary exchange rates, and changing the Articles was not going to radically alter that attitude.

A slight widening of the margins would not, therefore, do much to correct the basic problem faced at the present, Mr. Brand noted. Nevertheless, that proposal might assist in the day-to-day management of foreign exchange markets, without imposing a very substantial cost in other directions. Wider margins might help to induce greater self-equilibration in short-term capital flows than currently existed, even though they would perhaps be unlikely to do much to reduce the volume of gross flows. As to the amount to which margins might be widened, his Australian authorities were, at present, uncertain as to whether 2 per cent or less would offer any real benefit. As Mr. Lieftinck had pointed out at EBM/71/69, the upper and lower intervention points could, with that sort of margin, be very rapidly reached in a crisis and speculative pressure might be applied at a point further from the par value than occurred at present. His Australian authorities would like to see further discussion on the advantages and disadvantages of a widening of the margins to 2.5 per cent or 3 per cent. Beyond 3 per cent they believed the disruption caused to trade transactions would be too great and they would strenuously oppose any such widening. In summary, they did not believe a slight widening of the margins could by itself have prevented the latest currency crisis, but it might improve the mechanism for dealing with international currency movements, and might also suggest that the Fund was prepared to adapt the existing par value system to comply, where necessary, with existing circumstances.

His New Zealand authorities would not differ very much from what he had so far said, Mr. Brand observed. When final positions had to be taken, they would be interested in seeing where the Executive Board as a whole had come out and what were its proposals to the Board of Governors. His South African authorities had no enthusiasm either for wider margins or for legalized temporary floats because they did not believe that they would materially assist in solving current international monetary problems. In their view, preoccupation with those matters could divert attention away from the more important causes of the present difficulties, such as the U.S. balance of payments disequilibrium and world inflation. That did not, of course, mean that they would necessarily vote against any proposal that was made for amending the Articles; they were still making up their minds.

Mr. Brand indicated that he did not wish to comment in detail at the present time on the proposals set forth by Mr. Dale and by Mr. van Campenhout. Certainly, his authorities would have difficulty in supporting any proposals to introduce legislation in the form of temporary floats in the circumstances Mr. van Campenhout had suggested. To prevent problems arising from the movement of interest-sensitive capital, they would hope that "other measures," which had been mentioned by Mr. Dale in the sixth paragraph of his opening statement at EBM/71/69, would be taken. Turning to Mr. Dale's own proposal for transitional floats, he recalled that he himself had pointed out at EBM/71/69 that a strict time limit would be needed. The implication, provided by the reference to quarterly reviews in Mr. Dale's statement in that meeting, had been that the limit would be quite a long one. He himself favored a far shorter time period with a maximum duration for floats of six weeks, and with a strict limitation on the width of exchange rate movements to be allowed, and sanctions for those members that disobeyed the rules. Mr. Dale's proposal for the use of wider margins to be limited by authorizing the Fund to withdraw the option for their use, if they were being used in a way inconsistent with the purposes of the Fund, created many problems. The question was again raised whether the Fund would ever withdraw the option once it had been given, and if it did, and the government concerned continued to use wider margins, what action would or could the Fund take. Failing the establishment of really strong sanctions against countries that broke the rules, it would be better to widen the margins slightly and allow countries that wished to do so to use the availability of wider margins, whether on a temporary or on a permanent basis. No country ought to be forced to use wider margins if it did not wish to do so, and the Fund should not be placed in the potentially embarrassing situation of having to withdraw the option and to endeavor to enforce its decision. However, his mind had not yet been finally made up on that point, and he would be interested to hear from other speakers.

The Executive Directors agreed to continue their discussion on exchange rate flexibility in the afternoon.

APPROVED BY THE EXECUTIVE BOARD:
Meeting 71/108, October 15, 1971

PIERRE-PAUL SCHWEITZER
Chairman

W. LAWRENCE HEBBARD
Secretary