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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 82/22

10:00 a.m., February 22, 1982

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

Executive Directors	Alternate Executive Directors
M. Abdollahi	
	C. Taylor
	S. E. Conrado, Temporary
	H. G. Schneider
	P. D. Peroz, Temporary
R. D. Erb	
	T. Alhaimus
	T. Yamashita
	R. T. Salazar
R. K. Joyce	
	G. Jauregui, Temporary
	V. Supinit
S. Kiingi	
	G. Winkelmann
G. Lovato	C. P. Caranicas
	A. B. Diao, Temporary
M. Narasimham	
	S. El-Khouri
J. Polak	T. de Vries
A. R. G. Prowse	
J. Sigurdsson	L. Vidvei
Zhang Z.	

L. Van Houtven, Secretary
M. P. Blackwell, Assistant

Also Present

M. Stojiljkovic, Alternate Executive Director, IBRD. African Department: J. B. Zulu, Director; O. B. Makalou, Deputy Director; N. Abu-zobaa, F. d'A. Collings, S. E. Cronquist, C. Enweze, E. K. Martey, M. Sidibe, D. E. Syvrud, K. Yao. Asian Department: A. Abadjis, S. Kimura. European Department: B. Rose, Deputy Director; M. Dakolias, P. de Fontenay, L. G. Manison, H. O. Schmitt, G. Tyler. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; S. Mookerjee, Deputy Director; S. J. Anjaria, S. Kanesa-Thasan, J. Odling-Smee, P. J. Quirk. External Relations Department: A. Abushadi. Fiscal Affairs Department: A. M. Abdel-Rahman, R. D. Kibuka. IMF Institute: M. A. Ceesay, V. R. Jensen, Participants. Legal Department: B. R. Campbell, Ph. Lachman, J. V. Surr. Research Department: T. Gudac. Treasurer's Department: H. Flinch. Western Hemisphere Department: A. I. Abdi, M. E. Hardy. Office in Europe: G. Taplin. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: E. A. Ajayi, C. J. Batliwalla, M. A. Janjua, K. V. Jännäri, S.-W. Kwon, Wang E. Assistants to Executive Directors: L. Barbone, L. E. J. Coene, T. A. Connors, R. J. J. Costa, M. K. Diallo, F. G. Guena, P. Kohnert, J. S. Mair, J. A. K. Munthali, V. K. S. Nair, Y. Okubo, C. N. Pinfield, J. Reddy, J. Schuijer, D. I. S. Shaw, H. Suzuki, O. Üçer, J. F. Williams, A. Yasseri.

1. THE GAMBIA - STAND-BY ARRANGEMENT AND EXCHANGE SYSTEM

The Executive Directors considered a request from The Gambia for a stand-by arrangement equivalent to SDR 16.9 million and for approval of a multiple currency practice (EBS/82/17, 1/26/82; and Cor. 1, 2/19/82).

The staff representative from the African Department remarked that data recently received by the staff indicated that in the period ending December 1981 total government expenditures in The Gambia had been running well below program targets, largely because of lower than anticipated wage settlements and development expenditures. While the data were most encouraging, it had to be remembered that development expenditures in particular were of a "lumpy" nature and might begin to rise again in due course. Finally, the Gambian authorities had confirmed that all of the prior actions envisaged under the program had been met.

Mr. Kiingi made the following statement:

Since the discussion of the last Article IV consultation with The Gambia, the economic and financial situation has not shown any marked improvement. The production of goundnuts, which accounts for 90 per cent of exports, continues to be below potential after reaching 167,000 tons in 1978/79. The terms of trade have also deteriorated. This, together with expansionary monetary and fiscal policies, has led to continued pressure on the balance of payments.

The authorities have recognized the problems as well as the need to effect structural adjustment and have adopted a stabilization program for which they are requesting the Fund's assistance in the form of a one-year stand-by arrangement. To achieve the broad objectives of the program, a number of corrective measures are being taken to strengthen the productive base of the economy and contain the growth in aggregate demand. These are expected to lay the foundation for a medium-term program that the authorities hope will be supported by an extended arrangement with the Fund.

In the agricultural sector, the authorities are taking measures to increase the production of groundnuts and to achieve self-sufficiency in food. Producer prices for groundnuts and rice have been increased, and further increases are expected in the 1982/83 crop season. Infrastructural facilities designed to support the agricultural sector are also being developed.

In the energy sector, the authorities are placing emphasis on conservation measures to reduce the import bill for oil. All increases in petroleum prices are to be passed on to the consumer. Recently, prices of petroleum products were increased by between 54 per cent and 200 per cent, and electricity tariffs were raised. The authorities are encouraging the use of local sources of energy including groundnut shell briquettes. The World Bank is also assisting in a comprehensive Integrated Energy Survey and Master Plan for The Gambia.

With regard to fiscal policy, the authorities have introduced several tax measures in the 1981/82 budget. These include increases in duties on a number of imports and re-exports. Expenditure control measures are being strengthened. In this regard, expenditures are now preaudited and monitored on a regular basis. A high-level Financial Management Committee, under the chairmanship of the Permanent Secretary of the Ministry of Finance, has also been established. Furthermore, measures have been taken to strengthen the financial position of public corporations. These measures are expected to reduce the budget deficit from 10 per cent of GDP in 1980/81 to 8.2 per cent in 1982/83.

In the monetary sector, interest rates have been increased and growth in liquidity restricted in accordance with the policy of restraining aggregate demand and achieving a sustainable balance of payments position. Meanwhile, adequate credit is being made available for crop financing. Furthermore, a new Agricultural Development Bank has been established to commence operations by the middle of 1982.

In order to improve the external account, measures have been taken to strengthen administrative procedures governing the surrender of foreign exchange. The authorities have also adopted guidelines on the guarantee of external private debt and are paying particular attention to the reduction of external arrears.

The staff believes that the implementation of the measures contained in the program should improve the Government's financial position and the balance of payments and should reduce inflationary pressures in the economy. The authorities have indicated their willingness to take further measures as may be necessary to achieve the objectives of the program. I, therefore, commend to the Board for approval the request for a stand-by arrangement in the amount of SDR 16.9 million.

Mr. Taylor indicated his support for the proposed decision. The Gambia's difficulties could be accounted for in part by bad weather over the previous few years, but they had been considerably aggravated by inappropriate economic policies. Fortunately, the authorities' medium-term adjustment program reflected a welcome recognition that the country's problems were not transitory but the result of entrenched structural distortions. He hoped that the authorities would implement their economic plan with vigor and in continued cooperation with the World Bank. Could the staff comment about the timeframe in which the authorities planned to achieve their objectives? The most evident need in the short term was for stabilization as a means of correcting the exceptional financial imbalances caused by the political disturbances of July 1981. In the circumstances, a one year stand-by arrangement was quite appropriate; he hoped, however, that it would be followed by a longer-term arrangement in which underlying problems would be tackled in a sustained manner.

The authorities deserved commendation for the program that they had initiated, and, in particular, for their success in containing government expenditure, Mr. Taylor continued. He welcomed the increases in interest rates, and particularly the liberalization of the ceiling on the officially determined maximum interest rate for credit. Both monetary and fiscal policy now appeared consistent with the authorities' objectives, and he hoped that they would be applied with flexibility--for example, in response to any worsening in the weather. He welcomed the measures taken to channel investment into productive sectors of the economy and the assistance being given to institutions in the agricultural sector. The increases in producer prices in 1981/82 were also welcome; they should be maintained at realistic levels. Specifically, rice prices should be increased in a way that would lead to early self-sufficiency.

The Gambia Produce Marketing Board had been prone to financial difficulties for some time, and he welcomed, therefore, the efforts that were being made to give it greater stability, Mr. Taylor noted. The authorities had transferred some fixed assets to the Board in order to discharge a debt, and he would be interested to know whether they proposed to repurchase them at some time, or whether the Board itself would be selling them through alternative channels. It was vital that the Board's cash reserves should be safeguarded in order to cover the inevitable periodic losses that would follow periods of unfavorable trading conditions. He hoped that the newly acquired fixed assets would be used to that end and to ensure the longer-term viability of the Board. The increased proportion of STABEX receipts to be allocated to the Board should be helpful in that context, and should reduce the Board's dependence on bank finance.

The efforts being made by the authorities to improve the monitoring and efficiency of the nonfinancial public enterprises were most welcome, Mr. Taylor observed. However, in view of the serious financial difficulties of those enterprises, he wondered whether consideration had been given to the possibility of exposing their operations more fully to market forces, possibly by transferring certain of their activities to the private sector.

During the discussion of the previous Article IV consultation (EBM/81/84, 6/3/81), some Executive Directors had questioned the appropriateness of the link between the dalasi and sterling, Mr. Taylor recalled. Presumably that link had resulted in a fluctuating but generally appreciating real effective exchange rate. Did the staff share the authorities' view that the present exchange rate and exchange system were both appropriate? Might some alternative peg be desirable? If so, would the effective exchange rate need to be changed significantly? He welcomed the steps that had been taken to reduce arrears and to improve the collection of export proceeds. It was perhaps rather disappointing that external arrears would be reduced by only some 19 per cent in the period extending to June 1982, although the authorities did intend to reduce them more rapidly, should exports turn out better than expected. Had the staff considered linking the performance criterion on arrears more closely with the level of groundnut receipts? A similar linkage had been introduced quite recently under the Jamaican program. Finally, he commended the authorities for their efforts to maintain a relatively liberal exchange system.

Mr. El-Khouri noted that in June 1981 the Gambian authorities had embarked on a program of financial and economic reform, which had been interrupted by the political disturbances of the following month that had caused substantial economic damage. The Saudi Arabian authorities had been glad to provide some emergency aid at that time. The Gambian authorities had now reaffirmed their commitment to proceed with a reform program, and he warmly supported their request for a one-year stand-by arrangement. The program was comprehensive, calling for corrective actions in pricing, fiscal, monetary, and external sector policies.

Upward adjustments had been or would be made in the producer prices for groundnuts and rice, and in the retail prices for rice, fertilizer, public transportation, and energy products, Mr. El-Khouri observed. Through their fiscal policy, the authorities hoped to arrest the deterioration in the budget in 1981/82, and to make noticeable improvements in 1982/83. It was regrettable that the ratio of revenues to GDP had declined sharply since 1979/80; it was essential that that trend be reversed. He had been encouraged to note that some control was now being exercised over expenditures. The indebtedness of the nonfinancial public enterprises to the banking system had been a major source of credit creation in recent years. He wondered why the monetary survey in the staff paper grouped those enterprises with the private sector, so that it was not possible to see how much credit had been extended to the enterprises. He would be grateful if the staff could say whether the administrative reforms of the enterprises, which the authorities had said they intended to implement by February 1982, had, in fact, been introduced.

Imbalances in the external sector were quite significant, Mr. El-Khouri commented. The ratio of the current account deficit to GDP was estimated at 41 per cent for 1981, and was projected to fall to about 30 per cent in 1982. In that context, could the staff say why official transfers, which were a recurring feature of the balance of payments, had been classified under the capital account and not under the current account? If official transfers were to be included in the current account, the ratio of the current account deficit to GDP would be much smaller than indicated, perhaps between 15 per cent and 20 per cent. However that might be, such a ratio would still be high and would still point to the need for adjustment. On another point, could the staff explain what proportion of external arrears was accounted for by official debt service payments and what proportion by commercial payments? Could the staff also indicate to which governments and banks the arrears were owed?

He could approve extending approval of the multiple currency practice associated with the blocked local counterpart of external arrears, Mr. El-Khouri concluded. The regulations concerning blocked deposits were justifiable, since without them the deposits might be used for credit creation. Finally, he supported the proposed decision, commended the authorities for adopting a stabilization program, and urged them to make their best efforts to ensure its success.

Mr. Erb remarked that The Gambia faced a serious balance of payments problem, which resulted not only from two consecutive poor harvests, but also from a number of inappropriate domestic policies. He wished to pose a number of technical questions. First, the staff had described the changes in prices of rice and fertilizers that had already been made and had indicated that further changes could be expected later in the year and before the mid-term review. How important would those pricing policy adjustments be in relation to the overall program of balance of payments adjustment? What magnitude would the price changes need to be to be consistent with balance of payments adjustment objectives? Second, could the staff assess how important a role re-exports to Senegal had played in creating The Gambia's balance of payments problems? From the paper it seemed that they might have made a significant contribution. He would also be interested to know whether the tariff measures had been sufficient to reduce the problem of re-exports to neighboring countries and whether further tariff measures were likely to be necessary for that purpose. The Gambia's open and liberal financial market seemed to provide opportunities for entrepreneurs to work to their own advantage and to the country's detriment when the exchange rate was maintained out of line.

A third question related to The Gambia's Produce Marketing Board, Mr. Erb continued. Could the staff say whether the transfer of part of the Atlantic Hotel complex and another government-owned building to the Board would contribute to a solution of the Board's problems? If the Board's real problems stemmed from faulty pricing policies, would not the transfer of assets or STABEX receipts simply buy time and delay potential adjustment? His final technical question concerned the welcome implementation of a fiscal monitoring system. Could the staff indicate whether the Government's reporting system was adequate to enable the authorities to maintain sufficient control over expenditure?

At a strategic level, he would be grateful if the staff could give a more qualitative assessment of The Gambia's balance of payments objectives and the timeframe in which they were expected to be achieved, Mr. Erb said. Chart 1 in the staff paper indicated the direction in which the current account and the overall balance of payments were expected to move. It would be interesting, however, to know more clearly what balance of payments objectives had been set and what longer-term policies the authorities would need to implement to achieve them. It would also be interesting to know how the current program fitted in with longer-term plans. In that context, could the staff explain why it had recommended providing drawings equivalent to 125 per cent of quota, and making up to one third of the total amount involved available at the outset of the program?

The staff representative from the African Department remarked that the Gambian authorities intended to negotiate an extended arrangement with the Fund in the future. Following the political disturbances of

July and August 1981, the authorities had had to change their priorities and to place more emphasis on stabilizing the economic situation before embarking on negotiations for an extended arrangement. Moreover, the staff felt that it would be useful to see how the authorities would succeed under a one-year stand-by arrangement, and to assess what monetary and economic arrangements The Gambia would make with Senegal, before taking a position on how to proceed in negotiations for an extended arrangement. It was not yet clear whether The Gambia would join the existing West African Monetary Union as a separate entity or in association with Senegal. At the moment, the two countries remained independent.

Under the second Five-Year Development Plan, the authorities were placing particular emphasis on the need to increase agricultural production and would merely attempt to consolidate progress made in transport and communications, the staff representative explained. For that reason, an increasing amount of resources would be channeled to the agricultural sector and a decreasing amount--made up largely of carryovers from the first Five-Year Plan period--would be channeled to transport and communications. Expenditures on tourism, which had increased considerably under the previous plan, would also be cut back. The authorities intended to move cautiously with their new development plan, and expenditure for the first year would be limited largely to ongoing expenses from previous projects and some new expenditure designed, for example, to improve rice production, to stimulate indigenous non-oil energy sources, and to modernize the Produce Marketing Board. The authorities realized that the success of the plan would depend to a large extent on external financing, and for that reason were concentrating their efforts on those projects for which the availability of foreign financing was relatively certain. In response to questions about the Produce Marketing Board, the authorities envisaged that the Board would either lease or sell the assets transferred to it by the Government. He was not aware that the authorities had any plan to repurchase those assets in due course.

Market forces were expected to play an important role in the nonfinancial public enterprise sector, as recent changes in the prices of energy and transportation made evident, the staff representative commented. The authorities intended to transfer some hotels to private enterprise, although no detailed timetable had yet been drawn up.

The authorities believed that the link between the dalasi and sterling had a certain sentimental appeal to the population, the staff representative said. More important, recent studies that they had undertaken, as well as some staff studies, had failed to establish a clear reason for altering the link. If it was felt desirable to keep the dalasi as stable as possible, it would be advisable to link it to the SDR; however, the authorities were concerned that linking it to the SDR would make necessary the declaration of a daily rate for the dalasi against the dollar. Furthermore, the latest data indicated that although the exchange rate of the dalasi had appreciated up to the end of 1980, it had since depreciated. Finally, after much discussion, and considering that the groundnut sector was highly competitive--with producer prices much higher in nominal terms in The Gambia than in other countries in the region--and that the Produce Marketing Board had not been making losses on the groundnut crop as a result of its pricing policies, both the staff and the authorities had judged it appropriate to maintain the link for the time being. When there had been losses on the groundnut crop, they had been caused by drastic declines in volume following bad weather. For all those reasons, the staff shared the authorities' view that it would be better to begin tackling balance of payments problems through credit policies and fiscal policies rather than through exchange rate actions.

The Gambia's balance of payments problems, the staff representative continued, could be attributed to two major factors: a decline in the groundnut crop and an increase in the demand for imports. The strong import demand could be explained by the country's tariff level, which was lower than that of Senegal, and by the maintenance of an extremely liberal system of trade and payments. In consequence, the authorities believed that they should take steps to change the tariff differential and to observe what effects that change would have. The authorities also believed that credit policies, which had been somewhat expansionary in the past, should be controlled more effectively as a means of easing import demand. For that reason there was considerable emphasis in the program on monetary policies designed to compel the commercial banks to restrain credit in order to meet specified liquidity requirements. The ceiling on borrowing rates for imports had been removed, and a system of monitoring crop financing had been instituted; in the past, some credit designed for crop financing had been diverted into the financing of imports. The authorities would wait to see how effective such policies would be before considering any changes in the exchange rate.

More specific figures for nonfinancial public enterprises in Chart 1 would have been useful, the staff representative acknowledged. He had recently learned from the Gambian authorities that the Board of Directors of the National Investment Board, responsible for monitoring the enterprises, had approved all of the measures planned for implementation in February 1982. The measures were now awaiting presidential approval and would go into effect soon after it had been received. If the measures were not implemented by the end of the month, they should be soon thereafter.

In response to a point raised by Mr. El-Khouri, the staff representative explained that if official transfers were classified under the capital account of the balance of payments rather than under the current account, the current account deficit and its ratio to GDP would appear much smaller. However, the staff had wanted to obtain a clear view of the burden of adjustment in the economy for which the authorities could be called upon to take measures. Since grants had been exogenous, including them in the current account of the balance of payments would tend to distort the picture by understating the burden of adjustment that the authorities themselves would have to undertake. Some 95-98 per cent of external arrears in The Gambia were commercial. There had, on occasion, been some official arrears, but the authorities had always taken immediate steps to clear them.

The recent and prospective changes in rice and fertilizer prices were expected to play an important part in The Gambia's adjustment program, the staff representative explained. The authorities hoped to stimulate domestic production of rice so as to cut back on the need for imported rice. Changes in fertilizer prices had been motivated by the authorities' belief that farmers should pay a fair price for one of the major inputs in the agricultural sector. Both price changes should have a beneficial effect on the balance of payments. The authorities had undertaken to increase the retail price of imported rice by some 29 per cent, and the retail price of domestic rice by some 21 per cent. They hoped to be able to eliminate and halve, respectively, the rice subsidy and the fertilizer subsidies by 1983/84.

Both the staff and the authorities felt confident that the tariff measures in the program would have a significant impact on the problem of re-exports, the staff representative stated. Most of the planned tariff measures affected re-export items and should yield revenues equivalent to to about 3.6 per cent of GDP in 1982/83. Indications received not only from the authorities, but also from bankers and entrepreneurs, indicated that the tariff measures already undertaken were having the desired effect. The authorities were aware that the question of tariffs would have to be kept under constant scrutiny and that further measures would need to be taken in the future. A Fund team had offered technical assistance to the authorities on tax questions during 1981 and had made recommendations that might have a bearing on the re-export trade and on imports in general. The subject would be discussed again with the authorities in the review exercise in June 1982.

It was evident that government transfers alone would not solve the Produce Marketing Board's financial problems, some of which had been caused by poor pricing policies, the staff representative said. It was in recognition of that fact that the authorities had reduced subsidies on rice and fertilizers and had transferred part of STABEX resources to the Board. More important, the Board had on its own part taken measures designed to reduce its costs by some 5 per cent in 1981/82. More measures would be discussed in the context of the review in June 1982. It was still difficult to judge the efficiency of the reporting system on government expenditures. The authorities believed that there would be a time lag of some six weeks involved in collecting data and reporting it to the Fund. However, the Central Bank of The Gambia would be monitoring net government borrowing from the banking system on a daily basis and would, therefore, have a fairly clear view of how the Government's financial position was evolving.

In assessing progress in adjusting the balance of payments, the staff noted a number of encouraging signs, the staff representative from the African Department remarked. Export earnings were returning to normal after recent problems, and efforts were under way to diversify the export base. With the help of the World Bank, progress was being made in cotton production, and there were favorable outlooks for the fishing and tourism sectors. The authorities were aware of the unpredictable nature of some of the grants that they received. In the past, because of its good image and its liberal policies, The Gambia had attracted a considerable volume of grants. For the future, the authorities hoped to bring import demand to a level that would be sustainable on the basis of normal flows in the balance of payments.

The Chairman observed that it was evident from the table on page 14 of the staff paper that bank financing of the government deficit had increased from the equivalent of 0.4 per cent of GDP in 1979/80 to 0.8 per cent in 1980/81, and to 1 per cent in 1981/82, and that it was expected to remain as high as 0.9 per cent in 1982/83. Was such a level consistent with a stand-by arrangement that would make available resources equivalent to 125 per cent of The Gambia's quota? Perhaps the staff could explain whether it was interested in seeing any particular ratio of bank financing to GDP by the time of the review in mid-1982, and whether attempts would be made to reduce that ratio.

The staff representative from the African Department explained that the estimate of 0.9 per cent of GDP for 1982/83 took account of the possible revenue measures that would be enacted during that year, following the recommendations of the Fund mission that had advised on tax matters. In considering the figures, Directors should bear in mind that the increase in nominal GDP in 1981/82 had been much higher than it would be during 1982/83. It was also important to bear in mind that the authorities had stated their intention of keeping the evolution of the budget deficit under close scrutiny. In order to keep the budget on track over the coming two years, they were prepared to contain bank financing by rephasing or postponing some development expenditures. The authorities had also identified areas in which they could, at very short notice, implement revenue measures by administrative action, for example through the Gazette. The staff would watch the level of bank financing of the government budget very closely and would be discussing the question with the authorities during the review of the arrangement.

The Deputy Director of the Exchange and Trade Relations Department, responding to the Chairman's observations, commented that the proportion of bank financing of the government deficit compared favorably with nine other programs in the upper credit tranches approved by the Executive Board since mid-1981. In fact, in only one case had the proportion been less than 1 per cent of GDP. Taking a broader view, the program envisaged a 5.8 per cent increase in total bank credit during 1981/82--a level that once again was lower than in eight of the nine recent arrangements. However, that relatively favorable situation should not be taken to imply that little needed to be done to overcome The Gambia's fiscal imbalances during 1982/83.

The staff had considered introducing into the program an understanding that should groundnut exports exceed the targets, additional arrears would be paid, the Deputy Director said. A similar understanding had been reached recently with the Jamaican authorities in their stand-by arrangement. The Gambian authorities had felt that if such an understanding were reached, there should be full symmetry and that the amount of arrears to be repaid should be diminished if groundnut exports fell below target.

Given the magnitude of the arrears--equivalent to about 150 per cent of the country's reserves--the staff had felt that it would be appropriate to set at least a minimum reduction in arrears as a program objective. Recent information from the authorities indicated that the level of arrears in January 1982 had been significantly below the program target for March 1982; in other words, greater progress in repaying arrears than was called for in the program was being made.

Since The Gambia's balance of payments problems were large in relation to its quota, and since the authorities had already taken a number of adjustment actions, drawings from the Fund equivalent to 125 per cent of the country's quota seemed appropriate, the Deputy Director of the Exchange and Trade Relations Department commented. There was clearly a balance of payments need: reserves were equivalent to only one month of imports, and arrears were equivalent to about one-and-a-half times the level of reserves. With drawings equivalent to 125 per cent of quota under the present arrangement, The Gambia would have considerable room for further arrangements. Should all the drawings envisaged in the program be made, The Gambia would have outstanding drawings equivalent to about 238 per cent of quota, excluding drawings under the compensatory financing facility. From a tactical point of view, it was of the highest priority that The Gambia should liquidate its arrears as quickly as possible; use of 125 per cent of quota for that purpose was justified. As to phasing, it was perfectly normal for a member to be able to draw as much as one third of total resources available at the outset of a one-year stand-by arrangement. It should be noted that more than one half of the total resources available could be drawn only after the mid-term review.

Mr. Narasimham noted that the projected budget deficit for 1982/83 of 8.2 per cent of GDP was 1 percentage point lower than the program target for 1981/82, and that the projected level of bank financing of the deficit in 1982/83 was only 0.1 percentage point less than the program target for 1981/82. He hoped that during the review the staff would find the reasons for that discrepancy.

The staff representative from the African Department remarked that the projections for 1982/83 represented the best judgment of the staff and the authorities, since work on the budget for that year had only just begun. As required under the program, the program for calendar year 1982 had been worked out in any detail only up to June 1982. The projected figures for 1982/83 had to be seen, therefore, as indicative.

The Chairman commented that the staff would regard the question of bank financing of the budget deficit as a matter of importance. The level of bank financing of the budget deficit was in a way an expression of the contribution of money creation to the financing of the deficit.

Mr. Erb inquired whether the sharp decline in the exchange rate had reduced the incentives for re-exports.

The staff representative from the African Department responded that the decline in the effective exchange rate might have had some impact on the re-export trade. However, the most important influences on the re-export trade had been exerted by the fiscal and monetary measures recently enacted, and by the political disturbances of July 1981. To the extent that the depreciation of the exchange rate had caused an increase in prices, it would have had some effect, but the effect should not be overemphasized.

The Deputy Director of the Exchange and Trade Relations Department added that since the middle of 1981 there had also been an effective depreciation of the CFA franc; the relationship between the franc and the dalasi over the previous several months needed study.

Mr. Kiingi thanked the Executive Directors for their contributions and for their understanding of the problems faced by a number of countries in his constituency. He was sure that his authorities in The Gambia would consider the advice that had been offered in their attempts to solve the country's economic problems. After the disturbances in The Gambia during the summer of 1981, the authorities deserved commendation for their achievements. Given the substantial reduction in grants from an expected 10 per cent of GDP to about 4.5 per cent of GDP, economic performance had been creditable. Recent reports indicated that government expenditure was being brought under control and that, with better crops, expected revenues would increase and the balance of payments would be strengthened. Both he and his authorities in The Gambia expected that it would be possible to agree on an extended arrangement with the Fund at the completion of the present one-year stand-by arrangement.

The Executive Board then approved the following decision:

1. The Government of The Gambia has requested a stand-by arrangement for the period February 22, 1982-February 21, 1983 for an amount equivalent to SDR 16.9 million.

2. The Fund approves the stand-by arrangement attached to EBS/82/17 and waives the limitation in Article V, Section 3(b)(iii).

3. The Fund grants approval for the maintenance by The Gambia of the multiple currency practice arising from the counterpart deposit requirement for external payments arrears, as described in EBS/82/17, until December 31, 1982 or the completion of the next Article IV consultation, whichever is earlier. (EBS/82/17, 1/26/82; and Cor. 1, 2/19/82)

Decision No. 7056-(82/22), adopted
February 22, 1982

2. YUGOSLAVIA - 1981 ARTICLE IV CONSULTATION, AND REVIEW AND CONSULTATION UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1981 Article IV consultation with Yugoslavia (SM/82/24, 2/2/82), and the staff report on the review and consultation under the stand-by arrangement for Yugoslavia (EBS/82/20, 1/29/82). They also had before them a staff report on recent economic developments in Yugoslavia (SM/82/31, 2/11/82).

Mr. Stojiljkovic, Alternate Executive Director in the World Bank, was present for the discussion.

The staff representative from the European Department commented that price data for January 1982, recently received by the staff, indicated that the marked deceleration in the rate of inflation that had begun in mid-1981 had continued. In January, the retail price index had risen by 1.4 per cent and the industrial producer price index by 1 per cent. Those increases should be seen against the background of two facts: that reductions in subsidies had taken place, and that seasonal factors normally accounted for a 1 per cent increase in prices during January. Data on net foreign assets and external borrowing indicated that the performance criteria related to the balance of payments test and the external debt limit for December 1981 had been met. The performance criterion relating to the borrowing by the Federal Government from the National Bank had also been met in December 1981. No final data for domestic credit were available for 1981, but preliminary data indicated that the ceiling for December 1981 had been exceeded by a small margin, with domestic credit estimated to have risen by 22.7 per cent compared with the limit under the stand-by arrangement of 22.2 per cent.

Mr. Polak made the following statement:

> I should like to begin by thanking the staff on behalf of the authorities in Yugoslavia for the excellent papers produced for the discussion today. The report on the Article IV consultation and the review paper on the stand-by arrangement together provide a clear picture of policy developments in Yugoslavia over the past dozen years. Inevitably, there is some overlapping between the two papers, and I would personally favor, in cases such as this one, the preparation by the staff of a single paper to deal with the two interconnected subjects.
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> The staff correctly begins its exposition by a reference to the period 1970-79. These were years of rapid economic growth, but they were also characterized by a deterioration of economic management. This was evidenced by excessive and partially wasteful investment, increasing inflation, severe balance of payments deficits, and an accumulation of foreign indebtedness. As this situation unfolded, there gradually developed a realization that major policy changes were necessary, at first at the federal level, then in the republics and provinces.

Since 1980 a process of adjustment of policies has been under way. In the beginning the adjustments were tentative and relatively minor, such as those that supported a first credit tranche drawing of Yugoslavia in 1980. A much stronger set of measures accompanied the stand-by arrangement for 1981-83 that was approved a year ago. Still, the first year's effort under that stand-by arrangement was not yet as strong as a number of Board members would have liked, or as, indeed, the authorities in Belgrade would have liked. At that time there were still important constraints on the extent to which policy could be redirected. When the Board approved the stand-by arrangement in January 1981, and again on the occasion of the midyear review, important reservations were expressed with respect to certain aspects of policy. Most important among these ranked fiscal policy and insufficient flexibility of the exchange rate and of interest rates.

In the event the doubts about fiscal performance proved to be unjustified. The authorities kept a tight lid on expenditure, while a disappointingly steep rate of inflation raised revenues. Thus the Federal Government's accounts ended the year virtually in balance.

In other areas the combination of less than perfect measures and less than perfect cooperation led to disappointment. Thus the first half of 1981 saw sharp inflationary developments and an unsatisfactory performance of exports to the convertible area.

Nevertheless, the fact that major elements of policy were closely observed contained the damage within reasonable bounds. First of these was fiscal policy, as already mentioned. Second, incomes policy constrained the growth in the wage bill of each enterprise to the growth of its income, with the net--unplanned--result that real wages per worker declined 13 per cent over the two years 1980 and 1981 combined. Third, the monetary targets, which in the letter of intent had been geared to an expected rate of inflation of 20 per cent, produced a tight liquidity squeeze as inflation reached twice that rate and the authorities stuck to the targets initially agreed.

It is clear that the determination shown by the Federal Government is now paying off in a general recognition of the need for persistence in the policy course adopted. As noted in paragraph 5 of the letter of intent, "In ordinary circumstances the Federal Executive Council would come under increasing pressure to ease policies. On this occasion, however, steps have been taken to explain fully the need for the present course of action and to mobilize support for it throughout the country." This general recognition made possible major further improvements in two other major fields of policy:

The exchange rate for the dinar was depreciated by about 25 per cent in the six months to January 1982 and from now on will be adjusted monthly on the basis of expected developments in relative costs and prices and the evidence provided by the behavior of exports.

Interest rates were raised. In spite of a long tradition in the country of low and stable interest rates, there was an important policy breakthrough when, last month, the discount rate was doubled. This in turn will lead the commercial banks to raise their interest rates for deposits and for household credits to levels that will be close to the expected rate of inflation of 15 per cent per year. The interest rate increases for credits to exports and agriculture granted by the National Bank still keep these rates at very low levels, but the amounts of credit that can be obtained under these facilities are of course strictly rationed. The staff welcomes the moves made "as a step, but only a first step, toward an interest rate structure that will give the appropriate signals and incentives to the investment and saving decisions of enterprises and households" (EBS/82/20, p. 14). It is probably a fair comment to say that this move is "a first step"; but the increase in the discount rate from 6 per cent to 12 per cent is a major move in itself, as well as a clear indication--confirmed in the letter of intent--that the Government is now committed to a more active interest rate policy than that followed in the past.

As was already clear at the time of the mid-year review, the performance of the Yugoslav economy was quite satisfactory in terms of the variables describing the real side of the domestic economy, as well as the balance of payments. It can be noted that in those instances where the growth targets of the Five-Year Plan were too ambitious, this has been recognized by the scaling down of these targets. But an adjustment in the opposite direction was made to the target for the current account. The original aim had been the achievement of current account equilibrium by 1985. Now this target has been brought nearer, to 1983, with the current account deficit for 1982 projected at only $500 million, and a revised deficit in 1981 of $750 million. The aim is now to obtain current account surpluses in 1984 and 1985. The explanation behind this change in emphasis is clear. Although Yugoslavia has been spared the severe liquidity difficulties that certain other East European countries have encountered and has been able to establish a comfortable level of reserves, it has concluded that the risks involved in heavy reliance on capital imports--especially on short-term credits--are not worth the somewhat more rapid growth that can thereby be obtained in the short run.

In conclusion, Yugoslavia entered into its stand-by arrangement with the Fund with a clear determination to achieve the broad aims set out in the letter of intent, even though at that time not all the necessary policy instruments had been put in place. The experience of the first year provided further clarity on what additional policy action was needed and provided the impetus for the adoption of required policies. The willingness on the part of the authorities to take these additional measures augurs well for the success of the program in the next two years, so that Directors can feel confident in agreeing to the proposed decision for the second year of the program.

I also recommend adoption of the decision following the 1981 Article IV consultation, which, in its second paragraph, deals with a relatively minor restraint on the availability of foreign exchange for travel purposes. Perhaps of greater importance in this general area are the measures taken by the authorities in the direction of further liberalization of trade and the interest expressed by the authorities, in paragraph 15 of the letter of intent, in achieving external convertibility for the dinar.

Mr. Peroz commented that Yugoslavia was undergoing a thorough process of adjustment and had been able to meet the objectives of its stand-by arrangement. The authorities had been particularly successful on the external side, where the current account deficit in 1981 had been cut to less than one third of the 1979 level and more than $500 million below the program ceiling. The policy of demand restraint they had followed had been extremely effective in diverting more tradeable goods to the export sector and holding down demand for imported consumption goods. Demand management policies had been more successful than expected in cutting back on personal consumption, with real personal incomes falling by 6 per cent during 1981 after a decline of 7 per cent during 1980. Against the background of a 2 per cent fall in real final domestic demand, prices had increased by 39 per cent during 1981. That rate of increase was disappointing, but some encouragement could be derived from the fact that some of the enterprises had pitched prices too high during 1981 and would almost certainly adopt pricing policies consistent with a rate of inflation below 15 per cent, as planned, during 1982.

The disappointing inflation rate during 1981 reflected the difficulties experienced in adjusting the economy to new policies, Mr. Peroz observed. Pursuing the level of structural adjustment envisaged in the medium-term plan might lead to lower growth at a higher level of inflation than originally expected. Conversely, the acceptance of a higher level of inflation and the need to keep the economy growing at a sufficient rate could lead to a smaller amount of structural adjustment. Perhaps that was an inevitable feature of an adjustment program conducted in the framework of an economy that, in spite of its level of decentralization, remained fundamentally based on a large public sector and a socialist system. However that might be, it was essential that the authorities be ready to use all necessary policy instruments flexibly. He welcomed the new approach to interest rates that had been made evident in the doubling of the discount rate in January 1982 and the authorities' agreement to adjust the exchange rate of the dinar on a monthly basis with the ultimate objective of achieving external convertibility. He agreed with Mr. Polak that confidence should be placed in the authorities and in their willingness to achieve their objectives. When the present arrangement was completed, it might well provide an example of the scope in a number of socialist countries for adjustment and for achieving external balance.

Mr. Lovato said that he agreed with Mr. Polak that on future occasions, when Executive Directors were asked to discuss both an Article IV consultation and a review and consultation under stand-by arrangement, it might be useful if the staff could prepare a single paper, so as to avoid unnecessary duplications of information and comments. The adjustment efforts required of Yugoslavia during the period 1981-83 were well under way, and satisfactory progress had been made in many important areas. The current account position had improved substantially beyond the original program expectations. The authorities deserved commendation for having adhered to their program despite declining growth of the gross social product (GSP), and the credit squeeze brought about by the higher than expected inflation rate. The authorities' firmness and the support and understanding of the leadership of the republics and of the population as a whole had turned a potentially dangerous situation into a success.

A number of problems still required attention, Mr. Lovato continued. The assumption of an 8.5 per cent increase in the volume of exports to western trading partners seemed rather bold, particularly following the impressive growth of 10.6 per cent experienced during 1981. The present exchange rate policy should help in the achievement of that objective, but he wondered whether it was consistent with the objective of reducing inflation. He was rather skeptical about the feasibility of reducing the rate of inflation from 39 per cent to 15 per cent in one year. Present policies could well result in a futher reduction in real personal income and a lower expansion of real GSP. He was not trying to encourage the Yugoslav authorities to be more lax in their policy stance. He did however wish to alert them to the danger of setting an overoptimistic target for inflation that could cause an undue squeeze on the real growth that was essential to overcome the serious problems arising from regional differences.

Substantial changes had been made in interest rate policy, Mr. Lovato noted. He would be interested to hear staff views with regard to what could be considered as an appropriate interest rate for a country with a political system such as that of Yugoslavia. The Fund did not have much experience of dealing with centrally planned economies, and the unusual combination of free market economics and central planning in Yugoslavia made it particularly difficult to give valid recommendations in some areas. It was not clear, for example, in what ways positive real interest rates would be beneficial. Did the staff feel that household or enterprise savings, which formed a remarkably high proportion of GSP, would be influenced by interest rates? Would the allocation of investment expenditures be influenced by them? Answers to such questions would have to be found before any judgments on the appropriateness of an interest rate structure could be reached.

Even with the reduced growth outlook for the coming few years, the share of investment in GSP would remain at about 30 per cent, Mr. Lovato observed. It was surprising that such a large ratio--even among developing countries--would give rise to only modest real growth. Could the staff comment on that fact? Finally, Yugoslavia's performance over the previous year had been quite satisfactory; at a time when arrangements with the Fund tended to end prematurely, it was encouraging to see a country cooperating with the Fund and making considerable progress in improving its economic situation.

Mr. Winkelmann said that he had been encouraged to note that most of the performance criteria for the first year of Yugoslavia's stand-by arrangement had been met. The small slippage with regard to monetary assets, noted by the staff representative, would probably not be significant. It was most encouraging to note that domestic demand, which had been excessive between 1976 and 1979, had been brought under control largely as a result of a tight fiscal policy and a restrained wages policy. The authorities deserved particular commendation for their success in strengthening the balance of payments. However, many problems remained to be overcome. Domestic prices had been rising faster than planned, and structural rigidities were still hampering progress. It was therefore quite appropriate that the authorities planned to tighten their fiscal and monetary policies during the second program year.

The rate of inflation had fallen from 53 per cent in May 1981 to about 23 per cent in the last months of that year, Mr. Winkelmann noted. He had been happy to hear from the staff representative that that trend seemed to be continuing. The turnaround could be attributed to tight fiscal and monetary policies, particularly as the growth of public sector expenditure had been considerably lower than the growth of nominal GSP over the past two years. The authorities and the Yugoslav people deserved commendation for that success, which could not have been easy in the light of the fall in real income of about 10 per cent over the same period. He would be grateful if the staff could give further details on the steps taken by the authorities to limit price increases. He understood that the authorities had not imposed direct controls but some overall guidelines for a range of products, in an effort to dissipate any climate of inflationary expectation. The more active exchange rate policy, which the authorities had adopted as a means of boosting exports to the convertible currency area, might create inflationary pressures in the domestic economy. Nevertheless, the authorities should not return to the situation in which a rigid price structure had hampered structural changes and had led to the growth of "pent-up" inflation.

Perhaps some of the price increases during the first half of 1981 could have been avoided if monetary policy had been more effective during that period, Mr. Winkelmann considered. There was a longer time lag for monetary policy to achieve its objectives than for fiscal policy. Monetary policy should, therefore, have been tightened rather earlier in 1981, although, admittedly, progress in that direction had been hampered by problems with interenterprise credits that now seemed to be clearing up.

Perhaps the time lags might have been avoided by a more active interest rate policy. The authorities' intention of channeling credits to priority areas like agriculture and exports deserved support.

The elimination of the deficit on the current account of the balance of payments by 1983 was an ambitious and welcome objective, Mr. Winkelmann said. The commercial banks were likely to be more cautious in considering all loan requests from East European countries over the coming period. The Yugoslav authorities would be well advised to cut back on their balance of payments deficit as rapidly as possible. Figures in the staff papers indicated, in fact, that a viable balance of payments situation might be attainable during the course of 1983. The remarkable improvements during 1981 had been made possible in large part by the cuts in imports and declining domestic demand. If that trend continued, problems might arise from shortages in raw materials and intermediate goods. The authorities were right to adapt their import policy in such a way as to avoid bottlenecks and to facilitate a sustainable expansion of exports. It did not seem unreasonable to expect an 8.5 per cent increase in the volume of exports over the coming year, especially if the present active exchange rate policy were maintained. He hoped that the staff would give particular attention to the use and effects of exchange rate policy during the mid-year review.

The counterpart of the high balance of payments deficits incurred over recent years had been the increasing foreign debt, Mr. Winkelmann noted. A substantial part of that debt was of a short-term nature, and needed consolidation. Despite recent difficulties, he hoped that the authorities would succeed in bringing down short-term indebtedness to a more normal level.

He supported the general thrust of the stand-by program, Mr. Winkelmann concluded. The outlook seemed to be that Yugoslavia would continue with its success of the past year. The authorities should continue to restrain domestic demand and should try to ensure that the rate of inflation was not such as to compromise the export boom or hamper efforts to restructure the economy.

Mr. Conrado stated that he was in broad agreement with the staff appraisal of developments in the Yugoslav economy and with the proposed program for the second year of the current three-year stand-by arrangement. The authorities deserved commendation for the realistic approach that they had taken toward adjustment. The stabilization measures adopted in 1981 had already produced results: generalized excess demand had been removed, the deficit of the current account of the balance of payments had been cut back impressively, and exports had improved despite the unfavorable global environment. Unfortunately, inflation had remained disappointingly high and had not responded well to the stabilization measures. Quite appropriately, the authorities would concentrate their efforts on reducing inflation substantially during the coming year.

The proposed program for 1982 represented a continuation and a strengthening of the program for 1981, Mr. Conrado noted. The authorities had sensibly analyzed progress over the past year and had revised their medium-term plan to reflect current circumstances. Accordingly, emphasis had been placed on the release of resources for exports, growth targets had been reduced, an active exchange rate policy was to be continued, and more ambitious targets had been defined for the current account of the balance of payments. Incidentally, while the stabilization plan and policies for 1982 were designed mainly to tackle short-term problems, the medium-term plan was designed to tackle the fundamental weaknesses of the economy. In consequence, an appropriate balance was being sought between demand management and more fundamental supply policies. Obviously, the structural adjustment that was being attempted could not be brought about quickly. The decisions taken by the authorities hitherto had been courageous and had demonstrated their clear commitment to redressing the present difficult situation. He had no doubt that the authorities would persevere in their efforts over the coming few critical years.

Mr. Narasimham indicated his support for the draft decisions. The Yugoslav authorities had achieved considerable success in their adjustment efforts over the past year. They had set themselves a schedule of economic policy measures requiring stern discipline in terms both of demand management and of changes affecting the supply side of the economy. The success that they had achieved was a good measure of their determination. The most striking progress had been made on the external payments side. The authorities had set themselves the target of bringing the current account deficit down to a level equivalent to 2 per cent of GDP or $1.8 billion, but it was now apparent that the actual outturn for the first program year might be a deficit of $750 million or only 1.2 per cent of GDP. Not surprisingly, their success had enabled the authorities to bring forward by two years--to 1983--the goal of eliminating the deficit on current account.

Given the uncertainties in the cost of borrowing in the capital markets, Mr. Narasimham continued, he could appreciate the cautious attitude displayed by the authorities toward further loans from that source. As Mr. Polak had indicated, a heavy reliance on capital imports, particularly of short-term capital, would not be made worthwhile by the somewhat more rapid growth that might result over the short term. A considerable reduction in such borrowing was already planned for 1982 together with a corresponding enlargement of the area of domestic resource mobilization. The viability of the external account also depended to some degree on improvements in the debt profile. In 1981 debt servicing costs had risen by 54 per cent because of higher interest rates abroad and the growth of total debt. The sharp reduction in borrowing planned for 1982, and the move to alter the structure of debt in favor of medium-term credits, indicated the authorities' determination not to allow growing debt to jeopardize the goal of balance of payments adjustment.

Although the level of inflation remained uncomfortably high, there had been a marked deceleration in the rate during the second half of 1981 as a result of a combination of restrictive financial policies, wage restraint, and price controls, Mr. Narasimham observed. According to the staff, the annual rate of inflation was likely to fall to 15 per cent by December 1982. Although some of the factors responsible for the sharp increase in inflation during 1981--such as the depreciation of the dinar--might no longer exert the same pressures, the feasibility of the target was open to some doubt. Could the staff say whether cutting the rate of inflation to 15 per cent might not cause problems in achieving the objective of cutting back the current account deficit? Given the underlying strength of inflationary pressures, the authorities' desire to continue with tight fiscal and monetary policies appeared justified. Although an argument could be made that interest rates should have been raised higher, he felt satisfied with the authorities' statement that a more active interest rate policy would be pursued in the future following the quantum leap in the discount rate and other rates already undertaken. He shared Mr. Lovato's skepticism about the effects of interest rate policy in the Yugoslav economy.

He welcomed the emphasis on export-led growth in achieving balance of payments viability, Mr. Narasimham stated. He had some doubts, however, whether the ambitious targets for export growth would be met in the present situation of world demand. The reduction in real domestic demand, the decision to hold down real wages, and the implementation of a flexible exchange rate policy would facilitate the achievement of the authorities' objective. The impressive growth of exports to the convertible currency area during the second half of 1981 was a possible pointer to success. The sharp reduction in the annual rate of fixed investment should help the authorities to hold down import growth. Although fixed investment was now projected to decline more sharply still, priority sectors were to receive a much larger share of investible funds.

It would make sense for the authorities to attempt to increase exports to the nonconvertible currency area as long as Yugoslavia obtained from there essential imports such as crude oil and metals, Mr. Narasimham considered, especially if the increase represented an additionality to current export levels. It had to be recognized that protectionism and recession in the convertible area would make it difficult for an expansion of exports in that direction. In conclusion, the program for 1982 represented a continuation and strengthening of that of 1981. The authorities had demonstrated determination, courage, and a strong political will to undertake adjustment measures. It was gratifying that the Yugoslav people had been so willing to bear the brunt of the adjustment effort; it was only fitting that they should be able to count on Fund support.

Mr. Erb thanked the staff for having analyzed Yugoslavia's balance of payments problems and prospects in a long-term context. He believed that in some ways it would be desirable to keep Article IV papers separate from papers reviewing stand-by arrangements. In that way, the reports on Article IV consultations could remain detached from an evaluation of a specific program. It was clear that the Yugoslav authorities had implemented significant policy changes and had already achieved good results in adjusting the country's balance of payments. The measures that they had taken--particularly the more flexible use of exchange rate policy and interest rate policy--had established a sound basis for economic growth.

While he welcomed the adjustments to interest rates that had already been made, he hoped that further adjustments would be made in the future, so that the rates would remain positive over time, Mr. Erb remarked. Although relative price adjustments had contributed to inflation over the previous year or so, overall inflation had been significantly higher than expected, suggesting perhaps that monetary policy had had an adverse impact on prices, and that credit ceilings had not been observed strictly enough to bring down the overall rate of inflation.

He was somewhat concerned about the high export growth rate built into the program's projections, Mr. Erb continued. Admittedly, there had been strong export growth during 1981, but he wondered whether the projection that the volume of exports to the convertible currency area would increase by 12 per cent was not overoptimistic, given the OECD forecasts that imports to its members would increase by only 5 per cent to 6 per cent in volume during 1982. With regard to investment, it was clear that investment policies during the 1970s had contributed to balance of payments problems, not only because of sharp increases in the overall investment rate, but also because of the way in which the investments had been allocated. The staff had indicated that more investment was to be allocated to priority sectors, that pricing policies were to be used more flexibly in allocating resources, and that, therefore, it would be desirable to have a more flexible exchange rate and interest rates in order to promote the better allocation of resources. Against that background, could the staff say whether it believed that the authorities' pricing policies were sufficiently flexible? The staff papers were somewhat vague on that point, because at times they referred to the existence of continued price controls, while at others they stated the hope that the Government would maintain prices at realistic levels. It was not clear what process was being used to ensure that prices reflected underlying supply and demand developments, and that they sent the right signals to those making investment decisions.

Mr. Taylor commented that, after a rather difficult beginning, progress during the first year of Yugoslavia's stand-by arrangement had been quite good. The improvement in the external current account deficit had been larger than expected, and targets for fiscal and monetary policy had been met. Success in those areas and the application of an incomes policy and price controls had helped to reduce inflation from the extraordinarily high levels registered during the first part of 1981. On the less positive side, the rate of inflation was still high--although he noted the encouraging figures for January 1982 quoted by the staff representative--and the combination of higher than expected inflation and firm monetary and fiscal policy had created strong deflationary pressures within the economy. In consequence, domestic demand had been squeezed quite sharply, although the effect on output had been cushioned somewhat by what he presumed was a largely involuntary accumulation of stocks.

It would be interesting to know the principal reasons for the sharp improvement in the current account, Mr. Taylor remarked. The depreciation of the effective exchange rate seemed to have done little more than restore competitiveness to its long-term trend. The decline of domestic demand was, therefore, probably a more important cause. Incidentally, there seemed to be some uncertainty about the recording of trade flows in the trade statistics. The staff referred to a timing discrepancy reflected in the large errors and omissions item and mentioned that some imports recorded in the statistics for 1981 might, in fact, have entered Yugoslavia in 1980. He wondered, therefore, whether there was a corresponding possibility that payments for imports entering the country in 1981 might be deferred until 1982, and whether the trade deficit for 1981 might, in consequence, have been underestimated.

It was difficult to determine from the staff papers the extent to which import performance reflected restrictions that were part of the exchange and trade arrangements, Mr. Taylor observed. Did the reversal of import growth from the convertible currency area after June 1981 reflect a tightening of the conditionality affecting the retention of export receipts? In view of the importance of imports as inputs into the domestic production system and, in particular, into export production, and in view of the staff's belief that the decline in domestic demand during 1981 had been an important factor in explaining import performance, he wondered whether the extremely sharp reduction in imports recorded during 1981 would be sustainable. Some comments on that point by the staff or by Mr. Polak would be useful. Certainly it was a question that ought to be considered during the mid-year review. In addition, perhaps a future staff report on recent economic developments in Yugoslavia could analyze the export retention system, the implied link between imports and export performance, and the criteria for acquisition of foreign exchange.

If the authorities achieved their current account and external financing targets, external confidence in the country would probably be restored, Mr. Taylor continued. He welcomed the recent action on interest rates, although he wondered whether further moves toward positive real interest rates would not be appropriate. The steps taken to hold the nominal level of public expenditure at a fairly constant level were also welcome, as was the promised reactivation of the foreign exchange market--even though it was not clear how that would fit in with the export retention arrangements.

While he welcomed the policy adjustments that were being made, he nevertheless had some doubts as to whether the adjustment process was proceeding satisfactorily in Yugoslavia, Mr. Taylor observed. The improvement in the current account during 1981 had certainly been better than expected, but it was significant that almost all of the unexpected improvement had occurred in the nonconvertible currency area, which yielded little return in hard currency, and might even have had an adverse effect on hard-currency imports. Furthermore, the achievement of a 12 per cent volume increase in exports to the convertible currency area might prove difficult.

There had been sharp cuts in real wages and little growth in personal consumption over the previous two years, Mr. Taylor said. The authorities' policies had been tough, but he wondered whether there was not scope for reducing investment in low yielding projects, particularly in the public sector, still further. The ratio of fixed investments to GSP remained extremely high, and the marginal efficiency of new investment in Yugoslavia was quite low. It could well be that realistic interest rates would help to produce a better evaluation of investment projects and might help the enterprise sector to be more receptive to market signals.

It was difficult to reach firm judgments on a centrally planned economy that relied little on market forces, Mr. Taylor remarked. In that context, he had been interested by the questions raised by Mr. Lovato with regard to the role of interest rates. It was unfortunate that the issuance of the long-promised paper on the relevance of Fund policies to centrally planned economies had again been postponed. He looked forward to discussing the paper and the insight that it would give into the operation of market forces in centrally planned environments.

In conclusion, it was important that the adjustment process be pursued with firmness in Yugoslavia, Mr. Taylor observed. It was particularly important that international confidence be restored in view of the heavy burden of debt service payments that were due to mature over the coming five years. He was not confident that the authorities' policies were yet fully developed or that they would be able to maintain the good progress made during 1981. With those reservations, but also with the recognition that major progress had been achieved during the first year of the stand-by program, he could support the proposed decisions.

Mr. Salazar remarked that developments over the previous year had shown that the adjustment process was well under way in Yugoslavia. He was glad that all the quantitative performance criteria, with one small exception, had been met. He could, therefore, support both the proposed decisions.

During the 1970s, the Yugoslav authorities had followed an inward-looking development strategy; expanding domestic demand in conjunction with inadequate exchange rate policies had led to a poor export performance and a deterioration of the balance of payments, Mr. Salazar observed. Beginning in 1979, the authorities had taken measures to restrain domestic demand and to restructure the supply side of the economy by encouraging export-oriented activities. The restraint on public sector expenditures had done much to stabilize the economy over the previous two years, and, in fact, a small budget surplus was estimated for 1981. Although the rate of inflation was decelerating, it was still at a disturbingly high level. Its rise over the previous two years could probably be attributed to the increase in domestic energy costs, the deregulation of many commodity prices, and the significant devaluation of the dinar in June 1980. He agreed with the staff that the accommodating credit policies that had followed those events--particularly after the devaluation--were ultimately responsible for the persistence of domestic inflation.

Although money and credit conditions for 1982 were projected to be tighter than in previous years, savings would not be stimulated nor demand restrained adequately if interest rates continued to be negative in real terms, Mr. Salazar considered. The increase in the income velocity of money noted during the second half of the 1970s seemed to provide evidence for that concern. The adjustments to interest rates made during 1981 were welcome, but he wondered whether the further adjustment planned for 1982 would be substantial enough to curb the falling trend in the demand for money.

He welcomed the authorities' intention to make domestic prices reflect world prices more accurately, Mr. Salazar said. That intention was consistent with Yugoslavia's greater reliance on comparative advantage to determine its pattern of production and trade. The gradual removal of rigid prices and their replacement by guidelines would allow a certain degree of flexibility in accommodating changes in relative prices and was a positive step taken by the authorities.

There had been a steady increase in receipts from services and net transfers, and a significant reduction in the trade deficit, which had been reduced in 1981 to about half of its 1979 level and was expected to be reduced even further during 1982, Mr. Salazar observed. The planned growth in exports to the convertible currency area was an important objective, particularly since over the previous four years almost 90 per cent of Yugoslavia's global trade deficit had been with that convertible currency area. The new emphasis on trade with those countries represented a major shift from the pattern of trade prevailing during the 1970s, when export trade had been oriented heavily toward the nonconvertible currency area.

The authorities had obviously made considerable efforts to restrain aggregate demand, to adjust relative prices, and to promote the reallocation of resources--particularly investment--into tradeable goods sectors, Mr. Salazar concluded. He hoped that the authorities would continue to make progress along those lines.

Mr. Prowse commented that the staff papers confirmed the continuation of positive trends in Yugoslavia's economy that had become evident in the latter part of 1981. He could support both the proposed decisions. He agreed with Mr. Polak that it might have been useful for the paper on the Article IV consultation and on the review and consultation under the stand-by arrangement to have been combined together. Unlike Mr. Erb, he believed that the Article IV report should provide the essential framework for reviewing a stand-by arrangement.

Yugoslavia's stand-by arrangement was particularly interesting, because it was one of the largest negotiated under the Fund's enlarged access policy, and because the country's economic structures were unique, Mr. Prowse remarked. The authorities deserved commendation for the significant improvements made in economic performance over the previous year and also for the general orientation of their policies. Particular progress had been made in adjusting the interest rate and the exchange rate. Those instruments had not been fully used in the past, and he was not sure whether they were being fully used at present. While it was understandable that the effects of adjusting those rates would not have the same force as in market economies, he wondered whether they were benefiting Yugoslavia as much as was possible. It was difficult to understand from the staff papers the connection between the greater use of interest rates in resource allocation and the actual allocation of credit and finance on the basis of the priority program. Could the staff clarify the issues involved? Could the staff say specifically how interest rates were relevant to the allocation of resources? While he could understand that higher interest rates might make it easier to determine the appropriateness of investment projects, it seemed that in Yugoslavia that determination was made on some other basis.

In his statement Mr. Polak had described the authorities' belief that the disadvantages of a heavy reliance on capital imports outweighed the advantage of a more rapid short-term growth that such imports could bring about, Mr. Prowse noted. He wondered whether such an attitude was appropriate for a developing country. Was it right for the authorities to cut back on capital imports and thus deprive the country of some of the essentials for rapid development and structural adjustment? While the attitude was a recognition of reality and of the relatively high debt ratio, it should nevertheless be asked whether it was a short-term response to the current situation or whether it represented a medium-term or long-term strategy. In his view, the Executive Board should not recommend to the authorities that they should set a goal for a surplus on the current account in the foreseeable future. The objective for a developing country should be to obtain a viable deficit in the current account. Although at the moment it could be argued that a zero deficit was viable, that might not necessarily remain true over the long term. Some clarification by the staff of the authorities' long-term objectives for the current account would be interesting.

He was in broad agreement with the staff that the emphasis on import substitution in Yugoslavia had isolated the economy from international competition and technological progress, and that the new capacities developed had not been as economically efficient as they would have been if exports had been treated more seriously, Mr. Prowse stated. In deciding how to move from import substitution to export growth, the authorities would need to make a careful study of world markets. In his constituency, Korea provided an example of a developing country that had achieved success through emphasizing exports rather than import substitution. Finally, in its papers the staff had referred to the "economic sector" and to the "noneconomic sector" of the Yugoslav economy. He wondered how useful those categorizations were, particularly in view of the fact that the "noneconomic sector" included banking.

Mr. Alhaimus expressed his broad agreement with the staff appraisal and his support for Yugoslavia's request for further drawings under its stand-by arrangement. The authorities deserved commendation for the courageous way in which they had implemented their policies. As a result of the policy changes that they had made, the current account deficit of the balance of payments had been significantly reduced. At the previous discussion of Yugoslavia's stand-by arrangement (EBM/81/128, 9/16/81), the proposed reduction in the current account deficit had generally been considered ambitious. It went to the credit of the authorities that they had achieved more than their target.

In addition to improvements in the external sector, the budget deficit had been reduced to 0.1 per cent of GSP, and private and public consumption had declined by 1 per cent and 0.8 per cent respectively, Mr. Alhaimus noted. Such success had not, however, been won without costs: inflation had remained high, and the growth of exports to the convertible area had been slow. There had also been a shortfall in the growth of GSP. Such disappointments had to be viewed in a medium-term perspective, with particular reference to implications for personal incomes, savings, employment, and the restructuring of the country's investment. The adjustment measures already taken by the authorities during 1980 and 1981 had clearly demonstrated the responsiveness of the economy to corrective measures; it was only reasonable to assume that the measures incorporated in the 1982 program would elicit a similar response.

The 1982 program incorporated a set of policies designed to bring about continued adjustment in the context of the medium-term plan, Mr. Alhaimus commented. The plans to mobilize more resources, to give priority to the development of agriculture, and to strengthen further the external sector were welcome. If the current account deficit was to be eliminated by 1983 instead of by 1985, as earlier intended, more resources would need to be generated in the foreign sector than before. In view of the country's past performance, the authorities' objectives might not appear particularly ambitious, but he wondered if other options had also been examined under which a higher growth rate in GSP could be achieved while still working toward the elimination of the current account deficit by 1985. Given the performance of the export sector, a larger deficit on current account should be sustainable, and the economy should be able to realize a higher growth in GSP. Some staff comment would be appreciated on those points.

The implications for employment of the lower growth of GSP gave grounds for concern, Mr. Alhaimus continued. During the previous Executive Board discussion on Yugoslavia, his chair had described the proposed 4.5 per cent rate of growth of GSP during 1981-85 as optimistic in the absence of investment expansion, greater capacity utilization, or an improvement in the capital/output ratio. At present, fixed investment had started to decline, and the increase in productivity was estimated to be only 1 per cent a year. Comprehensive proposals were reportedly under consideration for a restructuring of Yugoslav industry based on high technology. With the growth of GSP estimated at 2.5 per cent, unemployment could possibly rise to an unacceptable level.

It might not prove easy to succeed in increasing domestic resource mobilization, particularly with regard to savings, Mr. Alhaimus considered. A significant part of GSP was already being devoted to investment. A marginal increase in resource mobilization at that level might not be easy, when personal income in real terms was stagnating or even declining. While an increase in interest rates was likely to achieve a more efficient allocation of credit, it was doubtful that there was any reasonable basis for expectation that it would also increase savings in Yugoslavia. He questioned whether savings could be increased beyond the present level, equivalent to about 46 per cent of GSP, while GSP growth was so low. Wage earners were already sustaining a reduction in their real incomes, and a significant part of the increase in GSP might be devoted to efforts to cut back the ratio of foreign debt to GSP. Finally, he could agree with Mr. Polak's suggestion that it would have been preferable if the Article IV consultation and the review of the stand-by arrangement had been dealt with in one paper, as had been done recently for Pakistan.

Mr. Joyce said that he agreed with Mr. Polak that it might be preferable in some cases to combine the staff appraisal of an Article IV consultation and its review of a stand-by arrangement in one staff paper; obviously, judgment would have to be made on a case-by-case basis. He could support both proposed decisions and could agree with the staff that the performance criteria proposed for the second year of the stand-by arrangement appeared appropriate, and that approval should be given to the continuation of existing exchange restrictions on foreign travel. The Yugoslav authorities deserved commendation for the success that they had achieved, and for the determination with which they continued to pursue their objectives. Despite persistent problems, they had made a good start in implementing adjustment measures. During 1981, the marked improvement registered in a number of key areas of the economy had been better than anticipated. He particularly welcomed the sizable real devaluation of the dinar, the large reduction in the current account deficit, and the success in restraining government expenditure that had made possible a reduction in the government deficit. The adjustment process had in some respects been painful--real wages had declined for the second consecutive year--and he hoped that the hardest part of the program had now been completed and that Yugoslavia would be able to move rapidly toward better balance both internally and externally. There were, however, a number of deep-seated problems that still needed solving.

The medium-term program for 1981-85 had already been revised in the light of recent developments, Mr. Joyce noted. A number of targets still seemed ambitious, particularly the elimination of a current account deficit by 1983. In that context, he agreed with Mr. Prowse that it was debatable what the appropriate level of balance in the current account should be in a country at Yugoslavia's stage of development. The same type of question applied to countries such as Australia and Canada, where the necessary development program required large-scale capital imports and inevitably extensive current account deficits. The objective of reducing the rate of inflation to 15 per cent by the end of 1982 and to below 10 per cent by 1984 was also ambitious.

Clearly bringing the rate of inflation under better control would have to be one of the authorities' priority objectives, Mr. Joyce continued. Prices had increased more slowly during the second half of 1981 than during the first half of the year, but there had been some acceleration of the monthly rate of inflation during the fourth quarter of 1981. It was not clear why that should be so and he would appreciate some clarification. It was not clear whether the institutional arrangements for determining prices between the Government and the enterprises would help bring down the rate of inflation to the projected level by the end of the year, even with tigher credit and monetary supply conditions. Was the staff, or were the authorities, concerned about the likelihood of agreement being reached between the Federal Government and the republics and provinces? There had been problems in that area during the period October 1980-March 1981. Perhaps encouragement could be derived from Mr. Polak's comment that the program had won broad acceptance in Yugoslavia. It was obviously crucial, given the linkages between prices and wage determination, that an agreement between the Federal Government and regional authorities be achieved.

The authorities had been wise in opting not for strict price controls but for a system of guidelines designed to limit the average increase in industrial prices to 15 per cent a year, while allowing room for relative price adjustment, Mr. Joyce suggested. He had some worry, however, that such targets might become regarded as a price floor, exerting upward pressures on expectations and on wage demands, particularly so since the target was expressed as an average, meaning that some price rises would be permitted to exceed the 15 per cent level. However that might be, a relatively loose system of that type was greatly preferable to rigid controls, although it could not be used as a substitute for consistent noninflationary monetary policy, and it could lead to economic distortions and shortages. If price performance was not as good as expected for 1982, the authorities would have to look at their policies again and see whether monetary growth targets would be appropriate.

He also had some concern about the propects for expansion in Yugoslavia's exports, particularly to the convertible currency area, Mr. Joyce remarked. The authorities had made great progress in reducing the current account deficit, but if Yugoslavia was to continue servicing its foreign debt, its ability to penetrate convertible currency markets had to be improved. The projections for 1982 were for a 12 per cent increase in export volume to those markets. Like some previous speakers, he believed that target to be rather optimistic, and he would be grateful if the staff could explain where export growth was going to be concentrated. Were agricultural exports to neighboring countries to be increased? Was more emphasis going to be placed on the exports of manufactured goods? Was the target realistic in view of expected growth rates within the OECD countries and the existing level of protectionism in some sectors?

The performance criteria seemed appropriate, Mr. Joyce stated. Two policy areas would need particularly close monitoring. First, the authorities would need to watch carefully the appropriateness of their monetary growth targets and be prepared to cut them back further if inflation were not brought under control as expected. The authorities should place greater reliance on interest rate policy. Although he welcomed the recent sharp rise in the discount rate, interest rates still remained negative in real terms. He would be interested in hearing the responses to Mr. Lovato's questions about the effectiveness of the interest rates in an economy such as Yugoslavia's.

A second area that would need close monitoring would be how well the country was avoiding the stop-start cycles it had experienced in the past, Mr. Joyce observed. Success in that field would depend upon a successful shift in investment toward the export oriented sectors and on making export industries more competitive in international markets. He welcomed the fact that, although investment as a percentage of GSP was to fall, the share of investment committed to exports and to tourism was planned to increase; such an increase would be an important first step in eliminating the structural imbalances in the economy. However, he shared the concern of some previous speakers about whether the rate of structural adjustment envisaged was in fact achievable.

Yugoslavia was on the right track, and he welcomed the authorities' determination to continue to pursue appropriate policies, Mr. Joyce concluded. His only concern was that some of the targets seemed rather overambitious for the coming year, and in particular that the envisaged structural adjustment might not be achievable with the rate of inflation currently projected.

Mr. Zhang commended the authorities for their achievements of the past year and for their determination to strengthen the economic program for 1982. Like Mr. Joyce, he wondered whether it was realistic to expect inflation to be contained at 15 per cent for 1982. He also wondered how realistic it was to expect an increase of exports to Western Europe in view of the present recession and the increasing number of trade restrictions. He could support the proposed decisions.

Mr. Jauregui expressed broad agreement with the staff appraisal and with the proposed program for the second year of the stand-by arrangement. The Yugoslav authorities were implementing needed economic policies on both the demand and supply sides of the economy. Their vigilance in keeping fiscal expenditures in check was commendable, as was their decision to increase greatly the discount rate and other interest rates. The new, more flexible interest rate policy should help to increase savings and to improve the utilization of resources in the real sector of the economy. He wondered whether the authorities were planning to expand or to reduce the priority sectors that were at present receiving subsidized credit.

Could the staff comment on how the impact of the depreciation of the exchange rate on inputs for production would be contained so that prices would not need to increase, Mr Jauregui inquired. He had been impressed by the fact that real personal incomes had declined for two consecutive years without pressures for upward adjustment becoming manifest. Was that situation likely to continue for the third year? Should such pressures mount up, how did the authorities plan to deal with them and prevent them from having an adverse impact on the rate of inflation?

The Executive Directors adjourned their discussion of Yugoslavia until their afternoon session.

3. EUROPEAN MONETARY SYSTEM - REALIGNMENT OF CURRENCIES

Mr. Schneider stated, at the request of his Belgian authorities, that the Ministers of Finance and the Governors of the Central Banks of the European Community had met the previous day to decide on a realignment of the exchange rates within the European Monetary System. As a result, the Belgian and the Luxembourg franc had been devalued by 8.5 per cent vis-à-vis the other EMS currencies, with the exception of the Danish krone, which had been devalued by 3 per cent vis-à-vis the other currencies. The new rates became effective February 22, 1982. For Belgium, the exchange rate adjustment was being supported by various measures, most importantly by a partial neutralization of the wage indexation mechanism until the end of 1982.

Mr. Sigurdsson stated that, in the realignment of exchange rates within the European Monetary System decided the previous day, the Danish krone had been devalued by 3 per cent against all other participating currencies except the Belgian and Luxembourg franc. The change was effective from February 22, 1982.

The Executive Directors took note of the statements by Mr. Schneider and Mr. Sigurdsson.

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Acting Secretary