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Minutes of Executive Board Meeting 82/146

10:00 a.m., November 12, 1982

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

Executive Directors	Alternate Executive Directors
	A. B. Diao, Temporary
J. Anson	C. Taylor
J. de Groote	H. G. Schneider
	A. Le Lorier
	M. Teijeiro
R. D. Erb	C. Dallara
	T. Alhaimus
	S. R. Abiad, Temporary
A. H. Habib	V. Supinit
T. Hirao	T. Yamashita
R. K. Joyce	M. Casey
	J. R. Gabriel-Peña
G. Laske	
G. Lovato	C. P. Caranicas
	A. S. Jayawardena
	J. E. Suraisry
J. J. Polak	T. de Vries
A. R. G. Prowse	
G. Salehkhou	
	E. I. M. Mtei
M. Senior	
	L. Vidvei
Zhang Z.	

L. Van Houtven, Secretary
J. Corr, Assistant

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Also Present

R. Sapunxhiu, Alternate Executive Director, IBRD. African Department: O. B. Makalou, Deputy Director. Asian Department: G. Szapary. European Department: L. A. Whittome, Counsellor and Director; M. Dakolias, H. B. Junz, W. E. Lewis, L. G. Manison, D. M. Ripley, A. Singh, H. Vittas. Exchange and Trade Relations Department: S. Mookerjee, Deputy Director; P. M. Keller, P. A. Molajoni. External Relations Department: D. M. Cheney. IMF Institute: S. Delic, Participant. Legal Department: J. G. Evans, Jr., Deputy General Counsel; W. E. Holder, S. A. Silard. Research Department: W. C. Hood, Economic Counsellor and Director; G. I. Brown, K.-Y. Chu, N. M. Kaibni, R. P. Menon, B. E. Rourke, A. Salehizadeh. Treasurer's Department: W. O. Habermeier, Counsellor and Treasurer; R. J. Familton, Deputy Treasurer; D. Williams, Deputy Treasurer; A. M. Al-Samarrie, D. Berthet, W. L. Coats, D. S. Cutler, A. Moustapha, M. Sami, T. M. Tran, G. Wittich. Bureau of Statistics: M. J. Brimble. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: J. Delgadillo, M. A. Janjua, G. Jauregui, P. Kohnert, H.-S. Lee, P. D. Péroz, Wang E. Assistants to Executive Directors: H. Alaoui-Abdallaoui, E. M. Ainley, H. Arias, L. Barbone, T. A. Connors, R. J. J. Costa, G. Ercel, I. Fridriksson, G. Gomel, M. Hull, J. M. Jones, M. J. Kooymans, V. K. S. Nair, Y. Okubo, G. W. K. Pickering, D. V. Pritchett, J. Reddy, C. A. Salinas, J. Schuijer, D. I. S. Shaw, P. S. Tjokronegoro.

1. SPECIAL DRAWING RIGHTS DEPARTMENT - DESIGNATION PLAN FOR SEPTEMBER-NOVEMBER 1982 - AMENDMENT

The Executive Directors considered an amendment to the designation plan for September-November 1982 (EBS/82/155, 8/30/82; Sup. 2, 11/5/82; and Cor. 1, 11/9/82).

Without discussion, the Executive Directors approved the proposed decision.

The decision was:

The Executive Board approves the amendment to the designation plan for the quarterly period beginning September 15, 1982 as set out in EBS/82/155, Supplement 2.

Decision No. 7245-(82/146) S, adopted November 12, 1982

2. YUGOSLAVIA - REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered a staff report reviewing developments during the first half of 1982 under the stand-by arrangement with Yugoslavia (EBS/82/181, 10/7/82; Cor. 1, 11/9/82; and Sup. 1, 11/10/82).

The Director of the European Department said that a staff team would visit Yugoslavia in early December to discuss the program for 1983 with the authorities.

Mr. Polak made the following statement:

I would like to express the appreciation of the Yugoslav authorities, as well as my own appreciation, for the staff paper reviewing the developments under Yugoslavia's stand-by arrangement that is now nearly two years old. The staff's paper discusses with perception the difficulties that Yugoslavia has encountered in the management of its economy. The paper also explores frankly the causes of these difficulties and suggests remedies. The Yugoslav authorities are grateful for the contribution that the Fund staff has again made in its analysis of the economic situation of the country, and they agree with the staff that only a full realization of the problems that have emerged can lead to the adoption of constructive and lasting corrections. Like the staff, they have been disappointed by certain aspects of the performance of the economy, and they concur with the staff where it has pointed out failures of policy that have manifested themselves so far this year.

One of the important weaknesses of policy was the excessive rise in real personal income in late 1981 and in the first half of 1982. This rise was both a cause and an effect of renewed surges of inflationary pressures. Indeed, one of the central difficulties of policy in Yugoslavia in recent years has been for the Government to get a sufficient grip on the practices of the country's collective enterprises with regard both to the setting of prices and to the distribution of wages. The successive rules promulgated to deal with these interrelated aspects of an inflationary spiral have not so far been sufficiently successful to control this spiraling process.

Excessive growth of real income of consumers has led to excessive demand for consumption goods. Moreover, other components of the domestic demand for output also did not perform with the moderation that had been expected. Public consumption grew more rapidly than had been planned, and the cut that was realized in investment activity was only about half as large as planned. As a consequence of these various forms of excessive demand, imports tended to increase and exports to decline. This started the operation of a causal chain, which was moreover intensified by external factors: the decline in exports reduced the availability of foreign exchange, which then forced a decline in imports of raw materials, which in turn restrained output and thereby the availability of goods for export.

There is at present a full realization in the Government that these unplanned and undesired developments cannot be allowed to continue and that quite radical changes in policy are needed to bring aggregate demand into line with what the economy can supply--after making allowance for the first priority of improving the current account of the balance of payments. It is recognized that the attainment of this latter objective in a setting of very slow growth in Yugoslavia's markets will involve much greater sacrifices by the population than those that have been absorbed in the past two or three years.

Accordingly, a broad range of measures has been taken since the middle of this year, designed to achieve a slowdown in domestic demand so as to make possible an increase in export and hence the increase in imports necessary to expand output. To back up this general policy, measures have been taken to bring about a deceleration in the increase in personal income as well as a decline in public consumption. Moreover legislation introduced in July limits the availability of financial resources for investment, increases the share of any investment that has to be financed from the savings of the enterprise itself, bans the use of bank credit to pay for cost overruns of investment, etc. As a result, fixed investment in the third quarter of the year declined by nearly 10 per cent in real terms. As regards public consumption, communities and other public bodies have been obliged, during the last five months of this year, to spend no more than 85 per cent of their revenues, the remainder being blocked in a special account.

It is the view of the Yugoslav authorities that the deceleration in the rate of inflation should primarily result from a fall in domestic demand. However, given the pressure on prices arising from the change in the exchange rate, the Federal Executive Council has also imposed price control on all goods and services.

In addition to the approach based on a contraction of demand, the authorities also adopted a number of measures that were designed to assist directly to bring about an improvement in the balance of payments. The most important of these measures was the decision, taken last month, to devalue the dinar by 20 per cent (in terms of the number of dinars per unit of foreign currency), after a depreciation by about 19 per cent brought about by the crawling peg adopted at the beginning of the year. The new devaluation should offset the disparity that had existed against European currencies and should make Yugoslavia's exports to Western European countries fully competitive.

Other measures were taken to improve balance of payments performance with respect to invisibles. Special mention may be made in this context of a recent decree that imposes (with some limited exceptions) the obligation on citizens traveling abroad to maintain an interest-free bank deposit for a period of one year. The amount of the deposit is Din 5,000 (about US$80) for the first trip in one year and then increases by Din 2,000 for each subsequent trip. New measures have also been taken to restrict the import of Yugoslav banknotes and to avoid the private conversion (i.e., outside of banks) of foreign exchange brought in by tourists.

In the field of energy, a number of additional measures have been announced to reduce consumption and encourage conservation.

I have already referred to the difficult international trading climate in which Yugoslavia is making its effort toward fundamental adjustment. Superimposed on these difficulties are the unfavorable credit conditions in international financial markets. During 1982, Yugoslavia has been subjected to an outflow of capital and to extreme difficulties in negotiating new credits. These conditions have put heavy pressure on the country's slim reserves, which were roughly halved in the first six months of 1982 and now stand at a low level. The situation has been worsened by the credit difficulties that one important and a few small commerical banks have brought upon themselves and which have had an unfavorable effect on Yugoslavia's credit status. Shortage of foreign exchange has been the most direct cause of the decline in output during the first half of this year, but this decline has been brought to a halt in the third quarter, thus fortifying the basis for a better performance with respect to exports.

The foreign exchange shortage has been one of the reasons for the introduction of the financial measures referred to above, as well as for the introduction of the limitation of US$250 per month in currency to be withdrawn from foreign currency accounts. Any additional withdrawals can only be made by checks payable outside the country. The extremely tight foreign liquidity position is a major preoccupation of the authorities, who are actively engaged in negotiating additional bank financing, admittedly under highly adverse circumstances. The staff is correct in pointing out (p. 14) that the first half of 1983 will commence with low levels of reserves and stocks of imported goods and a minimal amount of financial credits in the pipeline.

Many of the measures advocated by the staff in the final paragraph of its paper have in the meantime been taken. I should mention in particular measures to control the development of incomes and to restrain consumption, as well as the recent devaluation to ensure that the economy is fully competitive. Beyond this, the authorities are fully prepared to adopt new and even more severe measures should these prove necessary to bring their adjusted efforts to a successful conclusion.

Mr. Erb remarked that the task of adjustment in Yugoslavia had been made more difficult because of the weak state of world economic activity and, especially, because of unfavorable developments in the world capital markets. The authorities would have to continue to make extraordinary efforts to manage the adjustment more successfully. The growth in domestic demand had to be contained. In that regard, the staff had correctly described Yugoslavia's performance in the first half of 1982 as "disappointing." To contain domestic demand, the authorities would have to move simultaneously on several policy fronts, including pursuit of a long-term solution to the wage problem and of a tighter monetary policy while allowing interest rates to reach appropriate levels, and maintenance of a competitive exchange rate.

He would like to learn more about the measures to control the growth in personal incomes referred to by Mr. Polak, Mr. Erb continued. Part of the problem in Yugoslavia stemmed from the fact that there were incentives in the system to distribute profits as wages because, as he understood it, workers could not accumulate equity in the firms. The existence of relatively low interest rates meant that wages, i.e., distributed profits, flowed through to consumption because there was less incentive to save. The authorities appeared to be having difficulty implementing a tighter monetary policy. The staff pointed out that credit ceilings had been exceeded at certain times but that they had reverted to ceiling levels at the end of each quarter. Was that the result of seasonal factors? It might be more appropriate to set an average level for credit as a performance criterion rather than levels at the end of each quarter. He strongly supported the idea of buttressing performance criteria in 1983 by a series of quarterly reviews. Given the problems of forecasting, the review was important to increase the likelihood that the objectives of the program were being met.

There was room for adjustment of interest rates, Mr. Erb suggested, and it was also important for the Yugoslav economy to remain competitive. He commended the authorities for recently adjusting the exchange rate, and he urged them to adjust it further in a timely manner if it proved necessary to do so. Gasoline rationing had recently been introduced. If the authorities were attempting to cut back on excess demand, not only for gasoline but in the economy generally, why had they not raised taxes on gasoline instead of choosing rationing? He understood that the rationing system had large differential effects throughout the economy, hitting some parts of the country more sharply than others.

Mr. Lovato observed that the staff paper and Mr. Polak's statement indicated that the Yugoslav economy stood at a critical juncture, a point reinforced by the recently announced exchange rate decisions. A variety of unfavorable events, partly exogenous and uncontrolled, partly embedded in the policies pursued under the Fund-supported program, had had an adverse impact on both the external and internal balances. The fact that, nevertheless, Yugoslavia had scrupulously fulfilled the performance criteria and the understandings in the stand-by agreement should lead Executive Directors to reassess some of the policy actions previously recommended under a set of assumptions that no longer seemed to hold in light of recent events.

The staff had pointed out, Mr. Lovato continued, that, while the ceilings on domestic bank credit had continued to be fully met, nominal domestic demand and GDP had increased at a faster rate than expected, fueled by a growing interenterprise credit market and the expansion of foreign exchange holdings. There were two possible explanations: either forecast errors had been made regarding the velocity of circulation, or perhaps the techniques of credit control were not strong enough. If the latter were true, then the staff and the authorities should consider possible reforms. The length of the stand-by arrangement allowed leeway for the adoption of structural measures.

With regard to incomes policies, Mr. Lovato said, the staff policy recommendations hinged essentially on the claim that a decline in real wages was necessary to restrain domestic demand, particularly private consumption, in order to improve the balance of payments. First, while he recognized that consumption would have to fall, he did not understand why investment should also be required to fall. Financial policies had already been adopted in recent months to curtail private and public capital spending. If the strategy envisaged for a recovery in Yugoslavia was basically one of export-led growth, the authorities had to implement measures that would stimulate exports on the supply side as well. The principal reason for a decline in real wages was the need to release investible resources for expanding, modernizing, and diversifying export-oriented industries. How could that be reconciled with the credit squeeze on investment projects? The need to improve productivity, and therefore to increase investment, should be emphasized, particularly in an economy such as Yugoslavia's in which the cooperatives had a tendency to set aside most of their revenues for wages and to neglect investment, even maintenance-related investment.

Second, the recurrence of a wage/price spiral was connected, at least to some degree, with the workings of the self-managed economy in Yugoslavia, Mr. Lovato argued. The staff implicitly admitted that point, by noting "the practice by which enterprises raised prices and wages at the same time without undue difficulty." And Mr. Polak had candidly stated that "one of the central difficulties of policy in Yugoslavia in recent years had been for the Government to get a sufficient grip on the practices of the country's collective enterprises with regard both to the setting of prices and to the distribution of wages." It seemed clear that some far-reaching institutional reforms would be needed to correct such a situation. If so, what did the authorities propose to do, and what were the staff's views about incomes policy? Under a three-year stand-by program, there was room for policy changes going beyond short-term stabilization measures. Structural reforms were normally required with an extended arrangement, and a three-year stand-by arrangement should be no different.

He broadly agreed with the staff's assessment of the current situation regarding the balance of payments and the exchange rate, Mr. Lovato continued, and with the suggestions made for an appropriate course of action in the coming period. The capital account had deteriorated much more than could reasonably have been anticipated; as a consequence of a combination of adverse factors, the current account could not have been expected to improve more than it already had. Those factors included depressed world demand, unchanged domestic demand, and no gain in competitiveness. The devaluation of the dinar in October had modified the situation considerably. The magnitude of the depreciation was such that it more than offset Yugoslavia's inflation differential vis-à-vis major trading partners. He invited the staff to comment further on that issue. The size of the devaluation might have been excessive, but he was confident that it would give impetus to exports to the convertible currency area and that it would thereby improve the country's external accounts. On the other hand, a continuing depreciation of the currency could be difficult to reconcile with disinflation and with the need, reiterated by the staff, to impose stricter discipline on the enterprises' pricing behavior. The decision to impose price control on all goods and services was not a long-term solution. He feared that a policy of devaluation could cover the real problems--structure, income distribution, and productivity--without solving them.

Miss Le Lorier commented that the case of Yugoslavia was a striking example of the crucial role of the international banking system in creating the conditions for the successful outcome of a thorough adjustment effort. Of course, the Fund and the country concerned also had an essential part to play. However, action by the financial community would be crucial at the present juncture, since the Yugoslav authorities stood ready to take severe measures and to pursue actively their cooperation with the Fund.

The stand-by arrangement with Yugoslavia was one of the largest to date under the policy of enlarged access, Miss Le Lorier noted. In light of the results of the first two years, there was no doubt that the Executive Board's decision had been fully warranted with respect to the need for financing from the Fund, the length of time required to move from import substitution to export growth, and the thorough adjustment undertaken. The Yugoslav authorities had demonstrated an impressive willingness to keep the program on track and, more fundamentally, to sustain the progress toward a viable external position. It was true that important weaknesses of policy had had undesirable effects in the first half of 1982, but taking into account the corrective measures already implemented, Directors should warmly commend the authorities for their stabilization efforts. She agreed particularly with the staff statement that "...it was an achievement that the deficit on the current account in convertible currencies was reduced by approximately $500 million to a level of $1,500 million...between the first half of 1981 and the first half of 1982."

On the other hand, Miss Le Lorier continued, it was equally disappointing that domestic demand had been higher than anticipated. There were a number of reasons to regret that development. In the short run, it might have had a negative impact on the trade balance, as Mr. Polak had pointed out. It had weakened domestic and external confidence, thereby threatening the overall balance of payments, as the staff had noted. And, from a longer-term perspective, it was evidence of the difficulties involved in ending the wage/price spiral. The second and third factors deserved particular emphasis. The value of imports had declined by 11 per cent in the first nine months of 1982, while exports had increased in volume by 7 per cent. The performance of merchandise exports had slackened during the third quarter, mainly because of the decline in exports to the East European countries. It was difficult to assess whether excessive domestic demand or sluggish export markets should be held responsible for the less favorable performance in the trade balance than had been expected.

It was essential for the Yugoslav authorities to seek to improve the institutional arrangements prevailing in the field of price and wage determination, Miss Le Lorier suggested, in order to avoid the "stop-and-go" development observed during the previous year. Admittedly, stringent adjustments had already been undertaken: real wages had fallen by an estimated 15 per cent in the two-year period to September 1981, a development likely to put considerable upward pressure on incomes during the following months. The corrective measures already implemented had produced significant results: both real personal incomes and retail sales had declined markedly in recent months, fixed investment had declined by almost 10 per cent in real terms in the third quarter, and fiscal policies had been revised to contribute further to the reduction of real domestic demand. Although they had been necessary, those measures had not solved the structural deficiencies in incomes and pricing policies that would have to be overcome in the medium term.

Commenting on financial policy, Miss Le Lorier noted that traditional policy instruments were relatively inadequate in an economy that, despite the level of decentralization, remained based on a large public sector and was organized along socialist lines. With regard to credit expansion, the staff had suggested that the traditional credit ceilings should be supplemented by a series of quarterly reviews in the program for 1983. Credit policy certainly had an important role to play as a means of controlling the growth of fixed investment and consumer spending, and it would remain necessary to monitor the banking system. However, it was unclear what means might be used to control, or even to forecast, the swings in interenterprise credit or the variations in domestic transactions financed through domestic holdings of foreign exchange. She wondered about the extent to which a further tightening or easing of ceilings on bank credit during the course of 1983 would provide an adequate response to unforeseen development in that area. Perhaps the staff could say more about whether it would be appropriate to rely only on quarterly reviews rather than use them in addition to the traditional credit ceilings.

The authorities had agreed to raise interest rates significantly, Miss Le Lorier continued. She invited the staff to say whether it had reached definite conclusions on the role played by interest rates in the Yugoslav economy and, in particular, to comment on the impact of significant and abrupt changes in interest rates on the costs borne by enterprises, which could adversely affect the evolution of prices. It would also be interesting to know whether further increases in the interest rates on foreign exchange deposits would be desirable in order to lengthen their maturity and to provide a stronger incentive to the inflow of remittances from abroad. Exchange policy appeared to have been sufficiently flexible to date, and it would certainly need to continue to play an active role in the promotion of exports to the convertible area. Further success in slowing down inflation would be essential to avoiding large exchange rate depreciations.

The appropriate behavior for the financial community was a difficult issue, Miss Le Lorier observed. The Chairman had stated in his remarks to the Fourth International Monetary Conference:

> If the Fund is to be successful, the banks will have to maintain adequate net financing flows for those countries that have adopted strong adjustment measures; this involves the provision of a very large volume of new medium- and long-term flows in addition to the rollover of maturing short-term credit.

At the moment, Yugoslavia appeared to be a case of "too much adjustment and too little financing." Shortages of imported inputs were hampering its ability to export. Exports to the convertible area were not additional to exports to the nonconvertible area; they had been accompanied by a sharp reduction in the latter. The restraints placed on domestic demand might become unbearable; in that context, she fully shared the comments made by the staff on pages 11 and 12 of SM/82/181, and she had been particularly struck by the comment that "...at the present level of incomes, outlays on food comprised about 50 per cent of the consumer's expenditure basket." The restoration of the confidence of all foreign creditors was crucial and urgent. The restrictions recently imposed on the use of foreign exchange deposits well illustrated the urgency: they might reduce the amount of withdrawals, but they would presumably entail a slowdown in the flow of remittances. The authorities had proved by their determination to correct the recent slippages that they deserved the confidence of the international community. In the present circumstances, she would support any action that the Chairman felt was necessary to establish the basis for cooperative efforts with the banking system to assist Yugoslavia.

Mr. Laske noted that the three-year stand-by arrangement with Yugoslavia was entering the third year. Although the performance criteria for the second year had been fully met, developments in the Yugoslav economy had not unfolded as expected or hoped for in either the domestic or the external sectors. Unfavorable trends in both sectors had been reinforcing each other. For example, the stronger than expected increase in domestic demand stemming primarily from consumption had had an impact on the current account. The authorities' attempt to forestall that development by, inter alia, severely restraining imports had led to supply shortages and serious bottlenecks, highlighted by the resort to gasoline rationing, which in turn negatively affected production.

The Yugoslav economy was suffering from two structural, or institutional, weaknesses that worked to frustrate the authorities' efforts to achieve and maintain financial stability, Mr. Laske argued. One was the process of wage and price determination; the other was the uncontrolled credit expansion in the nonbank sector of the economy. The former appeared to be largely responsible for the sharp increase in personal income during the latter part of 1981 and early 1982, when inflationary pressures had been high. In that context, the staff had referred to the monopolistic position of many enterprises that allowed them to raise prices even in the face of weakening domestic demand. He wondered whether the authorities could take steps to make enterprises more responsive in their pricing policies to actual relationships between supply and demand. A large proportion of enterprises had been able to grant increases in incomes beyond their income generating capacity--40 per cent of the enterprises were reported to be out of line with the official policies on prices and incomes. What percentage of the work force was covered by those "undisciplined" enterprises?

The authorities had imposed a temporary price freeze at the retail and production level as a stop-gap measure in response to the recent upsurge in inflation, Mr. Laske noted. Some exceptions had been allowed to take account of the effects of the recent devaluation of the dinar. The price freeze could introduce a period of more reasonable price developments only if the wage determination process took full account of the anti-inflationary objectives of the authorities. As the latter realized, incomes policies had not worked well to date; he hoped that the legislation being prepared would be put in place in the near future and that it would produce the desired results. Mr. Polak had mentioned that the authorities had already contemplated measures in that area; he would be grateful if further details could be provided.

Another structural problem was the active credit expansion by nonbank enterprises, Mr. Laske commented. The expansion occurred in two forms: the deliberate provision of credit or loans, and the involuntary granting of credit when bills due were not paid. Both forms of interenterprise credit were apparently used to evade the tightened official credit policy. The development appeared to have hit the authorities unprepared since it ran counter to the assumptions underlying the stance of credit policy, and there was no indication in the staff papers that the authorities were considering specific measures to deal with the problem. Since the size of the problem might have been underestimated again in the current year, some consideration should be given to relevant measures. Despite the further increase in interest rates, all rates continued to remain negative in real terms by a considerable margin, given the present high rate of inflation. The authorities should therefore be prepared to take further action on interest rates, to the benefit of their restrictive demand management policies as a whole. Regarding the establishment of the performance clauses for 1983, he could fully endorse the staff's intention to provide for quarterly reviews to monitor more closely developments in the Yugoslav economy at the present critical juncture.

The most worrisome problem was Yugoslavia's precarious external position, Mr. Laske stated. External financing had not been forthcoming on the expected scale, resulting in a marked decline in reserves, and the current account had behaved contrary to expectations. It was disappointing that the current account deficit in 1982 would probably be twice as large as originally targeted, despite a significant decrease in imports. The growth of exports to the convertible currency area had slowed, so that the objective for 1982 as a whole might not be met.

Since the authorities had allowed the exchange rate to slide gradually, international competitiveness had not suffered significantly, Mr. Laske continued, but the large imbalance between exchange receipts and exchange payments strongly indicated that a more active exchange rate policy was necessary. In October, the authorities had devalued the dinar by more than 16 per cent, but whether that devaluation would prove adequate remained to be seen. Given the continuing high rate of inflation, the 4
authorities should take care not to allow the competitive position of Yugoslav exports to be eroded again. The Yugoslav authorities had also

taken measures to contain the demand for imports, but those could be regarded only as stop gaps. Rationing of energy products, especially gasoline, might hurt tourism when the 1983 tourist season began. Tourism was a major foreign exchange earner for Yugoslavia, but it had not performed as well as usual in 1982. In the interest of strengthening that particular segment of the services balance, a removal of the restrictions and their replacement by more general measures for the restraint of energy consumption would be highly desirable. The authorities had further tightened the restrictive stance of their fiscal policy in the summer of 1982, a necessary action in the light of the severe external constraints. It might be necessary to be more restrictive than currently envisaged in 1983 if events turned out less favorable than expected at the moment.

Mr. de Groote remarked that the Yugoslav authorities had shown a commendable willingness to observe the performance criteria mandated under the stand-by arrangement, and, indeed, all quantitative performance criteria had been observed up to September 30, 1982. Nonetheless, the economic situation was unsatisfactory. In spite of the measures taken by the Yugoslav authorities and envisaged in the stand-by arrangement, performance in the areas of the balance of payments, domestic demand, and interest rates had been less satisfactory than expected. It was another example of a situation in which fulfillment of a program had not resulted in satisfactory economic performance.

Apart from the obvious problem of the velocity of money referred to by several Directors, Mr. de Groote continued, there were probably two fundamental reasons why the program could not have been implemented by the Yugoslav authorities themselves, although they had implemented all the conditions proposed by the Fund. First, the program had been designed to control internal demand through control on domestic liquidity, but there was another form of money circulation by which large amounts of foreign exchange escaped the measures undertaken in the context of the program. The magnitude of those amounts was difficult to judge, and they were even more difficult to place under surveillance in the program framework. Second, the program had been designed to control macroeconomic variables, but there were many microeconomic decision-making centers that could affect spending.

Commenting on the balance of payments, Mr. de Groote noted that the overall balance of payments situation remained extremely critical, even though there had been a decrease in the trade deficit and an increase of about 7 per cent in export earnings in the first nine months of 1982 compared with the same period in 1981. Gross reserves were equivalent to about three weeks of imports, and the 10 per cent decline in imports would negatively affect the export performance of the Yugoslav economy, as Mr. Polak had correctly pointed out. The relationship between increases in imports and exports was a basic factor in the improvement of the balance of payments. Additional problems for export earnings in 1983 would be posed by the difficulty of foreign exchange transfers and the limitations on all types of imports.

The principal explanation for those different developments, Mr. de Groote considered, was that domestic demand, both personal and public consumption, had not been sufficiently constrained. The steeper than expected increase in domestic demand and the pressure on prices would continue to create adjustment problems for the system as a whole. Collective enterprises were able to make their own decisions on the distribution between wages and profits. It was important to note that the Yugoslav authorities had not used the two principal instruments that they might have used to deal with that situation: interest rate policy and prices policy. For example, in EBS/82/181, the staff clearly indicated that the level and structure of interest rates paid on both deposits and loans remained negative in the face of an inflation rate of over 30 per cent. The staff also noted that "in view of the expected deterioration in the rate of inflation, the authorities considered these changes to represent significant progress toward the goal of achieving real positive interest rates." The staff could not mean to advise Directors that policy changes had to await an abatement of inflation. If that was the intention, it was a mistaken application of the Fund's policy with regard to real interest rates. As Mr. Erb had indicated, the price instrument had not been used in relation to energy; the price freeze in place since July was even more worrisome and could not be regarded as a remedy. Internal demand should have been controlled through price increases in conjunction with a suitable incomes policy.

The situation was extremely precarious, Mr. de Groote continued, and two fundamental issues had to be faced. For the Yugoslav authorities themselves, there was a question of the preservation of Yugoslavia's economic system, a system that had great merit and that provided answers to some fundamental social and economic concerns. If the authorities wished to preserve the system, they would have to consider the possibility of some recentralization of decision making and the implementation of appropriate policies to deal with internal absorption. In other cases, the Executive Board had often recommended decentralization; to call for recentralization in Yugoslavia was simply an appropriately pragmatic response to the particular situation of the country.

The other fundamental issue had to be faced by the banking community, Mr. de Groote observed. There was about $10 billion worth of short-term foreign exchange present in the economy, and the authorities had been compelled to introduce restrictions on foreign currency deposits so that, as Miss Le Lorier had pointed out, further inflows under those conditions were hardly conceivable. There was a real question whether the authorities would be able to avoid debt rescheduling. Ideally, they should be able to obtain the necessary new funds without having to engage in rescheduling, and he hoped that the banking community at large, especially in those countries that had traditional relations with Yugoslavia, fully realized the importance of the choice facing it. In the absence of action by the banking community, the Yugoslav authorities would probably have to take a number of decisions, including perhaps debt rescheduling, that would jeopardize the achievement of their economic goal and the opportunity for the banking community to do further business with the country. The importance of finding a solution soon deserved emphasis.

Mr. Abiad suggested that the authorities should be commended for their responsible management of the economy in the face of continued difficult circumstances and for the determination with which they had pursued their adjustment efforts. The progress achieved during the period under review was a good measure of that determination. All the fiscal and monetary performance criteria had been observed. The Federal Government deficit had remained negligible in relation to gross social product (GSP), and the credit ceilings had continued to be observed. In the external sector, the staff had correctly indicated that "it was an achievement that the deficit on the current account in convertible currencies was reduced."

On the other hand, Mr. Abiad continued, the rate of growth of real GSP had been lower than originally envisaged, reflecting a slow growth of industrial output, mainly as a result of input shortages arising from reduced imports. At the same time, domestic prices had increased at a faster rate than planned. The factors responsible included not only increases in nominal wages, but also the implementation of measures usually recommended by the Fund, such as the substantial increases in administered prices, higher interest charges, and the effects of the dinar depreciation. It was worth noting, however, that while net personal incomes had increased sharply in the latter part of 1981 and early 1982, real personal incomes had remained virtually unchanged on an annual basis from May 1981 to May 1982.

The weakening of the capital account had overshadowed to a large extent the improvement painfully achieved in the current account, Mr. Abiad suggested. In that connection, the staff had indicated that the lower than expected growth of receipts from exports, tourism, and remittances "brings the appropriateness of the exchange rate into question." It would be useful if the staff could elaborate further on that point, particularly in view of the relatively large exchange rate change introduced by the authorities on October 22, 1982. He agreed with Mr. Lovato that it would be interesting to know whether a preliminary quantification of the likely impact of such a change on domestic prices had been made.

For the remainder of 1982 and beyond, Mr. Abiad remarked, the authorities had clearly expressed their awareness of the various difficult problems that remained to be overcome, as well as their determination to tackle them effectively. Their determination was well reflected in their restated commitment to continue to restrict domestic demand to make it possible to release more resources for the expansion of export industries, both under the current stand-by arrangement and for the remainder of the 1981-85 Medium-Term Plan. They had already taken a series of corrective measures and they were preparing to introduce a number of other policy actions aimed at further reducing inflationary pressures and expectations, tightening the control of investment expenditures as well as personal incomes and consumption, more actively promoting exports, and encouraging inflows of workers' remittances.

While it was true that the policy actions being taken were more than warranted by the economic difficulties expected in the period ahead, Mr. Abiad commented, it ought to be recognized that they involved, as Yugoslav officials had recently stated, "a great deal of effort and self-denial." That was particularly true in view of both the potential impact of the reduction in investments on economic growth and on an already high unemployment level, and the effects of the persistent recession and protectionist bias in European markets on Yugoslavia's export drive and flows of remittances. The authorities had demonstrated a clear commitment to redressing the present difficult situation; they should be encouraged in their adjustment endeavor through continued Fund support and international financial assistance.

Mr. Zhang said that he could fully appreciate the tremendous difficulties that the Yugoslav Government had encountered, not only in managing its economy in general, but in implementing the provisions of the stand-by arrangement in particular. As a result of the policy measures adopted and persistently carried out during the previous two years, the specific performance criteria under the second year of the stand-by arrangement had been met on March 31, 1982 and June 30, 1982. Those criteria included ceilings on domestic credit extended by the banking system, on National Bank credit to the Federal budget, and on outstanding convertible currency debt. Furthermore, as the data indicated, the internal and external balances had been considerably alleviated and the economy as a whole was becoming more stable and viable. Those were considerable achievements, and the Government ought to be commended for them.

The Yugoslav authorities would have to maintain the present policy measures in order to continue to meet the performance criteria and to realize the fundamental adjustment envisaged in the stand-by arrangement, Mr. Zhang continued. Moreover, as pointed out in the staff appraisal, additional measures would have to be introduced soon to consolidate and build upon the results already achieved. From an objective viewpoint, the adjustment task in the remainder of the stand-by arrangement period would not be easy, and it would be made even more difficult by the fact that the unfavorable trading climate and the stringent credit conditions in international financial markets experienced by Yugoslavia in recent months were expected to worsen. That point had been made clear by both the staff and Mr. Polak.

Even more worrisome, Mr. Zhang commented, was the fact that, for the next two to three years, the growth of national output in Yugoslavia would have to rely mainly on export expansion since domestic demand would continue to be restricted. However, the prospects for the expansion of Yugoslav exports could not be considered good in view of the continuing sluggish import demand and increased protection on imports from Yugoslavia among the country's main trading partners. Further devaluation of the Yugoslav dinar alone could hardly be expected to solve the problem.

Mr. Senior stated that he was in broad agreement with the staff appraisal of the developments in the Yugoslav economy during the first half of 1982. The compliance with the performance criteria in the second year of the stand-by arrangement indicated that some progress had been achieved as a result of the stabilization effort, but it had not been uniform. On the domestic side of the economy, real fixed investment had fallen by only 3 per cent, while the growth rate of public consumption expenditure had grown more than originally planned. That development, together with the rise in personal consumption resulting from the increase in real personal income that had taken place since the end of 1981, had resulted in higher than expected domestic demand accompanied by a resurgence of inflationary pressures. He agreed with the staff and with the authorities that the appropriate fiscal and credit policies carried out to date had to be accompanied by more adequate price and incomes policies if the desired reduction of real domestic demand for 1982 was to be achieved. It was encouraging to note that the Yugoslav authorities had already begun to adopt further measures to bring aggregate demand into line with supplies. A tighter incomes policy, restraint in public expenditure, and the continuation of restrictions on consumer credit would contribute to the authorities' goal.

Commenting on the external sector, Mr. Senior noted that in the first half of 1982 the current account deficit had been reduced considerably to a level of 1.5 per cent of GSP. Unfortunately, as a result of an insufficiency of medium-term and long-term credits and a large reduction in short-term credits from foreign banks, the deterioration in the capital account had led to a substantial worsening of Yugoslavia's external position. As Mr. Polak had pointed out, the unfavorable conditions in international capital markets had put heavy pressure on the country's foreign exchange availability and had therefore made the adjustment effort more difficult. The authorities should be commended for their policy of adjusting the exchange rate to offset fully the difference between increases in Yugoslav costs and prices and those in its trading partners. The continuation of such policies in combination with the capital expenditure policies would stimulate the competitive position of the economy. While the stabilization program and the policies set for the second year of the stand-by arrangement were geared mainly to coping with short-term problems, an appropriate balance between demand management measures and supply-oriented policies was needed in order to tackle the more fundamental weaknesses of the economy. The measures adopted by the authorities clearly showed their determination to tackle those fundamental problems.

Mr. Taylor commented that performance under the second year of the program had not been as good as expected. There had been policy shortcomings in conjunction with unfavorable external circumstances. His authorities' concern about the design of the program and the nature of the adjustment taking place in Yugoslavia were well known, and they believed that the application of "traditional Fund remedies" was insufficient in a country that relied heavily on administrative mechanisms. Directors seemed to agree that there was a need for further action at short notice, and he endorsed the thrust of the staff appraisal on that point. There would be a major need to restore external confidence as part of the effort required to finance the balance of payments in coming months, and careful thought would have to be given to the framing of the Fund program that would be an essential element in the future development of the Yugoslav economy.

Mr. Casey observed that in February 1981 the consensus of the Board had been to commend the Yugoslav authorities for their persistent and effective stabilization effort in 1981, particularly with respect to demand management policies. Directors had also felt that there had been a strong move toward correcting the underlying structural problems of the economy. However, much stronger adjustment measures would be needed in the third year of the program, both for internal reasons and to give correct signals to the international capital markets. In his authorities' view, simply meeting the performance criteria in 1982 would not be sufficient, because those criteria no longer appeared to be adequately geared to the targets. For the third year of the program, some reformulation of the performance criteria would be required. Perhaps alternative scenarios would have to be worked out on a contingency basis, along the lines suggested by Mr. de Groote.

The staff noted correctly that the most marked weakness in domestic demand lay in the area of personal consumption, Mr. Casey continued. It was therefore important that the projection for the second half of the year, calling for a 2.8 per cent decrease in real consumption, be achieved. The root of the problem lay in the recent increases in real wages; in that respect, the staff had been somewhat unclear about the wage-setting process and about the ability of the authorities to control wage inflation. For example, the staff stated that the current policy of increasing personal incomes in line with net enterprise incomes was open-ended if enterprises were able autonomously to raise prices and thereby increase wages. Was it true that the authorities were controlling wages almost exclusively through the announced price freeze? Could the staff or Mr. Polak elaborate on any other measures used by the authorities to control wages directly? The questions were relevant because the price controls seemed uncertain and partial, and, in any case, price controls could not be maintained indefinitely because they damaged resource allocation.

Despite improvements in the current account, Mr. Casey noted, the overall balance of payments position did not appear to be sustainable, principally because of a significant decrease in the flow of capital from international banks, largely an exogenous factor that probably reflected, in part, undue timidity on the part of international banks. He noted, however, Mr. Polak's suggestion that some of Yugoslavia's own banks might have contributed to the problem. With regard to the balance of payments with the convertible currency area, the export projections for the second half of 1982 seemed ambitious. They implied a 14 per cent increase over the same period in 1981, rather an optimistic view in light of the depressed international economy, a point that had been a matter of concern to Executive Directors in February. Furthermore, services and unrequited transfers had been revised from $4.6 billion in January to $2.7 billion in EBS/82/181. He invited the staff or Mr. Polak to comment further on the basic assumptions underlying the revised forecast, in particular with regard to tourism, interest rates, and the withdrawal of foreign deposits.

As other Directors had noted, the considerable increase in the income velocity of money was disconcerting, Mr. Casey observed. Had the staff been able to assess the impact of the increase in interenterprise credits and the use of foreign exchange in domestic transactions? As long as interest rates remained negative in real terms, it would be difficult for the authorities to control the interenterprise credit market. Table 2 in EBS/82/181 indicated that the performance criteria had been met precisely in March and June. However, the September ceiling on domestic credit had already been exceeded in August. It was possible that when the figure for September became available it would be found to have dropped back exactly to the September ceiling. That raised the question whether domestic credit was allowed to exceed the end-quarter ceilings within the quarter. The staff's comments on page 7 indicated that virtually any level of credit expansion was permissible between the test dates; that kind of performance criterion had little meaning. That aspect, in addition to the increase in income velocity and the persistence of negative real interest rates, might explain why the inflation rate remained high despite a partial price freeze and why the pace of adjustment generally had slowed down.

The program design should be carefully re-examined before the third year commenced, Mr. Casey considered. The re-examination should also include structural aspects, as mentioned by Mr. Lovato and others, and perhaps also the exchange rate, although the present exchange rate might be appropriate for the moment. However, the high rate of inflation and the inflation differential had to be taken into account. He joined other Directors in hoping that the Yugoslav authorities could avoid the need for debt rescheduling.

The Director of the European Department commented that many Directors had noted that the degree of adjustment in Yugoslavia had been considerable but, in the circumstances, inadequate. Speakers had rightly emphasized the question of wages policy. The staff would not claim to have a complete picture of the workings of the Yugoslav wage system; over the years, the Yugoslav authorities had made many attempts to deal with the issue, using a variety of instruments and devices, each of which had seemed workable ex ante, but had proved disappointing ex post. Part of the problem could be traced to the federal nature of the Yugoslav constitutional system, which, because of the country's different languages and different historical traditions, was less centralized than in most other countries. Some Directors had suggested that perhaps the degree of decentralization in Yugoslavia had reached a level that led to inefficiencies in economic decision making and implementation, but it might not be easy to change the system directly. Control over nominal personal incomes had to be sought indirectly by constraining the ability of enterprises to raise wages, and in that regard he agreed with those Directors who had emphasized the need for a sharp increase in interest rates so that they became positive in real terms. Mr. Laske had asked what proportion of the labor force was employed in loss-making enterprises. The staff's estimate was some 15-20 per cent.

A related point with regard to wages concerned the Federal budget, the Director continued. The Federal budget was usually projected to be in balance, but, as happened frequently, if the degree of inflation was underestimated there would be an unforeseen increase in Federal Government revenue. However, if, as was usual, the end-year outcome remained in balance, that was achieved either by reducing taxes or by increasing expenditure pari passu; in the circumstances, that approach seemed to the staff to be too accommodating.

A number of Executive Directors had referred to the use of credit ceilings in the performance criteria, the Director noted. The staff was unable to provide a breakdown of the relative contribution of enterprise credit and foreign exchange to the increase in income velocity that had occurred. The credit ceiling approach would be continued and would be supplemented by quarterly reviews. However, the mechanism relied upon had proved to be insufficiently restrictive; it was possible that a wider aggregate, one that the Central Government could control or strongly influence, could be sought. The staff was very much aware that the precise observation of credit ceilings on a quarterly basis raised concern; in fact, the September ceiling had been met, again almost exactly. The staff was considering adoption of an approach based on a moving average. The credit situation also underscored the need for a sharp rise in interest rates. While that would inevitably create difficulties for some enterprises, ways around particular problems would have to be looked at.

It had been suggested, the Director remarked, that a sharp increase in interest rates might freeze foreign exchange deposits. In normal circumstances that would be true, but the recent measures to limit withdrawals from those accounts had been prompted by net withdrawals running at a rate approximately $750 million higher than in the same period of 1981. It was an open question whether, in the present circumstances, an increase in interest rates would encourage holders to retain their holdings or whether it would have the opposite effect. The amounts involved were very large, almost $11 billion. However, the weakness of the control of credit could be only partially attributed to those accounts. In the context of credit control, the staff had also been referring to widespread holdings of foreign currencies in Yugoslavia. Almost by definition, no firm estimate of the amount of those holdings could exist; at one time they had been estimated at less than $1 billion, but recently officials had referred to amounts as high as $5-6 billion. While the estimates remained uncertain, it was known that the holdings were used in transactions in many essential consumer and investment goods.

The evidence in Chart 1 of EBS/82/181, Supplement 1, suggested that the recent devaluation had more than offset the deterioration in Yugoslav competitiveness, the Director commented. The staff had used the Yugoslav authorities' approach, an approach that was payments weighted and that, in consequence, gave a 48 per cent weight to the U.S. dollar. However, if the exchange rate was looked at on the basis usually used in the Fund, the loss of competitiveness since the end of 1981 had been 13 per cent against Western European countries, and as much as 23 per cent against the Federal Republic of Germany. In addition, it was necessary to induce a shift of exports from the Comecon area to Western markets, and the exchange rate had to be such as to enable that process to occur.

With regard to gasoline rationing, the Director continued, the Yugoslav authorities had told the staff that they had chosen to implement a rationing policy in order to bring home to the general population the grave balance of payments difficulties that the country faced; they believed that the "demonstration effect" would be extremely valuable. As for the general price freeze, the staff regarded it as no more than a means of buying a certain amount of time until longer-lasting and more effective measures could be introduced.

Investment in Yugoslavia, the Director of the European Department observed, faced the problem that the Federal authorities had sought to emphasize the development of the less developed Republics, a policy that had too often led to competitive investment by the Republics, and thus to an unnecessary duplication of investment. In 1980, investment had been 35 per cent of GSP, a high figure, but some Directors had correctly asked why it was being cut back when the need for increased productivity and increased exports was paramount. In the present emergency circumstances, the Government had had to take immediate direct actions in areas subject to its control and, like many other governments, it had found that cutting investment was the most convenient instrument. One Director had suggested that the projection of exports to the convertible currency area in the second half of 1982--14 per cent--had been too high. In fact, the projection had been revised substantially downward, but the revised estimate was not immediately available. Finally, Mr. Taylor had commented on the use of the "traditional Fund approach" when applied to an economy that depended heavily on administrative action. The staff recognized that there could be problems and had been seeking ways to supplement its approach, with some, albeit limited, degree of success. The particular difficulty in Yugoslavia was that not only was there a strong reliance on administrative action, but that the administrative action of the central authorities was not always effective, because of the constitutional framework.

Mr. de Groote said that the question of recentralization and the use of traditional fiscal and monetary policy instruments was an important one that deserved clarification. The main problem was to find a way to place decision taking by the autonomous entities, state enterprises, regional authorities, and the like within the general macroeconomic framework, particularly with regard to borrowing policy and investment policy. If the various entities had their borrowing and investment policies determined within the general framework of the Fund program, the traditional policy instruments would have an opportunity to play an effective role. He was not suggesting an increase in dirigisme; simply that microeconomic and macroeconomic decision making should complement each other.

Mr. Polak noted that a number of Directors had referred to the difficulty of price/wage controls in Yugoslavia. It was generally agreed that a price freeze was not an effective measure except in the very short run, and the authorities had not considered it a long-run solution. The main issue was wage control, and consideration was being given to ways of tightening it. For example, rules were in place to keep wage increases to no more than the increase in net receipts of the enterprises. However, the rules had not always been observed. In the past, the means of checking had involved annual audits with a one-year delay, so that, if it was discovered that wages had in fact exceeded receipts, there was little that could be done about it by that point. Moreover, the enterprises could excuse themselves on the grounds that they paid out wages more or less currently while receipts had to be estimated. The estimates were often optimistic, both with regard to the quantity of output and to the ability of the enterprise itself to set its prices. The enterprises had recently been advised that they would have to assume the effectiveness of price control policy and, in addition, the audits were to be speeded up, so that they would be undertaken on a quarterly basis. Those measures should make it possible to catch errant enterprises more quickly and to implement corrective action. Furthermore, the authorities were also considering whether wage increases should be limited to less than 100 per cent of the increase in net receipts by the enterprises.

It was clear that monetary controls had been ineffective, Mr. Polak continued. In other countries, the control of interenterprise credit was managed indirectly through the control of one form or another of the money supply. In Yugoslavia, however, enterprise liquidity had been built up in the past for various reasons not strictly related to the monetary need of the different enterprises, but according to certain regulations that set aside funds for particular functions. It appeared that those reserve funds were often drawn upon to a greater degree than the staff expected. In the circumstances, the staff's proposed new approach was welcome.

Directors had generally supported the Yugoslav authorities' exchange rate actions, Mr. Polak observed. He took note of Mr. Zhang's point that not all difficulties could be overcome by simply changing the exchange rate. Mr. Laske had observed that the recent change in the exchange rate might not be sufficient for long if inflation in Yugoslavia continued to exceed that in other countries. A number of Directors had expressed the hope that Yugoslavia would avoid a debt rescheduling. His authorities very much shared that hope; indeed, they intended to avoid such a development, even if it involved additional sacrifices by the population. The issue was related to the question of restoring external confidence, to which both Mr. Taylor and Miss Le Lorier had referred. There was also an obligation on the international community to do whatever might be needed to assist the Yugoslav authorities in establishing confidence. In that regard, he noted particularly the observation by Miss Le Lorier that in the present circumstances she would support whatever action the Chairman might feel was appropriate to establish the basis for cooperative efforts with the banking system to assist Yugoslavia.

The Chairman observed that the Yugoslav authorities had made strong efforts in the framework of their stabilizaton program. Adjustment had taken place, but not to a sufficient degree, and the situation was delicate. The balance of payments remained in heavy deficit, and considerable doubts surrounded the achievability of the program target of a deficit of $500 million for 1982 as a whole. Reserves were at a low level, and Yugoslavia was entering a period when seasonal difficulties would adversely affect the external accounts.

Although all the performance criteria had been observed, the Chairman continued, major difficulties persisted. That was the issue to which Directors had addressed themselves. The intensification of adverse external factors was only one reason; the sluggishness of world markets and the caution being demonstrated by financial institutions were well known. The adverse external environment could not be viewed as an excuse for the developments that had occurred, which were mainly due to two fundamental weaknesses in domestic policy: the control of nominal incomes and the control of credit.

Enterprises appeared to be paying out a high proportion of receipts as wages, the Chairman commented, with adverse consequences for the level of investment, especially in the crucial export sector. Directors had urged the authorities to strengthen the measures that they were taking to control the development of incomes, and some Directors had suggested that a degree of institutional reform might be appropriate.

The lack of control on credit creation and distribution, particularly interenterprise credit, the Chairman stated, had led Directors to emphasize the need to design and to monitor carefully the credit ceilings for 1982, and to tighten the performance criteria. Directors had suggested that a fundamental overhaul of the functioning of the economy was required.

A number of features of the Yugoslav situation were not compatible with the required adjustment effort, the Chairman observed. High inflation had resulted from an uncontrolled expansion of incomes, and at the same time real interest rates remained low. The coexistence of high inflation and low interest rates created incentives to borrow heavily while acting as disincentives to saving, particularly with regard to externally generated deposits. The situation not only undermined the confidence of domestic depositors but the confidence of all those who held monetary assets. The solution to that fundamental problem did not lie in price controls, a point that the Yugoslav authorities accepted.

An appropriate and effective macroeconomic policy in the present circumstances was closely related to the international context, the Chairman said. That Yugoslavia was cooperating in a Fund-supported program and had complied with the credit ceilings and the performance criteria would not of itself generate international confidence. International confidence depended on the tangible observation of rapid improvements in the balance of payments. The cooperativeness of the international financial community in 1983 would depend on the quality--and the perception of the quality--of the 1983 adjustment program designed by the Yugoslav authorities and the staff. The authorities were aware that the Fund's staff and management would be extremely active in the effort to galvanize international support for Yugoslavia. He had recently made clear the Fund's intentions in that regard. But that activity could not substitute for an effective adjustment program in 1983 that would have to address the fundamental question posed by Directors.

Executive Directors took note of the Chairman's remarks, and concluded the review of the stand-by arrangement with Yugoslavia.

3. NATURAL RUBBER BUFFER STOCKS ESTABLISHED UNDER 1979 INTERNATIONAL NATURAL RUBBER AGREEMENT - POSSIBLE FUND FINANCING

Executive Directors considered a staff paper on possible Fund financing of members' compulsory contributions to the buffer stock established under the 1979 International Natural Rubber Agreement (INRA), (SM/82/191, 9/22/82).

The Director of the Research Department noted that, since the establishment of the buffer stock financing facility in 1969, there had been only three commodities for which buffer stock financing had been agreed by the Fund: tin, cocoa, and sugar. The only buffer stock agreement for which Fund assistance was currently available was the 1977 International Sugar Agreement. No assistance had been provided by the Fund for cocoa, but a total of SDR 130 million had been provided for tin under the Fourth and Fifth Agreements, and, to date, SDR 117 million had been provided for sugar. If the Rubber Agreement and the Sixth International Tin Agreement were accepted by the Board as suitable for Fund financing, the amounts of assistance likely to be requested were expected to be a little over SDR 200 million for rubber, and SDR 100 million for tin. No other buffer stock agreements for which Fund assistance was expected to be made available were in prospect over the next several years.

A number of minor corrections and additions should be made to SM/82/191, the Director added. On page 12, line 12, the figure "649" should read "689.5." In line 13, the figure "252" should read "268." In addition, to date, the buffer stock purchases of natural rubber had reached 250,000 tons. The same corrections and addition should be made on page 23, lines 19 and 20.

Mr. Habib said that his authorities strongly welcomed the proposal for Fund financing of compulsory contributions to the natural rubber buffer stocks established under the 1979 International Natural Rubber Agreement. The subject of Fund financing of buffer stocks for natural rubber was of special interest to his constituency, as three of its members--Indonesia, Malaysia, and Thailand--accounted for almost 80 per cent of the world's total natural rubber production.

The main purpose of the Fund's buffer stock financing facility was to help to stabilize export prices and export earnings of primary producing developing countries, Mr. Habib continued. There were two important reasons why the need to stabilize rubber prices was so urgent for rubber producing countries in his constituency. First, natural rubber prices in the past two decades had shown great instability, thereby causing great instability in export earnings from natural rubber stocks. In fact, the price instability had been much greater than for many other commodities, including synthetic rubber. Second, it was necessary to stabilize natural rubber prices in order to provide encouragement for investment in new plantings of high-yielding rubber trees. Additional investment in new plantations was important, because without it a substantial imbalance between the supply of and demand for natural rubber was likely to arise. The staff estimated the potential gap between demand and supply as 0.5 million tons. Such a development could result in serious problems for the producing and consuming countries alike. It was, therefore, important to implement measures in advance to create enough confidence in the industry to ensure higher production and stable market conditions in the future. In his authorities' view, that was exactly what the buffer stocks created under the INRA were intended to achieve. The Fund should, therefore, support the important effort of rubber producers and consumers by providing financing for the buffer stock.

The INRA had several features that made it an effective device for stabilizing the price of natural rubber, Mr. Habib considered, and thus made the buffer stock created under it an excellent candidate for Fund financing. First, unlike the Sixth International Tin Agreement, the active participation in INRA was very wide, covering 7 exporting countries with 95 per cent of the world's export market for natural rubber, and 23 importing countries accounting for 80 per cent of the world market. With such strong participation in the INRA, it was bound to be successful in stabilizing the price of natural rubber. Second, the volume of rubber stocks envisaged under the INRA was sufficiently large to allow it to effectively influence the price. INRA provided for normal stocks of 400,000 tons of natural rubber and a contingency stock of 150,000 tons. Third, the effectiveness of INRA in stabilizing the price of natural rubber was improved by its having set a range within which prices were to be stabilized. The range could be revised every 18 months to ensure that it adequately reflected the medium-term trend in rubber prices. Fourth, the cost of financing was shared equally between the exporting and the consuming member countries. The members of INRA were committed to financing the full cost of a buffer stock of 550,000 tons. Therefore, there were no risks of major slippages in achieving the objectives of the INRA.

There were several additional important considerations that gave grounds for optimism concerning the ability of the INRA to achieve price stability, Mr. Habib remarked. For example, the current reference price around which the rubber price was to be stabilized was established at a realistic level in relation to the medium-term trend of natural rubber prices. Flexibility was introduced through appropriate provisions in the INRA, allowing for the reference price to be altered if market conditions changed. The staff's analysis showed that it was feasible to stabilize natural rubber prices successfully within a 15-20 per cent range. In addition, a substantial amount, 200,000 tons, of natural rubber had already been acquired by the buffer stock manager, considerably strengthening the effectiveness of the buffer stock in influencing the price level of rubber. The considerations that he had mentioned led him to conclude that buffer stocks established under the INRA would result not only in greater stability of prices, but also in greater stability of supplies, so that both the producing and the consuming countries would benefit.

The proposed draft decision could usefully be amended in a number of ways, Mr. Habib suggested. With regard to early repurchase as provided for in paragraph 3(b)(i), he wondered whether it could be amended to say that any distribution in currencies or physical quantity from that portion of the buffer stock not financed by the Fund should not be made subject to early repurchase. According to the draft decision and past practices, when the buffer stock distributed assets to the members, the members had to make an immediate repurchase payment to the Fund, even though the Fund financing of the contribution might come late in the life of the buffer stock. In his authorities' view, if the members made financial contributions using their own resources and used Fund resources only for later compulsory contributions, the members should have priority in receiving the distribution from the buffer stock.

The Fund should also consider revising paragraph 5 of Decision No. 4913-(75/207) as amended by Decision No. 6862-(81/81), Mr. Habib continued, to allow the Fund to approve a schedule of repurchase different from the normal three- to five-year period, i.e., to extend the maturity period for the buffer stock financing facility in line with the lapse of time between the contribution that used the Fund resources and the liquidation of the buffer stock. At present the maximum maturity for the buffer stock financing facility was five years, while the buffer stock agreement might be extended to seven years with, in addition, the liquidation period of two or three years. Therefore, it was conceivable that members drawing under the buffer stock financing facility might encounter difficulties in making repurchase in the absence of early distribution from the buffer stock concerned.

Paragraph 2 of the draft decision, Mr. Habib noted, indicated that the request for use of Fund resources had to be made not later than six months after the date of the contribution. Could that be interpreted to mean that a request could also be made prior to the contribution by the member? If so, perhaps the Board should make that clear in the draft decision.

Finally, total drawings under the buffer stock facility were limited to 50 per cent of quota, Mr. Habib noted, and the maximum use foreseen was only SDR 212 million. Actual usage was likely to be much smaller, so that its impact on Fund liquidity would be only marginal. The balance of payments need would have to be established, and the drawing member would have to pledge its cooperation with the Fund in order to find solutions to its balance of payments problems. His authorities were satisfied that the provisions of the INRA were consistent with the principles referred to in Executive Board Decision No. 2772-(69/47) as amended by Decision No. 4913-(75/207).

Mr. Anson commented that his authorities fully supported the proposed decision. They agreed with the importance of soundly based international agreements that had realistic prospects of achieving effective price stabilization. The large fluctuations and rigidities in supply in natural rubber made it the kind of commodity for which buffer stocks could make an important contribution. Stabilization would reduce the uncertainties impeding the larger-scale investment needed to keep natural rubber competitive with synthetic rubber and to ensure long-term supplies. Stabilization was particularly important given the planning problems involved in the seven-year production cycle and the dependence of synthetic prices on fluctuating oil prices. Fund support was, therefore, well justified.

The INRA was broadly based in that the membership accounted for 95 per cent of world natural rubber exports and 78 per cent of imports, Mr. Anson observed. The staff considered that the probability was high that the buffer stock should be adequate for effective stabilization of normal market fluctuations. The price of natural rubber was, however, extremely variable, and it was important in any Fund-supported buffer stock that there be a reasonable prospect of balance between demand and supply in the medium term. He hoped, therefore, that the staff would keep the Board fully informed of any important developments in the market.

Mr. Prowse commented that Mr. Habib had effectively put the case for Fund support of the natural rubber buffer stock. Subject to further detailed consideration of Mr. Habib's suggested amendment, his authorities warmly supported both the proposed decision on natural rubber and the proposed decision on tin, as drafted.

The provisions of the two agreements met the requirement of the 1969 decision, Mr. Prowse considered, and the implications for Fund liquidity were moderate. The likely maximum support under the INRA would be SDR 212 million, an amount that would not require the Fund to make special arrangements with regard to its liquidity. The probable maximum commitment under the International Tin Agreement (ITA) was SDR 114 million, only a little above the Fund's actual support under the Fifth ITA.

With regard to tin, Mr. Prowse continued, the staff had appeared somewhat critical of the past performance by the International Tin Council (ITC) in stabilizing rapidly rising prices. The staff had suggested that it had been the result, in part, of shortcomings in the design and implementation of the ITC operations themselves; for example, failure to hold sufficient amounts of metal, the small size of the overall buffer stock, excessive duration of export controls, and the like. It had concluded, nevertheless, that the ITC buffer stock operations should have helped to stabilize prices, and that there was a presumption that they had also helped to stabilize export earnings. In that regard, the possible smaller size of the Sixth ITA buffer stock, resulting from the decision of Bolivia not to join, at least initially, would probably not contribute to a better performance under the present agreement. The staff went no further than to say that in its view operations under the Sixth ITA would be able to exercise a stabilizing influence. To what extent did the staff maintain contact with the ITC? Were there regular consultations? To what extent would they be able to discuss the substance of their criticisms with the ITC and expect a response?

In SM/82/191, Mr. Prowse remarked, the staff had suggested that drawings might be affected by the relationship between the size of the drawing and the size of the member's quota. India, for example, had a relatively large quota but was not expected to make a large drawing. There ought not to be any presumption that the member's entitlement to purchase under the buffer stock financing facility, in relation to either of the two agreements, was in any way to be judged by reference to the size of the drawings in relation to quotas. That point should be clearly emphasized.

The proposed decision on the rubber agreement, Mr. Prowse noted, provided that any transfers of natural rubber from the buffer stock to a member should be valued at the lowest current price for each type of transfer during the 30 market days preceding termination of the agreement. That provision was consistent with the wording of Article 41, Section 2(a). However, it was unclear whether, in view of Sections 6 and 7 of Article 41, the purchase from the Fund resulting from the transfer of natural rubber could be significantly less than the market value at the time of the repurchase. The proposed tin decision, on the other hand, referred to an average price on the day of contribution. Thus, the question arose whether repurchases might be less and whether the basis for valuation of stocks was different under the two agreements.

Mr. Dallara stated that his authorities believed that the 1979 International Rubber Agreement was possibly the best international buffer stock agreement that had been reached. They agreed with the staff that the agreement satisfied in all respects the terms of the Fund's decisions on the buffer stock financing facility. Accordingly, they supported the proposed decision as drafted. He joined Mr. Anson in hoping that the staff would keep the Board informed of developments in the rubber market. Mr. Habib's proposed amendments would require further consideration, but his initial reaction was that the decision should go forward as drafted, since the proposed changes were fundamental in certain respects. In particular, his authorities would have difficulty with any changes whatsoever regarding the provisions for repurchase and the requirement that the request be made within a six-month period.

The staff had pointed out that, historically, the amount of Fund financing provided under the buffer stock financing decision had been very low, Mr. Dallara continued. It had also pointed out that, if the Board approved the two draft decisions under discussion, the possibility was that Fund financing under the buffer stock decisions could grow significantly. While the amounts would remain small compared with the Fund's other facilities, and while there were no other buffer stock agreements in prospect, the Board had never conducted a general review of the buffer stock financing decision and the Fund's role in such financing. Notwithstanding the regular reports that were made to the Board in connection with Fund support for individual buffer stock arrangements, he believed that it might be useful for the Board to conduct a more general review of its role in buffer stock financing at an appropriate time. However, any such review should await the completion of the current quota review and not be scheduled until management felt that it would not put undue strain upon the staff.

Mr. de Vries considered that the INRA was well designed, with wide participation by both producers and consumers. The intervention arrangements appeared realistic and, therefore, had a good chance of achieving some stabilization of the price of rubber. Stabilization was important if there was to be the necessary investment and if natural rubber was to be produced in competition with synthetic rubber. It was also important to stabilize the export receipts of some primary producing countries that were much affected by price fluctuations. Financing for such a facility was short term, and his authorities had always supported Fund assistance for well-designed buffer stocks. They fully supported the proposed decision. Mr. Habib's comments involved changing some basic policy decisions of the Fund and would require more detailed and careful consideration than the Board could give at the present meeting.

Mr. Senior said that he agreed with the staff recommendations and supported the proposed decisions, on both rubber and tin, as drafted. Financial assistance by the Fund to international buffer stock agreements was suitable as a means of working toward the achievement of the Fund's goals. In SM/82/191, the staff demonstrated the desirability of Fund support for the 1979 INRA. It was not difficult to see the beneficial effects that price stabilization of natural rubber would have on both producing and consuming countries. Stable prices would foster the growth of consumption and trade; the high probability that the buffer stock scheme would attain price stabilization would ensure that the use of Fund resources was temporary. The staff conclusion that the stabilization of international prices of natural rubber would help to stabilize export unit values, which would in turn tend to stabilize export earnings, was also encouraging. The staff recommendation on the financing by the member of its compulsory contribution to the acquisition cost of the buffer stock and the method to be used to determine the value of that contribution seemed appropriate. The actual amount likely to be drawn under the facility was such that the Fund would not need to make special arrangements with respect to its liquidity.

Commenting on the possibility of Fund financing of tin buffer stocks under the sixth ITA, Mr. Senior observed that it was a cause for concern that producer and consumer membership under the new agreement had been reduced, particularly because of the consequent reduction in the size of the buffer stock relative to the Fifth Agreement. However, the intention expressed by some members of the previous agreement to cooperate with the

International Tin Council was welcome. In that regard, he hoped that the cooperation of important producing and consuming countries outside the agreement would reduce the possibility of market disruptive actions. Despite the reduction in the size of the agreement, the staff had pointed out that sufficient broad-based participation remained and that the size of the buffer stock continued to represent a significant portion of annual trade flows in tin. He therefore shared the staff view that the changes in participation and size under the Sixth Agreement would not have significant consequences for its functioning. The expected limited consequences of the changes, together with the modification in the financing arrangement lifting export controls and improving the operating procedures for market intervention, appeared to be sufficient to enable the Fund to conclude that the agreement could contribute to the stabilization of tin prices. He supported the staff recommendation that the Fund should finance the full amount of eligible members' compulsory contribution to the normal buffer stock. As in the case of the Rubber Stock Agreement, the amount of purchases under the tin buffer stock would not have a significant effect on the liquidity of the Fund.

Mr. Laske said that his authorities were satisfied that the provisions of the INRA were consistent with the principles that had been established for the buffer stock financing facility; they therefore supported the decision as drafted. He had listened with interest and attention to the amendments suggested by Mr. Habib, but they seemed at first sight to be fundamental, and it would be preferable if detailed consideration could await a careful staff analysis.

Compared to other commodity agreements, the INRA had certain innovative features, Mr. Laske considered, that improved the probability that it would contribute to the stabilization of the price of rubber and of the export earnings of the primary producing countries without distorting market forces. Natural rubber was a commodity with certain special characteristics, the most important of which was that it faced strong competition from a substitute product, synthetic rubber. A careful operation of the buffer stock was therefore essential so as not to price the producers of natural rubber out of the market. A mechanism for stabilizing the price of natural rubber appeared advisable, given the price inelasticity of supply and the high price elasticity of demand. He agreed with the staff that the buffer stock had to aim at stabilizing the price around the medium-term trend because the price of natural rubber was strongly influenced by oil prices, by movements in oil prices, and by variations in economic activity in industrialized countries.

In SM/82/191, the staff stated that "the operational rules of the Agreement provide for sufficient flexibility regarding revisions of the reference price in response to market conditions," Mr. Laske continued. That provision was an improvement on comparable provisions in other international commodity agreements, and such a revision clause should be applied in an efficient, effective, and satisfactory manner. However, the change in the reference price under the INRA that had been made effective in May 1982 had lowered the price by only 1 per cent. He therefore doubted whether that Agreement had been operated to date in full conformity with the intention set out in the text of the Agreement. It was important that the reference price be set at an economically justified level that would take account of periods when the demand for natural rubber was not as strong as producers would like.

The importance of natural rubber for the export receipts of the producing countries had declined relatively strongly over the preceding two decades, Mr. Laske noted, and Table 6 of SM/82/191 indicated that the potential purchases from the Fund both in absolute terms and in relation to those members' quotas appeared to be small. He recalled a point raised by Mr. Casey in a recent discussion on an application for a purchase under the buffer stock facility, namely that purchases under commodity agreements should have a "floor," i.e., they should represent a certain minimum amount of the country's overall exports. At that time, he had supported the suggestion and he had favored its consideration at a future date. It was worth noting that the four large producers held on average 7 per cent of the export market for natural rubber, and the low drawing potential in relation to quotas of those members indicated that only a small number of countries would be eligible for the use of the Fund's resources under the buffer stock facility.

A more general consideration, about which his authorities were concerned, Mr. Laske went on, was that commodity agreements had a certain protectionist character. As a matter of principle, they would welcome the application by the Fund of strict criteria when judging the consistency of a commodity agreement with the provisions of the Fund's buffer stock financing facility so as to carefully control the provision of Fund assistance to contributions to buffer stocks. He joined Mr. Dallara in suggesting a full review of the buffer stock facility decision at a suitable time in the near future.

Mr. Hirao noted that the reference price and other relevant prices under the 1979 INRA were reviewed every 18 months and were revised in accordance with the trend in market prices and net changes in the size of the buffer stock. Those provisions appeared to give sufficient assurance that the buffer stock would operate effectively. He agreed with the staff that the stability in the price of natural rubber expected from the operations of the buffer stock would be instrumental in stabilizing export earnings, ensuring, in turn, the temporary nature of any possible use of Fund resources under the proposed decision. Furthermore, the agreement contained no provision for export quotas or other measures to restrict supplies, a positive contribution consistent with the principles of free trade. He therefore agreed with the staff that the 1979 INRA satisfied the terms of the Fund's decision on the buffer stock financing facility. More time was needed to study the amendments proposed by Mr. Habib; therefore, he supported the proposed decision as drafted.

Mr. Lovato commented that, given the depressed and uncertain conditions of world markets for primary products, international agreements to stabilize commodity prices (and export earnings for primary producers) through buffer stock arrangements should be welcomed and encouraged by an institution such as the Fund, strongly committed to international cooperation. It was in the interest of both producing and consuming countries to reduce excessively wide and disruptive swings in prices and supplies of primary commodities. The Fund should therefore extend to natural rubber the buffer stock facility, which had been helpful for many years in other primary-product markets.

It appeared, Mr. Lovato observed, that the Agreement's operating rules, the conditions of eligibility, duration, financing of costs of acquiring and managing buffer stocks, and the provisions for ensuring that the agreement would operate effectively to stabilize prices and export earnings were all in conformity with the Fund's principles for extending its assistance under the buffer stock facility. He therefore supported the proposed decision.

Commenting on the International Tin Agreement, Mr. Lovato said that the staff paper indicated that the most recent agreement had improved upon provisions and operational rules contained in the Fourth and Fifth Agreements that the Board had previously considered compatible with the principles underlying the buffer stock financing facility. Two features of the new agreement represented positive innovations: the compensatory nature of contributions to the buffer stock by both producing and consuming countries, and the greater degree of stringency applied to the adoption of export controls above and beyond the normal operation of the buffer stock as a complementary method of price stabilization. The staff suggested that the operating cost of the buffer stock would be largely met from other sources and that, even if all countries applied for Fund assistance, the total amount of purchases would not exceed SDR 114 million. That was an additional reason for recommending that the Fund should be prepared to finance the full amount of members' contributions to the buffer stock. He therefore supported the proposed decision; he also supported the request by Mr. Anson that the staff keep Directors informed about market developments. The proposal made by Mr. Habib would represent a departure from the philosophy and practice of the Fund; it would be preferable to study a staff report on them before a decision was taken.

Mr. Jayawardena noted that natural rubber had been one of the most price-volatile products in world trade since the development of the automobile industry early in the century. Only sugar and coffee were more volatile products in world trade. Such volatility had not only affected the demand by users, leading to the development of synthetics in the early 1950s, but it had also affected large numbers of poor people whose livelihoods were dependent on natural rubber cultivation and tapping, a highly labor-intensive activity. Given the long gestation of the rubber tree, and the 30-year effective production span, supply adjustments had not been easy.

Such producer-manufacturer-consumer relationships called for collective efforts at orderly adjustment and development, Mr. Jayawardena continued. Natural rubber had first been subject to international agreement in the 1930s. During World War II, the producer countries, despite their poverty, undertook to stabilize its price as a most strategic commodity, if not for which natural rubber prices would have exploded. Since then, several efforts had been made to reach agreement on orderly change, but they had not succeeded until the present, because of the growing availability of synthetics, the price of which, as a byproduct of the petrochemical industry, had been influenced by the previously prevailing low prices of petroleum. The new agreement included 7 producers accounting for 95 per cent of exports and 23 importers accounting for 78 per cent of imports, and it aimed at short-term price stabilization within a given long-term price range, determined conservatively. It also assisted the orderly development of the industry by raising productivity. It operated entirely as a buffer stock, without export quotas or restraint on supplies, and therefore adequate financing for the stocks was critical to the agreement. The cost of the buffer stock of 550,000 tons was shared equally between exporters and importers, proportional to their shares in world trade. The staff had demonstrated that the maximum demands made by participants would not strain the Fund's liquidity.

The staff had examined five criteria by which the Agreement was evaluated, Mr. Jayawardena noted. First, the Agreement had to be in accordance with accepted U.N. principles of commodity agreements. Second, Fund participation should be short term, and an appropriate part of the initial cost of buffer stocking should be made from sources other than international financial institutions. Third, participants should avoid discriminatory trade practices and should not seek long-term restriction of trade; in fact, members were obligated to expand trade and to make supplies freely available. Fourth, the Agreement had to be capable of stabilizing prices, so as to ensure the temporary use of Fund resources. Fifth, the Agreement should stabilize export earnings of producers so that repurchase obligations could be met. The staff had indicated that the Agreement met each of those five principles. He was therefore in full agreement with the staff's conclusion that the Natural Rubber Agreement satisfied the terms of the Fund's decision on buffer stock financing, and he supported the proposed decision.

Concerning the proposals put forward by Mr. Habib, Mr. Jayawardena suggested that the second and third proposed amendments were rather technical, and they might be resolved at the present meeting as they did not appear to involve serious issues of policy. Clarification of those two issues might obviate the need for waivers and exemptions in the future.

Miss Le Lorier stated that she was fully convinced that the 1979 INRA met the criteria for Fund assistance and that she therefore supported the proposed decision. In purely economic terms, wide fluctuations in the price of natural rubber over recent years, as well as the dominant influence of industrial countries' demand for rubber on the behavior of its price, justified fully the establishment of an international buffer stock. The stabilization of prices was further justified by previous price performance and production costs. She welcomed the extension of the buffer stock facility to natural rubber stocks, a development that should be encouraged to the maximum extent feasible in view of the importance of such agreements to the stability of international economic relations and to the development of more stable export receipts of primary producing countries.

She also supported the proposal that the Fund should finance the full amount of members' compulsory contributions to the acquisition costs of the buffer stock, Miss Le Lorier continued, a proposal that already applied to the buffer stock decisions on tin and on sugar. The staff had estimated the amounts likely to be drawn under the two proposed decisions; she wondered whether those estimates were based on use of the facilities by developing countries only. She agreed with Mr. de Vries that the Board needed more time to consider carefully Mr. Habib's proposals, and she suggested that they could be discussed in the framework of a more general review of the buffer stock financing facility. She invited the staff to comment on Mr. Jayawardena's suggestion that the third proposal suggested by Mr. Habib might be consistent with the existing legal provisions.

Mr. Casey noted that the INRA was comprehensive and flexible. The supply and demand elasticities of natural rubber led to serious price instability that ought to be dampened if investment in natural rubber production was to be encouraged. The price of natural rubber tended to rise as oil prices rose, which might explain why requests for financing had not been put forward in the recent past.

The INRA appeared to be better than the International Tin Agreement, Mr. Casey considered, in that there were no provisions for export quotas and in that there was a 90 per cent probability of stabilizing the price within a 15-20 per cent range. However, it would be difficult for the buffer stock manager to "locate a price trend before it becomes measurable." There was therefore an element of uncertainty surrounding the Agreement. The consuming countries would, presumably, attempt to avoid any upward ratcheting effect on prices, but he was not convinced that the consumers had been successful in that regard in the past. Therefore, it was conceivable that the Fund could be helping to raise prices above the long-run market trends that would otherwise have occurred. The staff had stated that there was "a strong possibility" that a significant part of the finance would come from sources other than international financial institutions. That was another element of uncertainty, and he wondered whether the World Bank intended to contribute to buffer stock financing. As he had understood it, the original intention had been that the World Bank would be involved in that area.

In endorsing the agreement, the Fund might have to commit a significant amount of resources, Mr. Casey observed, and perhaps a good deal more if the eligible consuming countries also applied for financing. He was not convinced that that represented the best use of Fund resources at a time when liquidity was tight and when the international economy was in such a poor condition. He supported the suggestion by Mr. Dallara and other Directors that the Board should have a general review of the buffer stock financing facility. He reiterated the point that he had made at a previous Board discussion, with which Mr. Laske had agreed, concerning the possibility that such a review might touch upon the question of setting a "floor" for purchases from the facility. He could not support liberalizing the repurchase provisions, as suggested by Mr. Habib, but that proposal and Mr. Habib's other proposals might be discussed in more detail at a later date.

Mr. Alhaimus remarked that the staff was correct in considering that the INRA satisfied the terms of the Fund's decision on the buffer stock financing facility according to the criteria for Fund assistance as set out in the 1969 staff study. He agreed with the staff analysis, and he supported the proposed decision.

The INRA was broad-based and could reasonably be expected to achieve the objectives of price stabilization that would be beneficial to both producer and consumers over the life of the agreement, Mr. Alhaimus continued. The staff had indicated that there was a 90 per cent probability that the buffer stock manager would succeed in stabilizing the price within a range of 15-20 per cent. The greatest amount that would be drawn on the facility would be about SDR 212 million. In practice, the amount might be much lower because not all members would have the need to draw. Participation by Fund members in the agreement would not result in consequential trade discrimination against other Fund members, nor would it lead to long-term restrictions on natural rubber supplies. The staff had stated that when the common fund became operational the Fund would have to re-examine the decision on financing of natural rubber stocks within the context of an overall examination of the terms of the 1969 decision regarding Fund financing of international buffer stocks. A similar statement appeared in SM/82/200 concerning the Fund's financing of tin buffer stocks under the International Tin Agreement. He invited the staff to elaborate on the purpose of such a re-examination of the decision. The suggestions put forward by Mr. Habib were interesting; their consideration by the staff would be welcome.

Mr. Diao stated that he could support the staff recommendations, subject to an assessment of the amendments suggested by Mr. Habib. Stabilization of export earnings was a critically important issue for developing countries that produced primary commodities, as stable export earnings allowed those countries to plan and to implement their development programs in a smooth and certain fashion. That being the case, he would welcome a more active role for the Fund in buffer stock financing, especially in the context of the Integrated Program for Commodities. He supported Mr. Dallara's suggestion for a review of the decision establishing the buffer stock financing facility and the role of the Fund in buffer stock financing.

Mr. Prowse stated that, on the basis of a preliminary consideration of Mr. Habib's proposals, he could support Mr. Habib's second suggestion concerning the possibility of scheduling repayments in the light of the early repurchase provision; it appeared reasonable in principle. The other suggestions, however, appeared to have technical and legal aspects upon which comments by the staff would be welcome.

Some Directors had put forward the idea of a "threshold" or "floor," Mr. Prowse noted. It was difficult to reconcile such a proposition with the practicalities of buffer stock financing. Table 6 of SM/82/191 indicated that there were some likely significant purchases under the facility, but that there were also a number of very small purchases in view; for example, by Ivory Coast, Nigeria, Papua New Guinea, Sri Lanka, and the like. Did the concept of a threshold imply that such purchases should be excluded in the future? If so, Directors should recognize at once that it would be in conflict with the whole concept of the buffer stock under the 1969 decision. The purpose of the facility was to encourage and assist participation in appropriate buffer stock arrangements, because such arrangements were perceived, and had demonstrated their ability, to improve the wider environment of international trade, and were therefore quite clearly consistent with the principal objectives of the Fund. What could be the logic of proposing to restrict access, on the basis of some new principle in the Fund's operations and procedures, to make certain minimum-size purchases unacceptable, although they would be justified under all of the other existing provisions of the Fund? The motivation for such a suggestion was puzzling.

Although a general review of the various Fund facilities, including the so-called "lower-conditionality facilities," might be considered, such a review was not urgent, Mr. Prowse suggested. If a review were scheduled, the staff should take into consideration the conclusion of the original Decision No. 2772, June 25, 1969, which remained the relevant decision:

> In view of the Fund's purposes, which include the facilitation of "the expansion and balanced growth of international trade," the Fund, in its consultations with members, will pay increased attention to their policies in the commodity field.

That was a general principle and a major element of the buffer stock decision that should be carefully assessed and reported on if a review were undertaken.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/82/145 (11/8/82) and EBM/82/146 (11/12/82).

4. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the proposal set forth in EBAP/82/389 (11/8/82).

Adopted November 10, 1982

5. APPROVAL OF MINUTES

a. The minutes of Executive Board Meetings 82/76 through 82/79 are approved. (EBD/82/273, 11/3/82)

Adopted November 9, 1982

b. The minutes of Executive Board Meetings 82/80 through 82/84 are approved. (EBD/82/275, 11/4/82)

Adopted November 10, 1982

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/82/388 (11/5/82), EBAP/82/390 (11/8/82), and EBAP/82/391 (11/9/82) is approved.

APPROVED: April 29, 1983

LEO VAN HOUTVEN
Secretary