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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 81/121

10:00 a.m., September 9, 1981

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

Executive Directors	Alternate Executive Directors
	O. Kabbaj
	C. Taylor
	E. M. Ainley, Temporary
A. Buira	M. A. Senior
R. D. Erb	D. E. Syvrud
J. de Groote	
M. Finaish	T. Alhaimus
T. Hirao	A. Nagashima
	D. I. S. Shaw, Temporary
	J. R. Gabriel-Peña
B. Kharmawan	V. Supinit
S. Kiingi	F. Sangare
G. Laske	G. Winkelmann
G. Lovato	C. P. Caranicas
	A. Le Lorier
	C. Bouchard, Temporary
M. Narasimham	D. L. Kannangara
J. J. Polak	T. de Vries
A. R. G. Prowse	B. Legarda
J. Sigurdsson	
Zhang Z.	

J. W. Lang, Jr., Acting Secretary
J. A. Kay, Assistant

Also Present

T. S. Kivanç, Alternate Executive Director, IBRD. African Department: J. B. Zulu, Director; O. B. Makalou, Deputy Director; A. Basu, E. L. Bornemann, J. P. Briffaux, S. E. Cronquist, J. W. Kratz, S. M. Nsouli. Asian Department: I.-S. Kim, L. J. Lipschitz. European Department: D. Burton, B. Christensen, M. Dakolias, P. B. de Fontenay, E. Gurgen, L. Hansen, J. J. Hauvonen, R. P. Hicks, P. C. Hole, H. O. Schmitt. Exchange and Trade Relations Department: C. D. Finch, Director; D. K. Palmer, Deputy Director; M. Allen, C. F. J. Boonekamp, D. J. Donovan, S. Eken, H. W. Gerhard, Z. Iqbal, S. Kanesa-Thasan, P. M. Keller, C. M. Loser, P. J. Quirk. External Relations Department: C. S. Gardner, Deputy Director. Fiscal Affairs Department: V. Tanzi, Director; W. A. Beveridge, Deputy Director; M. Z. Yucelik. IMF Institute: S. Kayir; T. Atalay, E. F. Gokbayrak, M. A. Mohsen, Participants. Legal Department: G. P. Nicoletopoulos, Director; W. E. Holder, Ph. Lachman, S. A. Silard. Middle Eastern Department: G. T. Abed, S. H. Hitti, M. Hosny, S. Ishii, B. A. Karamali, B. K. Short. Research Department: R. R. Rhomberg, Deputy Director; A. Lanyi. Western Hemisphere Department: S. T. Beza, Deputy Director; C. E. Sansón, Deputy Director. Bureau of Statistics: J. B. McLenaghan. Finance and Development: S. I. Katz, Editor. Personal Assistant to the Managing Director: C. M. Watson. Advisors to Executive Directors: E. A. Ajayi, C. J. Batliwalla, J. U. Holst, M. A. Janjua, G. Jauregui, A. K. Mullei, P. D. Peroz, F. A. Tourreilles, Wang E., F. Yeo T. Y. Assistants to Executive Directors: A. F. P. Bakker, M. J. Callaghan, L. E. J. Coene, E. Costa, J. L. Feito, F. Guena, J. M. Jones, P. Kohnert, S.-W. Kwon, J. E. Leimone, J. S. Mair, V. K. S. Nair, Y. Okubo, J. Pedersen, C. N. Pinfield, O. Uçer, J. F. Williams.

1. TURKEY - 1981 ARTICLE IV CONSULTATION, AND REVIEW OF STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1981 Article IV consultation with Turkey, together with a draft decision concluding the 1981 Article XIV consultation (SM/81/178, 8/24/81). In addition, they took up a paper reviewing the stand-by arrangement with Turkey, together with a draft decision (EBS/81/180, 8/24/81). They also had before them a report on recent economic developments in Turkey (SM/81/180, 8/27/81).

The staff representative from the European Department mentioned that, as envisaged in the papers before Executive Directors, the prices of fertilizers had been increased by more than 50 per cent on average, for a revenue yield much as expected. However, a disturbing recent development had been a sharp increase in the monetary base during the previous two months. The increase seemed to have stemmed entirely from an unexpectedly strong rise in the net foreign assets of the Central Bank, related apparently to a high level of workers' remittances in the peak holiday season, which had yet to be absorbed through transfers for imports. With a view to limiting the impact of the surge in liquidity on the broader monetary aggregates the authorities had required the commercial banks to place 25 per cent of the weekly increase in their deposits during August and September in a special blocked account with the Central Bank, and they had increased a number of central bank interest rates. Furthermore, general directives had been issued to the banks regarding credit expansion and the use of central bank resources. While those measures were clearly a step in the right direction, the staff did not yet have sufficient evidence to be able to say whether they would be adequate to contain the monetary expansion. The staff would continue to monitor developments, and it would be reviewing the situation thoroughly with the Turkish officials at the time of the Annual Meeting.

During August 1981, the staff representative continued, the exchange rate had continued to be adjusted gradually under the new exchange rate regime. In nominal effective terms, the lira had depreciated by rather more than 4 per cent, a movement which--allowing for expected inflation differentials--would probably imply a real depreciation of 1 to 2 percentage points. In the same field, one of Turkey's three remaining multiple currency practices, arising from the use of a less depreciated rate for making transfers for certain Turkish students abroad, had been eliminated on September 1, 1981. Finally, in the last line on page 28 of EBS/81/180 the sentence should read "the Government will limit the contracting of new nonconcessional public and publicly guaranteed foreign borrowing in the...."

Mr. de Groote made the following statement:

My Turkish authorities are very grateful to the staff for an excellent report, which gives a thorough and balanced description of economic developments in Turkey during recent years. While today's discussion covers both an Article IV consultation and a review of a stand-by arrangement, I will direct my remarks to the latter topic in view of its important bearing on future developments in Turkey.

The stand-by arrangement with Turkey has now been in effect for a full year. It is therefore time to assess the stabilization program that it covers. Are the basic objectives of the stabilization program still appropriate? If they are, does the progress realized so far match expectations at the beginning of the program? If progress until now falls short of expectations, what are the causes of this shortfall? Examination of these issues should lead us to the final question: Do the objectives of this stand-by arrangement need to be revised, and if so what further measures must be envisioned to achieve them?

The drastic reduction in the inflation rate, through the maintenance of a strict monetary policy, and the introduction of market mechanisms to allocate resources have brought greater stability. This allows a somewhat clearer picture to emerge of the fundamental problems affecting Turkey over recent years. Past policies had led to relative economic isolation, limited reliance on market mechanisms in the allocation of resources, and a lack of flexibility in the management of the economy, seriously distorting the domestic economic structure and weakening export performance. Developments related to the price of oil have aggravated this vulnerability in recent years. The Fund program aimed essentially at achieving better allocation of the limited resources by increasing reliance on market forces combined with the transfer of resources from the domestic sector to the balance of payments. In the medium term, the attainment of a sustainable current account deficit should allow balanced growth of the economy. The reduction of domestic absorption by a restrictive financial policy, the freeing of most domestic prices, especially for state economic enterprises, the liberalization of interest rates, and the introduction of a flexible exchange rate policy were the major instruments used to mobilize available domestic resources and direct them to the export sector. The progress so far achieved is a significant first step toward this fundamental goal. Further steps remain to be taken. One may therefore view the thrust of the present stand-by arrangement as still being appropriate.

The performance of the Turkish economy so far seems to warrant a certain optimism: there is indeed substantial improvement in most problem areas, in some cases even exceeding expectations, though in other areas results have lagged behind. On the positive side of the ledger we may point to the exceptional expansion of exports since the end of 1980: export proceeds are expected to yield about $4.2 billion in 1981, compared to an initial estimate of $3.5 billion. This is the more remarkable because the increase in exports applied broadly both to product groups and to geographical areas. This development was set in motion by successive adjustments of the exchange rate in 1980 and 1981. The freeing of the exchange rate since early last May by the adoption of a system of daily determination of the rate will assure that this favorable trend for exports can continue. This flexibility of the exchange rate, together with the restoration of confidence, has also greatly increased workers' remittances to Turkey, which are forecast to yield $2.5 billion in 1981 compared to $2.1 billion in 1980.

On the domestic side, financial conditions have also greatly improved. The inflation rate has dropped substantially. The freeing of interest rates has generated important savings, helping to reduce the large savings gap, which till now had impeded the financing of investments needed for the expansion of the export base.

One must not forget, however, the considerable cost of these positive results: a substantial reduction of real income in 1979 and 1980, and a very high level of unemployment. The authorities feel that this unprecedented deflation of personal income cannot be maintained for much longer without creating social and political difficulties. Therefore the spectacular pace of improvement evident till now in the aforementioned areas cannot in their view continue and must slow down in coming years. However, they are aware that in other areas, especially the sector of puclic finances, there is still much room for improvement. The performance of public finances, particularly that of state economic enterprises, lagged well behind expectations. It was too optimistic to expect improvement in this area to materialize immediately after the basic policy shift from a strongly guided to a more independent management of these enterprises. The overemployment that existed in this sector was not to be eliminated overnight, nor could market mechanisms immediately be set into operation. The Turkish authorities are well aware of the problems in the state economic enterprises and have already taken significant measures to correct the situation; the corrective price increases of 1980-81 have remarkably improved the financial situation of most state economic enterprises. Those which were allowed to adjust their prices are expected to show operational profits in 1981. However, those profits will be offset by the duty losses incurred by the state economic enterprises that for social and economic reasons remain under price controls. Although significant price adjustments were made in these subsidized sectors (fertilizers, railways, and maritime transport) the authorities felt they could not make larger adjustments without endangering other objectives of the overall stabilization plan, such as the development of agriculture. The authorities remain strongly committed to further correcting the financial situation of the state economic enterprises, especially in the sectors that are still subsidized. On balance, the measures taken will greatly reduce the overall financing requirement of the state economic enterprises and thus their burden on the budget for the current and subsequent years. The detailed and relevant staff analysis in Appendix II of the recent economic developments paper, with which the Turkish authorities fully concur, makes it clear that this problem has no short-term solution. The best that can be expected is a slow and gradual improvement in the financial situation of the state economic enterprises, which will continue to require the constant vigilance of the authorities to maintain the necessary discipline.

While the state economic enterprises can provide only gradual relief, the tax reforms enacted at the beginning of the year will benefit the public finances more significantly. The additional tax revenues expected from these reforms, together with limitations on increases in expenditures, will lower the consolidated budget deficit to about 1 per cent of GNP, in turn reducing the need for central bank borrowing and budgetary arrears. The improved financial soundness of the economy will leave room for the expansion of private investments, especially on the export side.

Looking ahead, it is clear that Turkey can only achieve a viable balance of payments situation by expanding its export base. The authorities are already taking measures to emphasize agricultural development in order to realize the large and immediately available export potential of this sector. They are convinced that there is a large margin for rapid expansion in this sector, where investments had declined in recent years. The industrial base, on the other hand, is rather small and currently more oriented toward import substitution, which limits possibilities for transferring existing resources toward exports. For this reason the authorities have some doubts that further adjustments of the exchange rate beyond the degree required to absorb the appreciation in real terms of the effective exchange rate during the first half of this year could succeed in diverting additional resources from the domestic to the export side. They fear that the additional price increases that would result, given the import structure, would outweigh any benefit that such further adjustment might produce on the export side. The authorities are committed to continue a flexible exchange rate policy that takes account of price developments in Turkey and abroad. For the present, however, they feel that, in view of the limited stimulus to exports that additional exchange rate adjustments would provide, any expansion of exports will have to be generated by new investments in export industries, especially in projects yielding quick returns. The Government has already liberalized interest rates in order to encourage the growth of domestic savings needed to finance these investments. Further improvement in the budgetary situation and in the financial soundness of the state economic enterprises should generate additional savings for the financing of investment programs. At the present level of incomes in Turkey, savings will have to be supplemented by large capital inflows if both investment and the existing current account deficit are to be financed.

The presence of these flows is thus essential to the success of the stand-by program. The dependence on outside flows is not limited to the Turkish case but is much more general in scope and is a condition for the success of a number of Fund programs. We must admit that the Fund does not possess the financing necessary to support its adjustment programs fully through stand-by or extended arrangements. If the Fund had to rely solely on its own resources to finance stabilization efforts, countries would be forced to adopt unbearable adjustment measures. The Fund therefore rightly operates on the basis of a number of assumptions about likely capital inflows, which are needed in addition to the Fund's financing to support an adjustment program. The Fund's leverage over these capital flows, however, is very limited; their failure to materialize can jeopardize stabilization programs by imposing supply constraints and protracting the duration of the stabilization effort. There is thus a clear danger, illustrated by the present case of Turkey, that the Fund may arouse a number of expectations at the beginning of a stand-by or extended arrangement that it cannot alone fulfill. If in the course of stand-by arrangements the anticipated capital flows do not materialize on time or in sufficient amounts, additional adjustment measures would be required from the countries to safeguard the initial objectives of the program--measures that the authorities would not be in a position to implement. Since the problem will have to be dealt with in a more general framework, I will not elaborate on it here.

Still, I had to raise the general issue now, because it explains why the Turkish authorities are of the opinion that there is hardly any room left for an additional adjustment effort beyond what was originally envisioned. The severe restrictive measures imposed at the beginning of the stand-by arrangement cannot be maintained over a long period without seriously endangering the success of the whole program. It has become clear that programs for structural adjustment cannot work without concomitant financial efforts by donor countries and private capital sources. Substantial capital inflows will therefore have to be obtained by Turkey now and in coming years. Private capital flows have so far shown some hesitancy with respect to Turkey. A greater responsiveness of these capital sources to the large-scale stabilization efforts of Turkey is, as I have stressed on several earlier occasions, a key element in the successful implementation of the program. The reaction of these sources is also a major test of the Fund's credibility. The initial hesitation of private banks seems from recent news reports to be giving way to cautious optimism. This is a most welcome development since it shows growing confidence in the Fund's judgment on Turkey and the achievements of the Turkish Government.

From our own studies and those of the Organization for Economic Cooperation and Development and banks it is quite obvious that the that the present program is only a first step toward a viable balance of payments situation. It would be quite useful now to begin an analysis of the nature, magnitude, and timing of the capital flows that will be required to make this adjustment fully effective. It would be extremely dangerous to assume or create the impression that the end of the present program will coincide with the achievement of a viable balance of payments situation on the part of what was until recently one of the most inward-looking economies in our membership, as evidenced by its low ratio of exports to GNP. Turkey will have to continue to rely for a rather long period on capital flows to support its rapid industrialization. Such an adjustment simply cannot be achieved within the time frame of a stabilization program. It would be helpful, in this connection, for the Fund to indicate, before the end of the present stand-by arrangement, approximately what kind of balance of payments situation may be expected to be achieved by the end of this arrangement. This would help assure the continuity of capital flows without which Turkey cannot sustain its present efforts.

May I stress in conclusion that my Turkish authorities greatly appreciate the close relationship with the Fund staff that has developed over the course of this stand-by program. This collaboration has led to mutual understanding of the problems on either side and has thus facilitated the search for solutions. Both sides firmly intend to maintain this cooperation beyond the present program. The Turkish Government is realistic; it knows and understands the present problems. The authorities realize that they face a long process of recovery and therefore welcome any collaboration that will help them accomplish this arduous task.

Mr. Winkelmann stated that he agreed with the staff appraisal to the effect that the authorities needed to continue strengthening both demand policies and those policies leading to supply-oriented adjustment, especially in the light of the existence of some unsecured external financing. He also supported the decisions set out in EBS/81/180 and SM/81/178.

At the beginning of the second year of a three-year stand-by arrangement, Mr. Winkelmann went on, it was clear that the authorities had achieved remarkable success in combating inflation, which had fallen from 100 per cent to 40 per cent in terms of Fund figures, and to 35 per cent in July 1981 according to the Organization for Economic Cooperation and Development (OECD). There had also been an improvement in the current account, some resumption of overall growth to 3 per cent or even 4 per cent, and an increase in private domestic savings. According to a well-known monthly periodical, the banking community rated Turkey higher than it had six months previously, and Mr. de Groote had mentioned that confidence was slowly returning. The Turkish authorities' policy of increasing reliance on market mechanisms and shifting the emphasis to export-oriented growth, coupled with restraint on budget deficits and a reduction in the losses of state economic enterprises, together with financial assistance from a number of countries and the World Bank, had provided a good foundation for the rehabilitation program. It was not easy to tell the exact contribution by commercial banks, but an improvement in the debt profile for the rather short-term debt incurred in the late 1970s would give some breathing space for the coming two or three years. However, as the staff had mentioned, there was a financing gap of about US$0.5 billion for 1981 and the prospects for 1982 were not yet fully identified. It was unfortunately clear that the way was not yet entirely open to self-sustaining overall growth, and further adjustment was imperative.

Taking up specific topics, Mr. Winkelmann said that he agreed with the authorities that it would be proper to undertake a further deceleration in the rate of monetary expansion in order to continue the fight against inflation and signal the necessity for less bank financing of budget deficits and the losses of state economic enterprises. He wondered whether the staff really considered the figures for the growth of monetary reserves on page 11 of EBS/81/180 to be realistic, if the expansion was in fact somewhat above the target rate as indicated on page 7 of SM/81/178. In that connection it would be interesting to know whether the compulsory 25 per cent deposits by commercial banks with the Central Bank were to earn any interest for the depositing banks. The terms offered by the Central Bank would affect the willingness of the banks to offer high interest rates to depositors. It was true that the expansion in the supply of money there could be offset by a reduction in the velocity of circulation, and an increase in the rate of savings could represent restraint in consumer demand and the reappearance of positive interest rates. It would certainly be useful if an expansion in the volume of money led to the availability of more credit for the private sector, particularly for firms concerned with exports, as well as to a reduction in the financing of public debt and in the losses of state economic enterprises. It was essential for the authorities to exercise restraint in public spending so as to provide room for the expansion of the private sector.

Similarly, Mr. Winkelmann observed, the goal of reducing the consolidated budget deficit from 4.6 per cent of GDP to 1 per cent of GDP was commendable; but he wondered whether it was attainable. There had been slippages during 1980 and an overshooting of the annual expenditure target during the first quarter of 1981. Moreover, on the revenue side, the implementation of the 1980 tax reform seemed to be rather slow, and there was some uncertainty about the elasticity of tax revenue. He therefore wondered whether the authorities would be able to continue with their policy of reducing the budget deficit during the second half of 1981.

A centerpiece of the restructuring of the economy, Mr. Winkelmann noted, was to be the attempt to make the state economic enterprises more efficient and more profit oriented. The Government of Turkey had said in its memorandum (page 26 of EBS/81/180) that it was acutely aware that the state enconomic enterprises must become self-reliant if the needed fundamental strengthening of the financial position of the public sector was to be achieved. His chair strongly endorsed the Government's intention to monitor the operations of the state economic enterprises and to reduce the contribution from the government budget to cover losses. Nevertheless, he really wondered whether the Government could bring about its aim without an undue increase in paperwork. Naturally, he recognized the effects of introducing a more cost-oriented pricing policy for the state economic enterprises on the struggle against inflation, and he hoped that the Government would be successful.

The Fund made its financial assistance available for balance of payments purposes, Mr. Winkelmann recalled. In that connection, the Turkish authorities had undoubtedly made some progress in strengthening the balance of payments. Exports had increased rapidly through restraint in domestic demand, special export incentives, and a relatively appropriate exchange rate policy. He further noted an increase in workers' remittances. His chair welcomed the intention of the Turkish authorities to introduce a new regime that would facilitate the pursuit of a more vigorous exchange rate policy, as necessary, during the program period.

One major area of concern, Mr. Winkelmann noted, was that of energy, since the import of oil consumed some 73 per cent of receipts from exports and workers' remittances, a level that could not be sustained. He was glad to see that the Government intended to launch a comprehensive medium-term energy policy aimed at developing indigenous sources of energy while stepping up the exploration for oil and the introduction of new technology. More important, the Government would continue to increase domestic prices of petroleum products in line with international oil prices and exchange rate movements. The postponement of adjustment measures that ought to have been taken in the past decade had resulted in a heavy burden on the Turkish economy in the 1980s. There would be many difficulties in exploiting the domestic energy resources, and he assumed that the World Bank would be heavily involved.

The Turkish authorities would have an uncomfortable journey for several years before reaching the path of self-sustaining growth based on stable domestic and external financial positions, Mr. Winkelmann considered. Adjustment and financing were complementary; to some extent they were also interchangeable. In practice, however, the provision of finance in the years ahead was likely to be a severely limiting factor. He therefore wholeheartedly wished the Turkish authorities both steadfastness and success in their efforts to stabilize and restructure the economy.

Mr. Erb commented that the efforts of the Turkish authorities under the current stand-by arrangement had yielded some tangible results, notably in slowing the rate of inflation, accelerating export growth, and bringing about a resumption in real economic growth after two years of decline. The United States welcomed those positive developments, but it shared the staff's assessment that the need for adjustment continued to be large and urgent. Despite some improvement in 1981, the current account deficit was still a larger percentage of GDP than it had been in 1978 or 1979; and the overall balance of payments deficit in 1981 was expected to be larger than at any time since 1977. In addition, much of the financing for that deficit remained uncertain. In that situation, the program correctly stressed that tighter fiscal and monetary policies and a more determined exchange rate policy would be the key elements in a stepped-up adjustment effort.

It was clear, Mr. Erb considered, that Turkey must achieve a high and sustained rate of export growth to finance an adequate level of imports and to service continuing heavy external indebtedness. The need for more aggressive management of the exchange rate was indicated by the continued reliance on such multiple exchange rate practices as subsidized rates for fertilizers and related agricultural imports, and foreign exchange retention schemes for a broad number of export categories. An elimination of those practices, in conjunction with a more vigorous exchange rate policy, should be accompanied by a careful study of ways to reduce or eliminate a number of other practices, such as fertilizer subsidies financed through budget levies on exports of agricultural products, and government monopolization of the export of certain agricultural crops, all of which distorted the allocation of resources. He was glad that the staff had been able to report that the exchange rate continued to be adjusted on a gradual basis over time.

While the Turkish authorities had done well in meeting the established credit ceilings in the past, Mr. Erb observed, the recent growth in broad money and the spurt in prices in June 1981 were both worrying. In the circumstances the authorities would have to follow a tighter monetary policy if the gains in reducing inflation were not to be lost. In connection with monetary policy, he noted that the combination of a falling rate of inflation and a reduction of impediments to the market determination of interest rates had produced a broadly positive real level of interest rates. If that encouraging development was maintained, it should help to stimulate private savings and lead to a more efficient allocation of investment. He urged the Turkish authorities to eliminate the remaining subsidized interest rates still available to a number of economic sectors.

The budget deficit, Mr. Erb considered, particularly the transfers to the state economic enterprises, continued to present major difficulties in controlling domestic demand and in achieving an efficient allocation of resources. He therefore welcomed the intensified efforts of the authorities to control the level of transfers to the state economic enterprises; but the deep-seated problems of the lack of managerial capacity, inadequate pricing policies, and overstaffing would require a determined attack if progress was to be made. He had been pleased to hear of the large increases in fertilizer prices. In conclusion, the United States continued to support Turkey's stabilization program in the expectation that the Turkish authorities would maintain their efforts, and in some areas intensify them, to meet the difficult adjustment requirements that lay ahead.

Mr. Lovato noted that the case of Turkey was a very special one, in particular because it represented at least to some extent a test of the validity of the stand-by arrangements under the new policy of enlarged access to the Fund's resources. In establishing its stabilization program at the beginning of 1980 with the support of a three-year stand-by arrangement with the Fund, Turkey had made a significant departure from its economic policies of earlier years. The movement in the direction of a market-oriented system, a new pricing policy--at least for interest rates and the state economic enterprises--and the more restrictive monetary policy, together with external financial assistance, had all helped to improve Turkey's economic position. The reduction in the rate of inflation, the marked improvement in the volume of exports since September 1980, and the increase in foreign exchange earnings--enhanced by workers' remittances--were signs that the program had had at least an initial success. Nevertheless, the adjustment still to be made was both large and urgent. Moreover, experience showed that the more severe the action needed to restructure the economy, the more difficult it was to carry it out on noneconomic grounds.

In the near future, Mr. Lovato continued, the cost of meeting the performance criteria would be even higher since the capital inflows on concessional terms might well be reduced, even if commercial banks continued their lending. While it was understandable that potential donor countries might have difficulty in providing aid because of budgetary or fiscal problems, the need for Turkey to resort to substantially nonconcessional financing could aggravate the already heavy debt burden. In all those circumstances, and especially because the rate of increase in the price index--after declining for more than a year--had begun to accelerate once again, it was essential for the Turkish authorities to observe the performance criteria very strictly, if only because there was clearly no short-term solution. There were two areas where the program would have to be carried out, perhaps only gradually, but certainly with determination. The first involved the improvement in efficiency of the whole productive system, at least in part by opening the economy to foreign investment and to the competitive influence of market forces. The second required the overhaul of the public sector, particularly the state economic enterprises. A reduction in the public sector deficit would make it possible to transfer some of the available credit to the private sector. It would not be easy to overcome the economic difficulties facing Turkey. Nevertheless, results already achieved in fighting inflation and in raising foreign exchange earnings, both prerequisites for making further advances, were both encouraging and promising.

Miss Le Lorier expressed her broad agreement with the staff appraisals, which gave reasons for optimism and described the main areas where further progress would be essential if the gains were to be consolidated. One of the most impressive gains of recent months was clearly the strengthening of exports. Another area where progress was visible was that of inflation, where the objective of reducing the rate of price increase to 40 per cent a year seemed to have been attained in the first part of 1981. Insofar as public finances were concerned, the implementation of the subtantial tax reform introduced since the end of 1980 seemed to have gone a long way toward redressing the large and probably unsustainable imbalances of previous years.

On the external side, Miss Le Lorier went on, one of the main questions seemed to be how long the present trend of export increases would last. The maintenance of such a trend would require continued restraint on the growth of domestic expenditure, improvements in the financial incentives for exporters, a continuation of imports of energy and raw materials, and--last but not least--close monitoring of the competitiveness of Turkey's export products. The present prospects, particularly for competitiveness, did not seem very satisfactory. Most of the progress in the export field had been concentrated on Iran and Iraq, while exports to other trade partners were much less buoyant. It might be much less easy to make further gains in present market shares on a wider geographical basis unless there was an improvement in competitiveness. There might be some doubt regarding the appropriateness of the exchange rate vis-à-vis the major trading partners, and continued difficulties regarding the availability of foreign exchange could also prove detrimental to economic activity.

On the import side, Miss Le Lorier observed, efforts should be made to achieve a more efficient allocation of the available resources. The staff had made particular mention of the possible benefits to be gained from both energy conservation and diversification. It was perhaps surprising that Table 17 in SM/81/180 showed that the price of regular gasoline was still comparatively low by international standards, and it would be interesting to know whether the authorities intended to take action to raise it.

The staff had mentioned, Miss Le Lorier recalled, that the authorities seemed to consider that they had reached the limit beyond which additional adjustment could not be pressed. The steps so far taken and the measures planned for the coming year or so clearly indicated that they were giving high priority to a return to equilibrium. It was difficult, however, to see what further progress could be made without further adjustment. In the circumstances it was important to bear in mind the extent of the imbalance still remaining in the balance of payments and in the overall budget, and--perhaps still more striking--the persistent mismatch between supply and demand, as shown by the recurrence of inflation. One of the reasons for the mismatch might be the fact that adjustment had taken place more slowly than the authorities had hoped. Monetary policy, for instance, had not become really restrictive until 1980, and fiscal reform had taken much longer to implement than had been expected. The underlying financial position of the state economic enterprises still left much room for improvement, and the allocation of resources continued to be less than adequate. Any sign of a weakening of the adjustment process should be a matter of concern to all parties involved in the prompt rehabilitation of the Turkish economy. External financial assistance did, however, continue to be a key to a more balanced state of affairs. A prompt response to any emerging sign of weakness in monetary restraint and in external competitiveness, as well as prompt reaction to any signs of inflation, would certainly go a long way toward preserving the recent improvement in confidence in the economy of Turkey.

Mr. El-Khouri stated that he supported the program for the second year of the three-year stand-by arrangement with Turkey. The program represented a continuation of the adjustment effort, during which the Turkish authorities had undertaken several painful decisions for which they were to be commended. The implementation of the first year's program had been by and large successful, and he wished the authorities every success in implementing the remainder of the program. The program was a comprehensive one that dealt with the basic problems facing the Turkish economy. The credit program for the period July-December 1981 was compatible with the goal of a further reduction in the rate of inflation. On the fiscal side, an attempt was being made to contain the deficits both in the government budget and in the accounts of the state economic enterprises. Externally, the introduction of a flexible exchange rate policy since early 1981 and the efforts that had been made to maintain a vigorous growth in exports were both welcome developments.

The staff had been frank in pointing out that, in view of the size of the task facing the Turkish authorities, it was important that there should be no slippage in any part of the program, Mr. El-Khouri commented. For that reason, he welcomed the various safeguards that had been provided. For instance, the authorities had stated their intention to ensure that, if the anticipated increase in net foreign liabilities did not materialize, the growth in net domestic assets would be limited by a broadly comparable amount. Moreover, the authorities had undertaken to consult with the Fund if budgetary transfers to state economic enterprises exceeded the specified limit either at the middle of the fiscal year or at the end. The authorities were also to consult with the Fund if the exchange rate was not adjusted sufficiently to compensate for the price differential between Turkey and its principal partner countries.

Raising some minor queries regarding the program, Mr. El-Khouri noted that roughly the middle of the fiscal year had been reached, and he wondered whether the staff had any information about the level of transfers from the budget to the state economic enterprises. Second, the staff had mentioned in SM/81/180 that one particular objective of wage policy was to ensure that awards to employees of the state economic enterprises and the private sector did not exceed those granted to government staff. Nevertheless, in EBS/81/180 it was stated that wage increases in the private sector and in state economic enterprises would average about 35 per cent in 1981, while those in the government sector would be limited to 25 per cent. He wondered whether it would not be possible to make wage increases uniform for employees in state economic enterprises and government. Third, the staff had mentioned that $100 million would become available from the World Bank as part of a structural adjustment loan toward the end of 1981, provided that certain structural reforms connected with energy taxation and the state economic enterprises were carried out. He wondered whether the amount of $100 million had been included in the balance of payments projections for 1981, and--more generally--what the prospects were that Turkey would receive that sum during 1981.

Mr. de Vries stated that he was fully prepared to support the decisions before the Executive Board; progress in Turkey during the past year had been quite remarkable, but the country still had a long way to go. Mr. de Groote had identified two main lines of approach that the Turkish authorities had adopted. They had been working first on the elimination of excess demand, and then they had introduced a number of measures to eliminate distortions in the exchange rate, in the interest rate, and in the pricing policies of the state economic enterprises. So far as the restriction of demand was concerned, Mr. de Groote had mentioned that the Turkish authorities had felt that nothing was to be gained by continuing indefinitely to suppress personal incomes; there must be some hope that personal incomes would rise in due course. If in fact the judgment of the Turkish authorities was valid, the implication was that the Fund should advise them to put even more emphasis on the elimination of distortions; and a careful reading of the staff papers seemed to show that there was still considerable room for doing so. He had for instance been struck to hear the staff announce that an unexpected inflow of foreign remittances should be considered bad news for Turkey. In most countries an unexpected rise in remittances from abroad would be taken as good news; if the inflows had really caused serious problems for the Turkish authorities, the event only went to show that a great deal of work was required to improve the efficiency of monetary management.

There were a number of more substantial elements pointing in the same direction, Mr. de Vries observed. The industrial base was small and it was mainly geared to the domestic market. The private sector still had rather little room for maneuver; it was perhaps being crowded out by the budget deficit and the losses of the state economic enterprises. Appendix II in SM/81/180 gave a detailed account of the state economic enterprises, and it did not make very happy reading. The original purpose of the state economic enterprises had been to bring Turkey into line with the advanced industrial nations. However, he really wondered whether that purpose would be fulfilled by the enterprises in their present form, and whether much more could not be done by the private sector. Instead of keeping the enterprises under better control the Government might do well to denationalize them as a way of solving the many present problems. It was not particularly comforting that the authorities had had to take decisions to raise the quality of management, reduce overstaffing, and rationalize production.

The staff had noted that the exchange rate was now being determined daily, Mr. de Vries observed, and he wondered whether it would not be better for the prices charged by the state economic enterprises to be determined in a similar fashion, preferably by the market. While measures of that sort might provoke considerable social discontent, they might in the end be inevitable. Mr. de Groote appeared to be saying that the authorities had done all they could on the demand management side and in the way of eliminating distortions, and that therefore Turkey needed assistance in the form of greater capital inflows. It might however turn out that the inflows were not as large as would be desirable; the authorities would then have to re-examine the rest of their program.

The state economic enterprises seemed to occupy a considerable part of the Turkish economy and much might be gained by starting with a thorough reorganization.

More generally, Mr. de Vries said, he agreed with the staff that it was important that the program should be fully implemented, since there was very little room for maneuver. Nevertheless, he could join Mr. de Groote in coming to a comparatively optimistic assessment of the work already achieved. The objectives of the stabilization program still seemed to be appropriate and the program had reached expectations in many fields. What shortfalls there were seemed to be confined largely to state economic enterprises and distortions caused by inadequate pricing. In those circumstances it was fairly easy to answer Mr. de Groote's last question as to what further measures should be envisaged. On the whole he had been greatly impressed by the efforts of the Turkish authorities, and he was glad to see that the confidence of the international banking community was slowly returning.

Mr. Taylor stated that he considered the paper to have been exceptionally helpful; he had particularly appreciated the longer-term perspective given in SM/81/178. The program for the period ahead seemed to be leading in the right direction, and he could support the proposed decisions. Turkey's progress under the stand-by arrangement continued to suggest that the economy was being guided along the right path. There had been a sharp reduction in inflation and an improved export performance. However, the recent improvements should not be allowed to distract attention from the continuing need to maintain firm and determined policies. More specifically, the persistence of high levels of external debt and a significant external financing gap warned against any relaxation of the stabilization effort and underlined the need to persevere with the necessary adjustment process. It would be a serious mistake for the authorities or the staff to base present or future programs on an assumed level of capital inflows that might not be forthcoming. The achievements under the stand-by arrangement demonstrated the authorities' ability to implement major adjustment measures successfully; he hoped that they would continue to show resolve in overcoming their present difficulties.

Taking up individual points in the staff papers, Mr. Taylor said that he would welcome confirmation that the monetary target for the period ending December 31, 1981 was sufficiently restrictive in view of the reduction in inflation that was projected. There were some indications that monetary conditions were becoming more relaxed, and he had been rather disconcerted by the staff representative's opening remarks. The intention to allow credit to the private sector to grow more rapidly than credit to the public sector in the second half of 1981 was welcome; if realized, it should help the export effort.

In the fiscal field, substantial improvements in the financial administration of the state economic enterprises were clearly needed, Mr. Taylor observed. Those improvements represented the cornerstone of the budgetary adjustment effort, and it was to be hoped that planned reforms would be more successful than in the past. Perhaps more attention might be given to reducing the level of the current costs of the state economic enterprises. He wondered how confident the staff could be that the enterprises would not be able to circumvent the restrictions that had been placed on their borrowing, for instance, by building up arrears or by not paying taxes. Pricing policies were clearly an area of concern, and he would welcome any information that could be given regarding recent developments in the wheat market. Might there not be a case for removing price controls on flour and bread? It seemed to him reasonable to believe that the establishment of more economic prices on those commodities would eliminate the need to import wheat on a significant scale, and could thereby reduce the drain on the already scarce foreign exchange resources. On the external side, he attached great importance to the authorities' commitment to the elimination of payments arrears by the end of June 1982 and to the understandings reached about the implementation of the revised and more flexible exchange rate policy. He welcomed the action that had been taken to remove the existing multiple currency practice, but he was not completely convinced by the justification given in SM/81/178 for retaining the exporters' retention quota scheme. Apparently the aim was to guard against shortages in the official market; but the pursuit of an appropriate exchange rate policy should render the scheme unnecessary. He would therefore be reluctant to agree to any recommendation approving the retention of the scheme beyond the end of 1981.

Mr. Nagashima considered that it was encouraging to be able to note that the Turkish economy had shown signs of improvement in the second half of 1980, and even more since the review of the stand-by arrangement in January 1981. The marked deceleration in the rate of inflation, resulting mainly from the efforts of the Turkish authorities to maintain a tight monetary policy, was particularly noteworthy. The net domestic assets of the Central Bank and net central bank credit to the public sector had also been kept well under control. There were encouraging signs of growth in export revenues, and workers' remittances were expected to increase substantially. The authorities' efforts to adjust the exchange rate in a timely fashion had contributed toward strengthening the competitive position of Turkish exports. The determination of the authorities to continue ensuring that the effective exchange rate would be gradually adjusted should enable Turkey to maintain favorable export growth.

Despite those encouraging signs, Mr. Nagashima continued, the task for the Turkish authorities was by no means easy. Total capital and financing flows were expected to fall from 1980 to 1981 by about $800 million, and total receipts from those sources were expected to be less than had been forecast in January 1981 by some $1.4 billion. External constraints would be made harsher by the increase in interest payments on external debt. The tightening of foreign exchange inflows was bound to require even firmer efforts by the Turkish authorities. As monetary policy had been kept properly tight and would continue to be operated cautiously in view of the recent increase in liquidity, it had become essential to strengthen the fiscal position. In particular, it was most important that transfers to the state economic enterprises should be kept at the same nominal level in 1981 as in fiscal 1980. If the authorities were able to achieve that aim and to make the tax reform of 1981 effective, they would thereby make a considerable contribution to strengthening the basis of the consolidated budget.

On the basis of the staff analysis, Mr. Nagashima stated, he would support both proposed decisions. The task before the Turkish authorities was still difficult even though there were some encouraging signs. If the authorities continued to pursue their primary goals with their present determination they would in the end certainly achieve success.

Mr. Sigurdsson observed that it was clear from the staff papers that the stabilization program initiated in January 1980 and supported by the current stand-by arrangement had yielded some encouraging results. Inflation had been brought down from the very high levels reached in 1979/80 and the growth of exports had remained strong. Nonetheless, the staff had observed, and the Turkish authorities had recognized, that the adjustment to be accomplished before sustainable growth could be resumed remained very considerable. Inflation was still high by international standards, and external current receipts were still modest in relation to payments needs, while Turkey's debt service payments remained very high despite the effects of debt rescheduling. Mr. de Groote was certainly accurate in saying that it was clear that Turkey could only achieve a viable balance of payments situation by expanding its export base.

One of the most worrying features of the Turkish economic scheme, Mr. Sigurdsson considered, was the sizable and unexpected reduction in the level of foreign concessional assistance and new commercial credit in the first half of 1981. The staff representative's information regarding the rise in inflows of foreign exchange was interesting and more details would be welcome. The reduced level of concessional assistance and the adverse international economic situation would make the task of continued adjustment even more of an uphill struggle for the Turkish authorities than before. It was essential for the authorities to continue the process of financial stabilization while opening up the economy and eliminating the rigidities that still impeded the efficient allocation of resources. Energy policy was a field in which improvement could be particularly valuable. He would welcome a comment from the staff on the prospects for a more realistic energy pricing policy; the staff representative's observations regarding the increase in fertilizer prices earlier in the meeting were encouraging.

In the short run, Mr. Sigurdsson commented, it was particularly important that the Government should adhere strictly to its policy of strengthening the public finances. The intention to limit transfers to the state economic enterprises was a major decision; if implemented, it should improve the budgetary situation and provide a much-needed spur to the state economic enterprises to adopt more realistic prices for their output. The statement by the Turkish Government on exchange rate policy in the letter attached to EBS/81/180 was encouraging and realistic. It was to be hoped that much of the differential between prices in Turkey and prices in the principal trading partners could be eliminated by reducing the general rate of domestic price increase in Turkey. In that connection the incomes policy of the authorities would be of crucial importance, and he would welcome staff comments on the prospects for the success of the Government's policy on wage restraint.

The current economic situation in Turkey contained many difficulties, and the task of adjustment in 1982 was unlikely to be any less difficult than it had been in earlier years, Mr. Sigurdsson commented. He agreed with the staff that the thrust of the adjustment effort should be on monetary restraint, and on strengthening public finances and improving external competitiveness. It was to be hoped that the measures adopted by the Turkish Government would help it to reach those goals. Even so, Turkey would have to rely on further concessional finance from bilateral and multilateral sources. There would clearly be need for considerable support from international institutions, foreign governments, and international commercial banks. The banks should not take away the umbrella before it stopped raining, and the downpour was likely to continue for some time yet. Certain program targets were based on assumptions that might be called rather optimistic, namely, those related to export growth and inflation. The authorities should watch developments in those areas closely, and they might need to introduce supplementary measures rather rapidly if adverse developments emerged. The safeguards built in to the program might be helpful in securing timely responses.

Mr. Iarezza stated that he was in general agreement with the staff appraisal and that he was happy to see that most of the policy targets for the period since the previous review had been fulfilled. He was particularly pleased with the results obtained by the Turkish authorities in curbing inflation during the first half of 1981. He noted with particular interest the marked increase in nominal interest rates resulting from the authorities' decision to free most interest rates on bank deposits and loans, thus encouraging private savings and prompting reductions in stockholding. He urged the Turkish authorities to continue along the same road, not only for interest rates but also for other prices as well.

A tight control of public expenditure was clearly essential for the success of the stabilization program, Mr. Iarezza observed. He therefore recommended additional efforts to reduce the fiscal burden of the state economic enterprises on the government budget, and he shared the staff view that there was a need to institute arrangements that would permit efficient control over the accounts of the state economic enterprises. Efforts to restrain the growth of domestic expenditure, and in particular the volume of public sector claims on available inputs, would decompress domestic markets and provide temporary relief to the balance of payments. As the level of unemployment was relatively high he would not recommend across-the-board reductions in public expenditure; what was needed instead was a reordering of priorities enabling the authorities to press ahead with those projects that would widen the supply base of the economy, such as the development of domestic energy resources. On a medium- to long-term basis, such a policy would also make a contribution toward alleviating the heavy burden of oil imports on the available foreign exchange.

He had been particularly interested in Mr. de Groote's remarks about the need for capital inflows to sustain the process of economic growth in Turkey, Mr. Iarezza stated. He was glad to see that the attitude of the private banks toward investing in Turkey was changing for the better. He could also support the more general implications of the point made by Mr. de Groote. In conclusion, he would support the two proposed decisions.

The staff representative from the European Department, answering questions, stated that, if certain assumptions made by the staff were accepted--assumptions relating to the velocity of circulation of money and the money multiplier--monetary policy would be sufficiently restrictive to achieve the objectives that the authorities had set themselves. What had been disturbing had been the bulge in the monetary base that had occurred during the past two months. Admittedly, July and August were a period when foreign exchange receipts were normally strong; and in 1981 there appeared to have been a rather larger return of immigrant workers to Turkey than in previous years, both because of a calmer domestic situation and because of the coincidence of a religious holiday with the vacation period. The authorities had reacted with something of a lag and the effect remained to be seen.

Dealing with the question of whether deposits by commercial banks with the Central Bank bore interest, the staff representative replied that they did. Another question raised by Mr. Winkelmann had been whether the budget estimates for fiscal 1981 were attainable. The staff had no more information than had been given in EBS/81/180. The prospects hinged critically on the results of the tax reform. If expenditure continued to run slightly ahead of what was expected for the year, and the tax reform did not yield all that was expected of it, there would clearly be difficulties on both sides. The authorities' determination to undertake a very serious review of the budget at midyear, and to take action if necessary, was therefore of the greatest importance.

The operation of the state economic enterprises had been of interest to a number of speakers, the staff representative recalled. Mr. Winkelmann, for instance, had wondered whether additional monitoring would be within the administrative capacity of the authorities. The authorities themselves had realized that the additional monitoring would represent a considerable burden, and that it could only be carried out slowly. The approach they had adopted was to start by stepping up the frequency of reporting by the enterprises, first from a semiannual basis to something like a quarterly basis. The figures had just become available for transfers from the central government budget to the state economic enterprises in the first half of 1981. The transfers had been slightly more than half of the amount appropriated for the fiscal year as a whole. That situation was, however, entirely consistent with the profile that had been discussed with the Turkish authorities, given the front-loading of advance payments for investment projects that took place at the beginning of the fiscal year. He agreed with Mr. de Vries that the original purpose of the state economic enterprises had perhaps been lost over the years and that they had represented a particular strain during the 1970s. It was rather early yet to determine to what extent the structural changes decided upon by the authorities had been implemented. Nevertheless, an important benchmark in the World Bank monitoring of its second structural adjustment loan to Turkey involved a detailed look at the staffing, management and investment programs in the enterprises. The World Bank had produced a very comprehensive public investment review paper that was to be discussed with the Turkish authorities shortly.

Some Executive Directors had inquired whether it would not be better if the prices of the products of the state economic enterprises were determined by the markets rather than by the Government, the staff representative continued. Many prices for the products of the state economic enterprises were in fact currently determined by management in the light of market conditions. And, as managers were now to be hired and fired on merit, it was to be expected that prices would be adjusted more flexibly. Some prices continued to be controlled but there had been an important shift in policy on that point since the middle of 1981, and it was the firm intention of the authorities to change prices more frequently and by smaller amounts than in the past. Since July 1981 there had in fact been several small changes in prices in energy, electricity, iron and steel, and other products. Whether the state economic enterprises would be able to circumvent the limit on budgetary transfers--a point made by Mr. Taylor--depended very much on the authorities, who were keenly aware of the weakness of their controls. They had certainly expressed an intention to ensure that the state economic enterprises should not escape the monitoring they intended to impose.

A number of Executive Directors had remarked on the increase in the rate of inflation in June 1981, the staff representative recalled. Since the staff papers had been published the July figures had become available. They seemed to show that the rate of increase in prices had fallen back to about 2 per cent a month, and preliminary figures for August were of the same order. No substantial increase in the price of gasoline was contemplated at present; but the World Bank had attached to the release of the second tranche of its structural adjustment loan a condition that energy pricing should be in line with that in the international market.

Some speakers had posed questions regarding wage policy, and particularly on the way in which the various wage increases envisaged for 1981 were expected to come about, the staff representative observed. For the civil service, wage increases were determined by the Government; but the state economic enterprises employed two categories of workers: some were civil servants and some were not. Consequently, the average wage increase in the state economic enterprises differed from that of the civil servants. In the state economic enterprises a norm had been set which yielded a 35 per cent increase on average. In private sector settlements, negotiators were being urged to settle at rates that were not in excess of those for the state economic enterprises, and so far that guideline had been observed.

There were two final technical questions, the staff representative from the European Department recalled. The first was whether the second tranche of the World Bank structural adjustment loan had been incorporated in the balance of payments forecast. In fact, the balance of payments forecast did include provision for disbursements of both World Bank and IMF aid in calendar year 1981. Second, Mr. Taylor has asked a question regarding developments in the wheat market. The staff had no information additional to that mentioned in the papers. While Mr. Taylor's comments were well taken, the matter was an extremely sensitive one in Turkey.

Mr. de Groote thanked Executive Directors who had supported the two proposed decisions and who had in general shown that they agreed with the stance of policies followed by the Turkish authorities during the first year of implementation of the stand-by program. It had been interesting to compare what the Executive Board had said and expected in June 1980, when the program had been approved--and at various other times when the Board, together with staff and management, had been trying to find a program suited to the circumstances of Turkey--with the present remarks. The current situation was certainly better than had been expected in June 1980 and far better than had been expected two years previously.

There could be little doubt, Mr. de Groote went on, that the improvement had been due essentially to the fundamental shift by the Turkish authorities to market-oriented mechanisms in the last year or so. The Turkish authorities were known for their realism and determination. During the past few months in particular they had shown that they were not afraid of pushing through unpopular measures, even when they led to a major reduction in real income for the population and a substantial increase in the rate of unemployment. The fact that the program could be carried out and that positive results had been achieved in other fields was a stong inducement to continue along the same road, in the hope that there would in due course be an improvement in employment and in people's incomes, since that was after all the ultimate purpose of financing any program. He had no doubt about the determination of the Turkish authorities in that respect.

In June 1980, Mr. de Groote continued, Executive Directors had to some extent put their trust in what he had said about the determination of the Turkish authorities, who had not failed to respond. They had indeed shown great courage and he had reason to believe that the program would continue to be implemented. Despite the unavoidable difficulties, some due to external circumstances, the authorities would persevere, with no intention to deviate from the arduous process of adjustment.

Taking up individual points in the program put forward by the Turkish authorities, Mr. de Groote mentioned first that the tax reform had not yet had time to yield results. He was, however, confident that if the returns that were expected from the reform did not materialize, the Turkish authorities would take further action; they were firmly committed to changing the tax system, to bringing about a more even distribution of the tax burden, and to ensuring higher government revenues from taxation. Incomes policy remained well in hand. It had been difficult to avoid an even larger increase in nominal incomes. The rapidity of the reaction by the authorities to changes both in the exchange rate situation and in the monetary base indicated that they were determined not to let the situation slip out of hand.

On the question of state economic enterprises, Mr. de Groote considered, it was important to have a balanced view. In the first place, Table 5 in EBS/81/180 showed that, including transfers to the enterprises, government expenditure in 1981 would represent some 24 per cent of gross national product. In many industrial countries the percentage rate of gross national product represented by government expenditure was almost three times as large. The Government only intervened to a very small extent in the economic life of Turkey. It was true that the state economic enterprises had had an unfavorable effect on economic development in Turkey because they had led to an inefficient allocation of resources. However, it would be wrong to exaggerate the scale of the problem. A large segment of the Turkish economy, particularly agriculture and trade, was in private hands.

Another point to note, Mr. de Groote continued, was that many activities that in other European countries would simply be incorporated in the budget were shown under the heading of state economic enterprises. For instance in Turkey the budget for the railways came under the heading of state economic enterprises, whereas in other European countries it would simply be part of the central government budget under the appropriate ministry. The same applied to shipping companies and some others. Nevertheless, he had no doubt that the Turkish authorities were firmly committed to submitting the state economic enterprises to the rules of the market. If they did not succeed in certain cases, it was not because of any dogmatic views on the matter, but simply because of practical circumstances. To give two examples, if the price of fertilizers was left completely to the market, it seemed likely that the large majority of farmers would not use any fertilizer at all for a year or two, in the hope of retaining the present yield of their crops. The reason the authorities kept the price of fertilizers artificially low, though not so much as in the past, was precisely to encourage the use of fertilizers by farmers as a means of assuring that there would be adequate agricultural production for export. Similarly, railway fares were subsidized at a level well below cost. If the price of railway fares was immediately raised to the economic level, there would be a major shift away from railways to the use of buses, with a consequent large increase in the use of imported oil. The point he had been making was that if the Turkish authorities continued to subsidize the goods or products sold by the state economic enterprises, it was for specific purposes. They would certainly eliminate those features in due course.

What Turkey needed, Mr. de Groote stated, was capital, which would in most cases be remunerated for being invested in Turkey; and that was something very different from assistance. For instance, Table 4 in EBS/81/180 showed that the value of exports was expected to rise from

$2.9 billion in 1980 to $4.2 billion in 1981, a 45 per cent increase. In other words, if the program was to be implemented, exports would have to increase by 45 per cent, and they had in fact risen by 50 per cent in the first half of the year on an annual basis. At the same time, financible imports were expected only to rise from $13 billion in 1980 to $14.5 billion in 1981, making an increase of some 5 per cent in non-oil imports, compared to a 45 per cent increase in exports. It was quite evident that such a high rate of increase in exports was not sustainable for very long unless imports increased pari passu. It was for that reason that he took the view that the financial resources that the Fund and the remainder of the international economic community were ready to lend to Turkey were inadequate. The argument was a fundamental one to which he wished to draw the attention of his colleagues from OECD countries and OPEC countries alike. In the past, Executive Directors had had occasion to notice the considerable slowness with which OECD credits were disbursed. Although some effort was being made to accelerate OECD disbursements, much could be done to provide better results. Meanwhile, the Turkish authorities were very grateful for the assistance they had received from OPEC countries, and especially from Saudi Arabia; they were confident that similar efforts would be continued in the future. He was glad that the present meeting had shown that, although further difficulties would inevitably arise, the Turkish authorities were making progress along the slow road to recovery.

The Chairman made the following summing up

Executive Directors commended the Turkish authorities for the results of the stabilization effort achieved so far, most notably the reduction of inflation and the rapid growth in foreign exchange earnings. This success was seen as largely reflecting adjustments in the exchange rate, interest rates, and the prices of public enterprises' goods and services, and more generally the greater reliance on market forces in each of these areas. The key role played by the program of monetary restraint was also noted. Directors observed, however, that the need for further adjustment continued to be large and pressing, particularly in view of the continuing pressures on the balance of payments and the level of external debt, and also in view of the recent reduction in the level of concessional aid, and they saw a need to strengthen the policies initiated to date if the objectives of the 1980 program were to continue to be achieved.

Most Directors felt that the program the authorities intend to pursue in the period ahead was going in the right direction in view of the adjustment task that had to be faced, and that the program deserved the support of the Fund. They urged the authorities to implement this program fully. In particular, it was seen as crucial to achieve the intended improvement in the public finances. The importance of holding budget expenditures to the level of appropriations, and of reducing both the operational loss and investment outlays of state economic enterprises as planned, was stressed. In that connection, Directors welcomed the Government's intention to limit budgetary transfers to the state economic enterprises in fiscal 1981 to the same nominal level as in fiscal 1980, and they encouraged the authorities to monitor systematically the enterprises' accounts to see that the discipline imposed by such limits was not being circumvented. They emphasized the crucial importance of resolving the deep-seated problems related to the existence and functioning of the state econommic enterprises: quality of management, overstaffing, rationalization, increasing competitiveness, increasing flexibility in pricing policies, etc.

In general, Directors expressed satisfaction with the implementation of monetary policy, particularly the adoption of a flexible interest rate policy and the recent change in credit allocation in favor of the private sector. However, they noted with concern the recent acceleration in monetary expansion, emphasizing the importance of moderating the growth in broader monetary aggregates if the planned reduction in inflation was to be achieved. Directors welcomed the recently announced measures to cope with this problem and urged the authorities to keep policies in this area under close scrutiny. They stressed the importance of continued implementation of a flexible interest rate policy to ensure that a broad range of positive real rates was achieved.

With regard to the balance of payments outlook, Directors believed that the Government's program, if fully implemented, could bring about a significant reduction in the external current deficit. They noted, however, that if the growth in foreign exchange earnings was to be sustained at a sufficiently rapid rate, it would be essential for the flexibility afforded by the new exchange rate regime to continue to be utilized forcefully in order to improve competitiveness. Directors stressed the importance for the medium-term balance of payments outlook of reducing the energy bill and expressed satisfaction with the policy measures taken in this area since early 1980, including the steep increases in domestic energy prices and the stepped-up efforts to develop domestic energy resources. They noted the importance of continued capital inflows and, in particular, of concessional assistance on an adequate scale to support the program.

Noting with satisfaction the recently announced reduction in multiple currency practices, Executive Directors expressed the hope that Turkey would be able to follow practices that would facilitate the elimination of the remaining restrictions on payments and transfers for current international transactions and to eliminate arrears in international payments.

The Executive Board then took the following decisions:

Decision Concluding 1981 Article XIV Consultation

1. The Fund takes this decision relating to Turkey's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1981 Article XIV consultation with Turkey, in the light of the 1981 Article IV consultation with Turkey conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Turkey continues to maintain restrictions on payments and transfers for current international transactions as described in Turkey's recent economic developments paper (SM/81/180). The Fund approved on January 28, 1981 the retention by Turkey of the multiple currency practices described in EBS/80/29 (2/8/80) and EBS/80/126 (6/4/80) until December 31, 1981. The Fund hopes that Turkey will follow policies which will facilitate the elimination of these restrictions.

Decision No. 6944-(81/121), adopted
September 9, 1981

Stand-By Arrangement - Review

1. Turkey has consulted in accordance with paragraph 3(e) of the stand-by arrangement for Turkey (EBS/80/126, Supplement 3, 6/19/80) as modified by paragraph 3(b) of Decision No. 6836-(81/67), April 24, 1981, in order to establish performance criteria subject to which purchases may be made by Turkey during the second year of the stand-by arrangement.

2. The letter from the Minister of Finance of Turkey dated July 22, 1981, setting forth the objectives and policies which the authorities of Turkey will pursue for the second year of the stand-by arrangement, shall be annexed to the stand-by arrangement for Turkey, and the letter of June 2, 1980, annexed to the stand-by arrangement, shall be read as supplemented by the letter of July 22, 1981.

3. Accordingly, Turkey will not make purchases under the stand-by arrangement that would increase the Fund's holdings of its currency beyond the first credit tranche plus 12 1/2 per cent of its quota during the second year of the arrangement other than the initial purchase of SDR 100 million after the date of this decision but before the end of September 1981:

(a) during any period up to December 31, 1981, in which the limits on net domestic assets of the Central Bank of Turkey or its credit to the public sector specified in the table appended to the memorandum attached to the annexed letter of July 22, 1981, are not observed;

(b) during any period after December 31, 1981 and up to June 30, 1982 in which understandings have not been reached or are not being observed on

(i) the net domestic assets of the Central Bank of Turkey, and

(ii) net central bank credit to the public sector.

(c) throughout the second year of the stand-by arrangement, July 1, 1981-June 30, 1982, during any period in which new external payments arrears are incurred, or in which the limits on new foreign borrowing specified in paragraph 13 of the memorandum attached to the annexed letter are not being observed, or in which understandings relating to:

(i) the exchange rate of the Turkish lira, referred to in paragraph 3 of the annexed letter;

(ii) net transfers from the budget to the state economic enterprises referred to in paragraph 3 of the annexed letter and paragraph 7 of the memorandum attached to the annexed letter; and

(iii) the maintenance of the existing effective liquidity and reserve requirements for banks referred to in paragraph 5 of the memorandum attached to the annexed letter,

that have been reached are not being observed.

Decision No. 6945-(81/121), adopted
September 9, 1981

2. ETHIOPIA - REVIEW OF STAND-BY ARRANGEMENT

The Executive Directors took up a paper reviewing the stand-by arrangement with Ethiopia, together with a draft decision modifying paragraph 4(a) of the arrangement (EBS/81/176, 8/21/81).

The Deputy Director of the African Department reported that he had received a cable from the Ethiopian authorities regarding the monetary position survey on June 30, 1981. The data implied that the overall balance of payments deficit for fiscal year 1980/81 had been only SDR 48 million compared with the estimate of SDR 75 million. Domestic credit had increased by only 8 per cent, compared with the 14.6 per cent provided for under the ceiling. The increases in claims on government and on the rest of the economy were both considerably lower than anticipated. The cable seemed to indicate that the Ethiopian authorities were carrying out the program satisfactorily.

Mr. Kiingi made the following statement:

It will be recalled from our recent discussions on Ethiopia that the authorities had been confronted with serious budgetary and foreign exchange constraints. Depressed world demand and falling prices for coffee and most other Ethiopian exports had considerably reduced foreign exchange earnings from exports. Higher import bills reflecting, among other factors, the effect of higher oil prices coupled with a reduced inflow of foreign loans and grants compounded the situation. Consequently, by the first half of 1980/81 the external payments position had worsened, with the overall balance of payments deficit running at an annual rate of about Br 233 million or about 5.1 per cent of GDP. Net foreign assets had dropped to a critical level that could hardly cover one month's imports.

With a view to correcting the deterioration in economic performance, the authorities adopted, on May 8, 1981, an 18-month stabilization program supported by the Fund covering the period from January 1981 to June 1982. The program aimed at achieving an average growth rate of about 5 per cent, improving fiscal performance, reducing inflation, and restoring balance of payments equilibrium. The overall fiscal deficit/GDP ratio is to be reduced from 4.5 per cent in 1979/80 to 4 per cent in 1980/81 and 2.5 per cent in 1981/82. The program also aimed at containing the overall balance of payments deficit to SDR 115 million in 1980/81 and SDR 67 million in 1981/82.

As noted in the staff paper, performance under the program has been broadly satisfactory although the rate of growth in real GDP in 1980/81 was 4 per cent lower than the 5 per cent envisaged in the stabilization program. The performance criteria for the period ended June 30, 1981 were observed. A 15 per cent fall in receipts from taxes on foreign trade notwithstanding, total revenue rose by about 2.3 per cent. With the total elimination of subsidies on petroleum and petroleum products in March, sharp reductions in other subsidies coupled with continued restraint in other current expenditure items, and a 5.6 per cent cut in capital expenditure, my authorities were able to narrow the overall budget deficit from Br 377.4 million, or 4.5 per cent of GDP in 1979/80 to about Br 330.5 million, or 3.8 per cent of GDP, in 1980/81. The deficit was covered partly by net foreign borrowing of Br 89.5 million. Net borrowing from the domestic banking system was Br 205 million. The remaining Br 36 million was financed through bond sales to the Pension Commission.

Despite the deterioration in the terms of trade which led to a widening of the current account deficit from SDR 144 million in 1979/80 to SDR 237 million in 1980/81, the authorities were also able to narrow the overall balance of payments deficit to SDR 75 million or about 2.2 per cent of GDP and to maintain net external assets at a level sufficient to finance about 1.4 months' imports. This compares favorably with the 0.5 month import cover projected for 1980/81.

Against this background of improving economic conditions, my authorities consulted with Fund staff in June 1981 and agreed on the performance criteria for the 1981/82 fiscal year. During this period the authorities intend to complement measures already taken in 1980/81 with some additional ones to ensure that the objectives of the program are achieved.

The authorities feel that agriculture must remain the focus of development effort. In order to reduce dependence on coffee for export revenue, the authorities intend to intensify their diversification policy with increased emphasis on the production of cotton, sugar, and oil seeds. They are taking measures to improve the quality and increase the quantity of hides and skins and expand exports of processed meat products.

In the industrial sector, emphasis is to be placed on small- and medium-sized labor-intensive industrial projects. In order to reduce the pressure on the external payments position, priority will continue to be put on import substitution industries including foodstuffs, beverages, textiles, cement, and sugar, which rely mostly on domestic raw materials.

On the budgetary front, my authorities are fully aware of the implications on government revenue of the continuing depressed prices for Ethiopia's main exports, particularly coffee, in the world market. They therefore intend to increase domestic tax revenue by 18 per cent through improved tax administration and collection and by overhauling the indirect tax structure with a view to raising total revenue by about 4 per cent to Br 1.7 billion in 1981/82. However, despite this commendable attempt to raise revenue, the budgetary picture, as the authorities point out, is expected to be less favorable. With total expenditure estimated at Br 2.2 billion, the overall budget deficit is likely to widen to Br 564 million or about 5.6 per cent of GDP compared with the 1981/82 deficit/GDP ratio of 2.5 per cent originally assumed in the program. The authorities hope to meet about Br 300 million of the fiscal deficit through long-term external borrowing and credits and about Br 228 million through recourse to the domestic banking system. This will be within the agreed ceiling. Bond sales to the Pension Commission will account for the remaining Br 36 million. The expansion in domestic credit is to be designed to allow for an increase in real GDP of 5 per cent.

In order to further harness domestic savings, my authorities plan to continue to expand the banking and other financial institutions. They are constantly reviewing the interest rate structure and will effect changes as need may arise.

In the external sector, the authorities have stated that they will continue to reduce the rate of import growth and expand the volume of coffee and noncoffee exports. They are currently reviewing producer prices with a view to increasing production and export.

Furthermore, they have commissioned a study on the possibility of determining the exchange rate of the birr through a basket of currencies. They intend to discuss the outcome of the study with the staff before a final decision is taken.

The staff agrees that the policies of my authorities are sufficient to achieve the objectives of the program. My authorities have indicated that should developments call for further corrective measures, they will not hesitate to take appropriate action after due consultation with the Fund. I therefore hope that the Executive Directors will agree with the staff assessment and approve the draft decision on the stand-by arrangement.

Extending his remarks, Mr. Kiingi noted that the remarks by the Deputy Director of the African Department had changed the tenor of his own statement considerably.

Mr. Bouchard, speaking on behalf of Mr. Nana-Sinkam, stated that he had been agreeably struck by the sensible and courageous way in which the Ethiopian authorities had been dealing with the first part of the program. On the whole, they should be commended for their laudable efforts in following the program as closely as possible, despite the existence of factors beyond their control.

It was clear from the staff paper that the central objective of Ethiopian economic policy was to establish and maintain the conditions for a self-sustaining expansion, Mr. Bouchard commented. However, the possibility of a return by the Ethiopian economy to equilibrium largely depended not only on economic developments abroad but also on the political willingness of some major countries to assist Ethiopia with capital inflows, which would be of great importance for the development of the country in view of the lack of sufficient domestic savings. His chair was pleased to note that the Ethiopian authorities were putting more emphasis on the problems of the external sector, which for the most part had been brought about by the sharp downturn in the world price of coffee, one of Ethiopia's major exports. The authorities should certainly be encouraged to continue with their efforts to widen the export base. Further attempts to increase productivity would also be conducive to self-sufficiency in basic foodstuffs, a point well recognized by the authorities.

On the expenditure side, Mr. Bouchard said, the authorities seemed to be trying to exercise effective control over current budget expenditures and to generate a surplus that could, in the absence of domestic savings, be used to supplement the uncertain foreign inflows needed to finance domestic development. The Ethiopian authorities had for some time devoted considerable attention to improving the rural standard of living as part of an overall plan. To prevent an excessive flow of population away from the rural areas, it was clearly proper to implement a policy including both an increase in producer prices and selective wage increases. It was often difficult to reconcile economic growth with the welfare of the population, but the authorities seemed to be firmly committed to both those goals. It was encouraging to read that in the view of the World Bank, Ethiopia's development efforts as reflected in the public investment program were realistic. In view of the course of action being pursued at present, he shared the view that the program could be a first step toward an extended arrangement with the Fund, as mentioned by the staff. Finally, he agreed with the proposed modification of paragraph 4(a) of the stand-by arrangement as set out in EBS/81/176.

Mr. Syvrud stated that Ethiopia seemed to have demonstrated a strong commitment to the Fund program, and that economic performance had been generally satisfactory. He could therefore support the proposed decision.

He did however believe, Mr. Syvrud went on, that Ethiopia's performance would be significantly improved if the authorities were able to take more expeditious action in some key policy areas. Inadequate producer incentives continued to be a major cause of shortfalls in both output and exports, although he noted that the Ethiopian authorities were reviewing the structure of producer prices and that an exchange rate study was under way. Unfortunately, he recalled that such reviews and studies had been under way on the last occasion that the Executive Board had discussed Ethiopia. Perhaps the time had come for action by the authorities on both producer prices and the exchange rate if Ethiopia was to achieve its objective of increasing production and exports. Similarly, in connection with the mobilization of domestic savings, the staff had long emphasized the need for new policy measures, and in particular an increase in interest rates. Mr. Kiingi had mentioned that the authorities were keeping the interest rate under constant review. He urged them to take the necessary measures as soon as practicable. He welcomed Mr. Kiingi's comment to the effect that the Ethiopian authorities would not hesitate to take appropriate action if developments required. However it did seem to him that they were limiting themselves to doing only what was sufficient to meet the modest objectives of the Fund program. On the basis of their performance to date, they could do better. If they forcefully adopted the actions in the policy areas that the Executive Board had been discussing, it seemed likely that by the time of the next review in February 1982, the country's economic performance would be excellent.

Mr. Ainley stated that he could support the proposed decision modifying the stand-by arrangement. Moreover, like others, he wished to commend the authorities on the generally satisfactory performance so far. Most of the objectives for 1980/81 had been achieved, a very encouraging result. Nevertheless, the authorities' room for maneuver remained severely restricted by the uncertain balance of payments prospects, and they had no choice but to continue with cautious demand management policies. He agreed with the staff that the budget performance in particular represented a considerable adjustment effort. He welcomed the sharp reduction in consumer subsidies, the improvement in tax administration and revenue collection, and the rationalization of the indirect tax structure. It was perhaps disappointing that the budget outlook for the next financial year was less favorable than had been originally anticipated; but it was encouraging that continuing efforts were being made to phase out the remaining subsidies.

He welcomed the authorities' renewed commitment to making the public enterprises surplus-generating and self-sustaining, Mr. Ainley observed. It did seem from references in the letter of intent that progress had been made toward that end. It would, however, be helpful if the staff could provide some indication of the time within which a real improvement in the finances of those enterprises was expected. His chair had asked a similar question in May 1981 when the Executive Board had discussed the stand-by arrangement.

In general, he agreed with the staff that the projected shortfall in export taxes, and the critical importance of mobilizing domestic savings, reinforced the need for new tax measures, Mr. Ainley remarked. Perhaps the staff could comment on the likely scope for additional taxation and for broadening the tax base in the short to medium term. Like others, he had been encouraged to see that the World Bank had assessed Ethiopia's investment strategy as "realistic." Nevertheless, in view of the projected increase in the ratio of oil imports to export earnings, which appeared likely to rise from 30 per cent in 1978/79 to 63 per cent in 1981/82, he wondered whether there might not be scope for even more investment in the energy field than had been outlined in SM/81/176. Implementation of the investment program would depend critically on foreign financing. Given the lags in disbursements during 1980, it would be helpful if the staff could say whether the external financing was likely to be available on a sufficient scale.

Discussing the monetary policy of the Ethiopian authorities, Mr. Ainley remarked that he was much in favor of the Government's intention to implement the planned expansion of banking and other financial institutions in order to stimulate domestic savings. But that process would take considerable time and he could also endorse the staff view that interest rates should be increased.

On the external front, Mr. Ainley stated that, like Mr. Syvrud, he looked forward with interest to the results of the exchange rate study; he hoped that it would be completed by the early part of 1982 at the latest. He welcomed the understandings reached to the effect that exchange restrictions would be relaxed as soon as net foreign assets were sufficient to cover approximately three months of imports. It was an excellent idea to have such a concrete target. His authorities also hoped that outstanding claims for compensation in respect of nationalized industries could be settled speedily and felt that such a settlement would help to improve the investment climate in Ethiopia. Finally, he agreed with the staff that successful implementation of the financial program in the coming year should help to create the necessary preconditions for a possible extended arrangement with the Fund.

Mr. Legarda stated that, like others, he would commend the performance of the Ethiopian authorities. The program guidelines had been followed in very difficult external circumstances; he therefore had no problem so far as the implementation of the program was concerned. He did, however, have some questions to put to the staff, mainly with regard to domestic savings. The staff had referred to the lack of domestic savings, but it had mentioned that both public revenues and budget performance had been quite good. There was apparently no lack of public savings. He therefore wondered whether it was relevant for the staff to say that interest rates should be increased in order to mobilize greater amounts of private savings. His impression was that the public sector played a much larger role in Ethiopia than the private sector; he was therefore not entirely convinced that measures directed to the private sector would be particularly relevant. Apparently the Ethiopian authorities shared his view because they had told the staff that they considered that a general increase in interest rates would be of limited value. It would be interesting to know what role the private sector actually did play in mobilizing savings in Ethiopia.

The authorities seemed to prefer to mobilize savings by expanding banking and other financial institutions to make them available to the persons who might have the resources to save, Mr. Legarda commented. It might be said that what they were in fact doing was building up a financial infrastructure; but when they doubted the validity of some of the policies recommended by the staff, it was time for Executive Directors to ask the sort of question he had raised. In conclusion, he supported the proposed decision modifying paragraph 4(a) of the stand-by arrangement with Ethiopia.

The Deputy Director of the African Department, replying to questions, explained that in a centrally planned economy the exchange rate was part of the pricing system. In the circumstances of Ethiopia the export prospects did not very clearly justify any action on the exchange rate at the present moment, as Mr. Syvrud had suggested. However, in the light of the balance of payments outturn, the Ethiopian authorities would discuss whether any action on the exchange rate could lead to a greater diversification of exports as a means of making them less reliant on coffee. The authorities had cooperated very closely with the Fund and had requested from the Managing Director technical assistance in carrying out the studies they wished to undertake on possible changes in the exchange rate. Both the Governor of the Central Bank and the Minister of Finance were extremely well versed in economic matters; they themselves had carried out studies on exchange rates that were available to the Fund, and they were perfectly prepared to cooperate with the Fund's Research Department and with other Fund departments in carrying out further studies. At present, however, the main concern was the fluctuation of major currencies, and particularly the U.S. dollar, to which the birr--the national currency of Ethiopia--was pegged. They wished to reduce the amplitude of the fluctuations in the birr, and they were seeking a basket of currencies to which the birr might be pegged. The study could be completed in time for review by the next Fund mission, which was not a conditional review mission. The mission would also look into the studies that the Ethiopian authorities had carried out on the interest rate, which was part of the pricing policy as it represented the price of money in the national market.

The authorities certainly wished to extend the intermediation system, to provide more banks, and to bring the private sector more closely into the economy, the Deputy Director explained. Consequently, work on the interest rate policy would deal with the allocation of resources, with retaining national resources at home, and with encouraging inflows of capital. It would also be designed to permit some allocation of resources through the mobilization of private savings; public savings would be mobilized inside each institution, but they were really not sufficient. The authorities had made substantial efforts to increase tax revenue but they still needed to improve the tax system on the whole, in particular shifting from a specific tax system to an ad valorem one. They were carrying out a study of the tax system and were asking the Fund for technical assistance to review their findings.

The producer prices in Ethiopia were appropriate, the Deputy Director considered. The authorities had done a great deal to improve the production system; in particular they had taken a decision to ensure that state farms represented no more than 2 per cent of the total rural economy and to ensure that the state farms had the most up-to-date technology. Nothing was being done to hasten the introduction of cooperative systems, and the general trend was to allow peasant farmers to work in their own way. Output was increasing and exports would rise still further. Export revenue had been calculated on the basis of a price of $1 per pound of coffee; but the world coffee price had already risen to nearly $1.15 per pound, and both the balance of payments and the budget situation would improve accordingly.

Discussing questions by Executive Directors regarding compensation for the nationalization of foreign companies, the Deputy Director explained that he had been asked to meet the President of the Compensation Commission. The authorities had been very consistent; they intended to register all claims and to discuss them bilaterally with every company concerned. So far, discussions had been completed satisfactorily with three Japanese companies, and one U.S. company had received compensation. The authorities were prepared to provide compensation for all claims once they had been discussed by the Commission.

Of all the countries in Africa, the Deputy Director of the African Department remarked, Ethiopia was one of those that cooperated most closely with the Fund. At a recent international meeting, the Ethiopian chairman had stated that as far as he was concerned he had nothing but good to say about cooperation between Ethiopia and the Fund, regardless of the country's ideology.

Mr. Caranicas remarked that he had been moved by the Deputy Director's interesting reply to Mr. Syvrud to raise a question about the general progress of agriculture in Ethiopia. Agriculture was one of the main sectors of the country's economy, and Mr. Kiingi had observed that the authorities were trying to diversify into cash crops such as cotton seed, sugar, and the like. The Deputy Director of the African Department had indicated that the state farms should not represent more than 2 per cent of agricultural output, and the staff had said that the authorities intended to provide incentives to peasant farmers to raise the volume of cash crops. If he had understood the situation correctly, despite the planned nature of the Ethiopian economy, virtually the whole of agricultural output was in the hands of peasant farmers. If he was correct, he wondered what actually remained in the hands of the state.

The Deputy Director of the African Department remarked that the ideology of the Ethiopian authorities was very largely verbal. When it actually came to the management of the economy, they were very pragmatic. When the Fund mission had first met the members of the Supreme Council for Planning and Economic Orientation, the Council members had feared that the mission had come with the intention of laying down a fixed course of action that they would have to accept. The mission had, however, devoted itself to listening to what the Council had to say and by the third meeting the atmosphere had become very friendly. He had explained that the Fund was interested in management of the economy and that, regardless of any political points of view, the Fund would make resources available provided it was convinced that it would in due course receive its funds back with the proper interest.

Discussing agriculture and indeed the economy in general, the members of the Council had said that they had observed what had happened in other socialist countries and that there had been a great deal of discussion in Ethiopia about the desirability of accepting a Fund program, the Deputy Director went on. Some ideologists had warned them that it would be unwise to accept a program with the Fund because it would be contrary to the general direction of the state. Those that wanted such a program had replied that, even without Fund intervention, the authorities would have to adopt a program similar to what the Fund would recommend. Similarly, the authorities did not wish to expand the state farms until they were convinced that they were efficient. Nor did they wish to expand cooperatives, perhaps because they were aware that a neighboring country which was not on particularly good terms with the Fund had entered rather heavily into the cooperative system. His own feeling was that the Ethiopian authorities wished to provide more and more space for the private sector both in industry and in trade. They had said that they wished to expand the private banking system and to encourage the private sector in general. Such an attitude might seem surprising in an apparently socialist economy; in fact the authorities were running the economy very competently and were well in control of both the supply and the demand sides.

Mr. Syvrud commented that he had raised the question of producer prices in the context of the discussion on the exchange rate; and Mr. Caranicas had remarked that 98 per cent of agriculture was in private hands. Particularly in a country that wished to diversify its agriculture into cash crops and to export more of its agricultural produce, the export price was a vital factor in stimulating the planting and production of new export crops. The point was one of particular importance for inclusion in the study that the authorities were undertaking on the impact of the exchange rate.

Mr. Kiingi thanked Executive Directors who had spoken for having taken such a positive approach to the request for a change in the stand-by arrangement. He would draw the authorities' attention to the point made by Mr. Syvrud regarding producer incentives, although he would take into account the comment by the Deputy Director of the African Department that for the time being they were adequate. He would also inform his Ethiopian authorities of comments made by Executive Directors on the exchange rate and interest rates; but when deciding whether or not to take action, the authorities would of course take into account all the factors they might consider relevant. He would also communicate to the authorities the observations made by Mr. Ainley on demand management policies, investment in energy, and the compensation of nationalized concerns. As had been explained by the staff, action was being taken in that field, but it was bound to take some time before the last claimant could expect to be paid. Meanwhile, he was glad to be able to say categorically that the authorities were taking the proper action.

The Deputy Director of the African Department explained that the authorities had decided that for all major export crops they would follow the world market price, which was a very liberal policy indeed. In reply to Mr. Ainley's question regarding the World Bank attitude to the Ethiopian investment program, he could only say that he had never seen the World Bank so enthusiastic about a country's investment program and the priorities built into it.

Mr. Legarda commented that he was delighted to hear that relations between Ethiopia and the Fund were so satisfactory. It was particularly for that reason that he would not wish the Ethiopian authorities to feel that the Fund was taking doctrinaire positions where they were inapplicable; just because many other countries in the world had been drawn toward high interest rates was no reason to compel the Ethiopian authorities to follow suit. He had raised the point because in a planned economy the opportunity cost was either zero or the inflation rate. In passing, he had not seen the role of inflation given in any of the staff papers. The alternative for the authorities was to place their public savings in foreign deposits, but in order to do so the financial system would have to be sophisticated enough to allow for the transfer of funds. In any event, the opportunity costs should be taken into account in any prescription for interest rate policy.

The Executive Board then took a decision modifying paragraph 4(a) of the stand-by arrangement as follows:

"(a) during any period in the first two months in which the data at the end of the preceding period indicate that:

(i) the limit on total outstanding domestic credit described in paragraph 19 of the letter of April 7, 1981 and paragraph 7 of the letter of June 24, 1981 or

(ii) the limit on net credit to the Government described in paragraph 17 of the letter of April 7, 1981 and paragraph 7 of the letter of June 24, 1981

are not observed; or."

Decision No. 6946-(81/121), adopted
September 9, 1981

3. YEMEN ARAB REPUBLIC - 1981 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1981 Article IV consultation with the Yemen Arab Republic, together with a draft decision concluding the 1981 Article XIV consultation (SM/81/165, 8/6/81). They also had before them a report on recent economic developments in the Yemen Arab Republic (SM/81/173, 8/19/81).

The staff representative from the Middle Eastern Department informed Executive Directors that, since the consultation papers had been issued, the Yemen Arab Republic had made a purchase in the reserve tranche in the amount of SDR 10.8 million. The transaction had taken place on September 3, 1981 and had brought the Fund's holdings of Yemen rials to 100 per cent of quota.

Mr. Finaish made the following statement:

Since the early 1970s, the economic policies pursued by the Government, together with substantial inflows of workers' remittances and external assistance from neighboring countries, have brought about a sizable measure of economic growth as well as structural transformation in the economy. The country has been able to sustain high levels of consumption and investment, while at the same time accumulating substantial external reserves. The process of structural change in the economy is reflected in relatively high growth rates in the nontraditional sectors of mining, manufacturing, electricity, construction, and financial services. Both the public and private sectors have contributed to this progress; the former by establishing modern institutions and socioeconomic infrastructure, and the latter by active participation in construction, manufacturing, trade, and services. Although agriculture continues to depend mainly on weather conditions, investments in irrigation schemes and improvements in the supply of inputs and extension services point to higher growth rates in the coming years. Helped in large part by local initiative and resources, the rural areas have also witnessed a significant development of facilities such as water supply systems, schools, and health centers.

As a consequence of rapid economic expansion, a number of constraining factors have become more pronounced in recent years and, together with a stagnation in workers' remittances and external assistance, have slowed down the pace of economic activity. These factors derive mainly from manpower shortages and limitations on the capacity of public administration. Among other things, these have affected the implementation rate of the First Five-Year Plan since 1978/79. Activity in the agricultural sector, which employs more than 60 per cent of the country's labor force, has been hindered by the migration of workers to neighboring countries as well as from rural to urban areas. The slower demand for Yemenis in the neighboring countries, together with a reduction in wage differentials, somewhat alleviated the labor shortage and helped to stabilize wages in Saudi Arabia, where most of the Yemenis work, has increased the attractiveness of that market. To cope with the labor shortage in the short term, the authorities have adopted a liberal policy toward the employment of foreign nationals. As a longer-term measure, vocational centers are being opened to train workers in various skills.

Another development in the recent period has been a turnabout in the Government's financial position since 1978/79. There has emerged a sizable budget deficit, reflecting the emergence of strains on financial resources. This development has been the result of both a continued strong increase in expenditures and sluggish growth in revenues. The latter is attributable in part to the recent slowdown in economic activity and in part to the institutional and administrative contraints on tax collection. The increasing deficit, together with the stagnation in the inflow of resources, has led to an increase in government recourse to bank financing. The 1979/80 budget reflected some improvement in the fiscal performance, namely, a decline in the deficit as a percentage of GDP. However, this ratio is projected to go up again in 1981.

The authorities have demonstrated their full awareness of the recent deterioration in the Government's financial position as well as of the need for policy measures to improve the fiscal performance. In the years ahead, they expect an improved performance on both the revenue and expenditure sides. An expected increase in external assistance would help reduce the recourse to bank financing. A number of revenue-raising measures have already been put into effect. In particular, steps have been taken for a more effective collection of duties on imports entering via overland routes. Some specific levies have been converted to ad valorem rates. The authorities have indicated that additional revenue measures would be taken, if necessary, at the time of the review of the 1981 budget. Further, an aspect of government policy has been to avoid burdensome subsidization schemes. As a reflection of this, the prices of petroleum products have been adjusted frequently to pass on the increased costs to consumers. More generally, the authorities have indicated that the size of the budget in future would be estimated on the basis of the availability of revenues from noninflationary sources. A committee headed by the Prime Minister has been set up to supervise the formulation of the 1982 budget. The authorities also intend to undertake a comprehensive review of the fiscal structure so as to develop effective policies and institutional mechanisms for the mobilization of domestic resources in the light of a study on the subject prepared by the World Bank with Fund participation.

On the monetary side, the rate of liquidity growth has declined steadily in recent years. The major influence on liquidity growth since 1978/79 has been the deterioration in the Government's budgetary position and the consequent greater recourse to bank financing. This is in contrast to earlier years when the main impetus to liquidity growth came from large balance of payments surpluses that the country then enjoyed. The decline in liquidity growth since 1978/79 is attributable in part to the countervailing monetary effects of the Government and the external sectors and in part to the slowdown in the rate of economic expansion, especially in the private sector. The latter is also reflected in a relatively sharp decline in the growth rate of credit to the private sector over this period.

The slowdown in liquidity growth has been an important factor contributing to a fall in the rate of increase of the prices of consumer goods to about 10 per cent in 1979/80. The rate of inflation is expected to fall appreciably in 1981. It also needs to be mentioned that the authorities have been pursuing a policy of flexible interest rates, and several adjustments have been made in the interest rate structure since the beginning of 1980. Among other recent monetary measures is the elimination in March of this year of reserve requirements on interbank deposits.

In recent years, the country's balance of payments has come under increasing strain. On the receipts side, this has resulted from the leveling off of the inflow of resources in the form of workers' remittances and external assistance and, on the payments side, from the continued strong growth of imports, reflecting the expanding absorptive capacity of the economy. Notwithstanding these pressures and the consequent drop in the level of reserves, the authorities intend to continue to follow a liberal trade and exchange system. The expected improvement in aid receipts and workers' remittances, together with the likely impact of the interest rate adjustments on the recently evident outflow of capital, should help to ease the recent pressure on the balance of payments. It should be noted that the country's external debt remains relatively small and that debt servicing represents less than 2 per cent of current external receipts.

In conclusion, while the Yemen Arab Republic has achieved impressive growth rates since the early 1970s, continued efforts would have to be made to maintain the growth momentum. Of the various problems, productivity in agriculture and industry is still quite low; additional domestic resources need to be mobilized for development; and public administration, manpower resources, and export industries need to be strengthened considerably. Among other things, these problems will be attended to in the Second Five-Year Plan (1982-86) now being formulated on the basis of the experience of the First Five-Year Plan (1976/77-1980/81) as well as the results of sectoral studies and censuses.

Mr. El-Khouri made the following statement:

The Yemen Arab Republic has undergone substantial change during the past decade. Following the cessation of the civil war hostilities in the late 1960s, the country embarked on a development effort that resulted in high growth rates and a substantial improvement in the standard of living of the population. This development effort has been aided by the existence of a liberal exchange and trade system and, in general, by a free economic environment that enabled the private sector to grow rapidly and encouraged about 1 million Yemenis working abroad, mainly in Saudi Arabia, to remit substantial amounts of money back home. The economic aid that the Yemen Arab Republic received from friendly countries and development institutions over a long period of time has also been a major factor in promoting its development effort. The Fund has itself contributed significantly to the development of the economic and financial institutions of the country through its technical assistance program whereby a total of six experts have been assigned by the Fiscal Affairs and Central Banking Departments to provide technical assistance to the Ministry of Finance and Central Bank of Yemen. We strongly approve of this technical assistance program and hope it will be continued for some years to come.

We agree with the staff that recent financial trends have been disquieting. On the fiscal side, substantial budgetary deficits have emerged in the past two fiscal years, and another large deficit is projected for this year. Furthermore, these deficits have been increasingly financed from domestic bank borrowing. It is important that the gains made by the Y.A.R. economy in the past as a result of prudent financial policies not be jeopardized at this time or at any other time. For this reason, we support the recommendations made by the staff regarding the raising of the level of budgetary revenues and the rationalization of expenditures. In this respect, we would like to ask the staff whether the recommendations made by the World Bank mission concerning the mobilization of domestic resources are essentially the ones that have been mentioned in the staff papers before us.

In the external sector, the balance of payments has come under increasing pressure due to the rapid growth in imports and a stagnation of foreign exchange receipts from transfers and capital inflows. As a result of these developments, there has been a rapid decline in external reserves in 1980 and the first part of 1981, and the Y.A.R. authorities expect that reserves will decline further during the second half of 1981. While this matter might cause some concern, it should be noted that the ratio of reserves to imports remains relatively high, and if the Y.A.R. authorities undertake the appropriate demand management policies, the decline in reserves could be arrested.

Mr. Caranicas noted that the staff had used the expression "the resident population" in the Yemen Arab Republic. It was the first time that he had seen such an expression used in a staff paper. He realized that the reason for the use of the term was that so many Yemenis worked abroad that there was a labor shortage at home. However, if the term "resident population" were used for the Yemen Arab Republic, it might be well to use it for other countries in similar situations; there were many countries where a large proportion of the population either lived permanently abroad or went abroad to work and returned after a long or shorter period. It would be interesting to have a definition of the population of the Yemen Arab Republic including Yemeni nationals working elsewhere.

The staff representative from the Middle Eastern Department, replying to questions, explained that the World Bank's report on domestic resource mobilization, prepared on the basis of a mission to the Yemen Arab Republic in February 1981 in which the Fund staff had participated, was essentially reflected in the staff appraisal. The recommendations had focused on two specific areas: fiscal affairs and monetary policy. The World Bank report had made suggestions for raising revenues as well as for some control of expenditure. The revenue recommendations had been the most important and had been included in the Fund staff's appraisal. Some of the suggestions had been the restoration of revenues from import duties to the level of earlier years, and the conversion of specific rates of duty on petroleum products to ad valorem rates. The recommendations on monetary policy had also been reflected in the staff report; they had mainly concerned the deregulation of interest rates and the pursuit of a flexible interest rate policy.

Regarding the definition of the resident and nonresident population, the staff representative explained that the difficulty in the Yemen Arab Republic was that there were no firm figures for the total population, including the nonresident population. A population census had just been completed when the mission had been in the Yemen Arab Republic, but the figures were not available. The World Bank had been working very closely with the Y.A.R. authorities to try to determine the number of Yemenis residing in neighboring countries, for the purpose both of estimating the population's per capita income for its own sake and of arriving at a better estimate of remittances. The figures for Yemenis residing abroad ran from some 600,000 to just over 1 million. No final figure had yet been determined.

Mr. Finaish thanked those who had spoken and the staff for answering questions. The World Bank report on domestic resource mobilization, to which the staff representative had referred, had recently been submitted to the authorities; he himself had not yet read the report. Concerning the general economic situation, there was no major disagreement between his Y.A.R. authorities and the staff appraisal. The authorities were fully aware of the difficulties characterizing the economy of the country. They had already taken a number of remedial measures mentioned by the staff and also by himself in his opening remarks. The Y.A.R. authorities were grateful for the Fund's technical assistance, which had proved to be very useful.

It was significant that the economy of the Yemen Arab Republic, Mr. Finaish went on, was not subject to monetary or trade controls. It was also one of the very few countries in the developing world that had not been occupied by a foreign power. Between 1975, when he had first visited the Yemen Arab Republic, and 1980, when he had last visited it, major changes had taken place in the economy; a whole institutional framework had developed and the participation of the people in the development process was clearly visible. Another thing that was interesting was the openness of the economy--representatives from a large number of countries in the world were to be found there. They were all taking part in the development effort in a country that had been closed to the outside world until recently.

The Chairman made the following summing up:

My understanding is that Executive Directors have shown broad agreement with the views put forward in the staff appraisal contained in the 1981 Article IV consultation report with the Yemen Arab Republic and that satisfaction has been expressed with the high rates of growth and the economic diversification achieved in recent years.

Some concern was also expressed over the sharp turnaround in the fiscal and balance of payments positions in the past two years, and in that context the need for remedial measures was noted. As the authorities themselves have already very clearly recognized, these measures would center on demand management policies aimed at the reduction of the overall budget deficit and the Government's recourse to bank borrowing. In this connection it was noted that, despite the recent sharp decline, the Yemen Arab Republic's relatively comfortable level of reserves permitted the authorities a reasonable margin of maneuver to implement the measures.

Directors commended the Y.A.R. authorities on maintaining an open and liberal exchange and trade system and noted with satisfaction that the authorities intended to continue to adhere to these policies in the period of adjustment that lies ahead.

The technical assistance provided by the Fund to the Yemen Arab Republic was also noted and welcomed.

The Executive Board then took the following decision:

Decision Concluding 1981 Article XIV Consultation:

1. The Fund takes this decision relating to the Yemen Arab Republic's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1981 Article XIV consultation with the Yemen Arab Republic, in the light of the 1981 Article IV consultation with the Yemen Arab Republic conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes with satisfaction that the Yemen Arab Republic continues to maintain an exchange system that is free of restrictions on payments and transfers for current international transactions.

Decision No. 6947-(81/121), adopted
September 9, 1981

4. STANDY-BY ARRANGEMENTS IN UPPER CREDIT TRANCHES - REVIEW OF ARRANGEMENTS APPROVED IN 1978-79, AND SOME ISSUES RELATED TO CONDITIONALITY

The Executive Directors took up a paper reviewing upper credit tranche stand-by arrangements approved in 1978-79 and some issues related to conditionality (EBS/81/152, 7/14/81; Cor. 1, 9/4/81; and Sup. 1, 9/1/81). They also had before them two departmental memoranda on fiscal adjustment in financial programs supported by stand-by arrangements in the upper credit tranches, 1978-79 (DM/81/50, 7/1/81), and on the real responses associated with exchange rate action in selected upper credit tranche stabilization programs (DM/81/52, 7/2/81).

Mr. Buira recalled that the guidelines on conditionality required that the Executive Directors "evaluate and compare the appropriateness of the programs and the results achieved." Since the programs were the Fund's most important activity, the task merited careful consideration. The first thing to note was that, of the 23 cases reviewed in EBS/81/152, only 11 programs had been observed while 12 had not. Moreover, of the 23 cases, only 5 had been observed in the original form, meaning without waivers or modifications. As that was not a very high rate of success, the matter deserved looking into further. The lack of compliance with programs might be attributable to a number of causes, ranging from unforeseen internal developments, such as droughts and other natural disasters, to external developments, such as changes in the terms of trade, lower than expected inflows, noncompliance with domestic policies on the part of the authorities, and, last but not least, problems with the design of the program itself.

Naturally, the various possibilities would call for different approaches, Mr. Buira remarked. If unforeseen exogenous developments occurred, or if a key assumption--such as a given level of capital inflows--did not materialize, the program should be revised. However, the need for revision was not always apparent to the Executive Board, nor was there a procedure for the rapid or semiautomatic adjustment of ceilings in such cases. To the extent that capital inflows did not materialize, the country might be faced with a situation in which substantial additional adjustment efforts would be required in order to enable it to comply with the program targets. The additional efforts would result in a degree of adjustment, and probably a loss of real income, much greater than had been envisaged in the original program, and might well be one that the authorities would not be in a position to implement. The cases of Turkey and Costa Rica were quite relevant.

The question of the dependence of certain programs on assumptions about capital inflows or on some other assumptions--an issue raised earlier by Mr. de Groote--merited full and careful consideration by the Executive Board, Mr. Buira commented. When the flows did not materialize, was it appropriate to demand compliance with the credit targets without revision, thereby requiring a much larger adjustment effort than envisaged in the program or indeed than might be possible? Was it in the interest of the Fund and the member country to deprive the country of its drawing privileges when the flows were late in arriving or proved to be inadequate during the first year of a program? Could the Fund not continue to support the program in such cases? By withdrawing its support did the Fund not give the wrong signal? Such questions raised many issues regarding the distinction between ends and means, the consideration appropriate to quarterly targets, or the required degree of adjustment and its relation to macroeconomic objectives. At present a country that deviated from a program might feel that, since it had fallen from grace and its external credit standing had been affected, the damage had been done, and that further effort to comply with the year's program was rather pointless.

Since the differentiation between endogenous and exogenous factors and their bearing on lack of compliance was not normally established in the programs themselves, it had also not been adequately considered in the main paper, Mr. Buira asserted. Indeed, the information contained in most programs, as well as in EBS/81/152, was insufficient to make analysis possible. The analysis in EBS/81/152 was compartmentalized in such a way that it was not possible for the reader to relate compliance with any of the targets or policy prescriptions to attainment of the other targets or, more important, to the overall objectives. In fact, he found it difficult to escape the feeling that some of the conclusions contained in EBS/81/152 had had an existence of their own before the paper was written, something that was perhaps unavoidable in view of the bureaucratic structure of an institution like the Fund. The conclusions, it would probably have to be admitted, reflected a certain view of the working of the economies of the countries and of the adjustment process; and that view was of course the traditional Fund doctrine. It had been said that Per Jacobsson, a former Managing Director, had summed up the Fund's stabilization programs as consisting of three parts: balancing the budget, limiting monetary expansion, and establishing an appropriate exchange rate. While it would of course be entirely wrong to question the relevance of such a prescription for a large number of cases, it would be no less foolish to pretend that it had universal validity. It clearly implied a certain vision of causality, meaning the acceptance of the idea that inflation and balance of payments disequilibria were the result of excessive credit expansion, which itself normally followed excessive public expenditure. It also implied that external imbalances were soon accompanied by distortions in relative prices affecting competitiveness of the economy and preventing the growth of its productive capacity.

With such a view of the working of a country's economy, Mr. Buira went on, it was not surprising that the conditions contained in Fund programs were very frequently the same, or that they showed very little variation over time. A study of 20 programs in the early 1970s showed that in every case they contained a limitation of credit expansion; in 55 per cent of the cases they contained a devaluation; in 50 per cent of the cases, trade liberalization measures; and in 15 per cent of the cases, wage restrictions. In 80 per cent of the cases, the programs included limits on external indebtedness, and in 80 per cent of the cases they also contained clauses on the pricing of goods and services provided by the public sector. A review of Statistical Appendix Table 3 in EBD/81/152 suggested that the policy content of the Fund's programs had remained essentially unchanged.

Traditionally, Mr. Buira recalled, debtor countries had been rather ambivalent on the issue of conditionality. Lord Keynes had favored the retention of maximum freedom by member countries and was against allowing the Fund any authority to interfere in matters of domestic policy, as Sir Joseph Gold had recently reminded his readers. Conditionality had not always been a characteristic of the Fund; it had been introduced several years after the Fund's establishment under pressure of the largest creditor country. The European countries, which at that time had been the major potential debtors, had not supported conditionality; they had only accepted it reluctantly as a means of securing the financial participation of the United States. Indeed, it had not been until the early 1950s that the Executive Board had accepted conditional drawings; and it was not until 1955 that the Executive Board had agreed that conditionality would increase in direct relation to the size of drawings. As the years had passed and the European countries had become creditors, they had endorsed the principle of conditionality as a means of securing prompt repayment of the drawings on the Fund; and it had not been until 1969 that the Articles of Agreement incorporated the notion that the Fund should establish safeguards to ensure that the use of its resources was temporary. In addition, conditionality at times contained a shade of paternalism, based on the conviction that the Fund knew better than the country what was necessary to achieve adjustment in the interest of the country itself.

During the 1970s, Mr. Buira recalled, there had been a certain hardening of conditionality, which had led to a period in which there had been virtually no net use of Fund resources except those in the compensatory financing facility and the oil facility. That situation had led the Group of Twenty-Four at the 1979 Annual Meeting to express concern over what the Group regarded as a paradoxical situation in which the Fund had a great deal of liquidity but there was little use of its resources at a time of sharp deterioration in the external position of most Fund members. Such criticisms had helped in leading to a recognition of the structural nature of the problems faced by most developing countries and, as a corollary, of the need to enlarge access to the Fund's resources and to lengthen the repayment period. The introduction of those new policies at a moment of continued weakening of the external positions of the less developed countries had led to an unprecedented increase in Fund operations in 1980 and 1981. Furthermore, when the guidelines on conditionality had been introduced in 1979, they had incorporated the notion that the social and political circumstances of the country should be respected, as well as the cause of its balance of payments problems, that the number of performance criteria should be limited, and that the appropriateness of programs and the effectiveness of policy instruments, together with the observance of programs and the results of so doing, should be reviewed periodically. Since then, the Fund had accepted some small modification in its approach to the adjustment process, particularly recognizing that demand management policies were not by themselves sufficient.

He would not discuss at the present meeting, Mr. Buira observed, the possibility that, despite the changes he had mentioned, the Fund's approach continued to rely excessively on demand restriction and to be essentially deflationary rather than supply oriented. Nor would he take up the question whether structural adjustment programs could do more to combine the promotion of investment and production, and move toward a more development-oriented adjustment process. He would also leave to one side the matter of whether the absolute priority given to the balance of payments in most programs was more useful to foreign creditors interested in the prompt repayment of their debts than to the authorities of the member countries, whose economic policy goals were necessarily much wider. In any event, there would be no dispute that Fund conditionality should be appropriate to the circumstances of each case. Unfortunately, the reviews of past programs had not provided the necessary information to see whether that was in fact the case. Indeed, in preparing the review papers, the staff had found itself in the difficult position of being both judge and jury. The staff faced the temptation of attributing success when it was achieved largely to the merits of the program, and of accepting the presumption that the program failures were the result of inadequate efforts on the part of the authorities, thus discounting the possibility that unforeseen developments might have diminished the relevance of the program, and entirely ignoring the possibility that the program itself might have been flawed.

For that reason, Mr. Buira stated, he particularly welcomed EBS/81/152, Supplement 1, in which the main issues to be faced in future programs were clearly set out. Those issues were the required degree of adjustment and the time period over which it should be made; the adjustment effort involved set out in such a way as to ensure its internal consistency; the assumptions underlying the financial program, meaning the assumptions underlying projected monetary developments and balance of payments targets; and the specification of underlying relationships between economic variables, whether on a statistical or a judgmental basis. Such an approach seemed entirely suitable and indeed necessary, as did the relationship between the program and the emergence of a viable payments position, whether over the program period or over a longer time span. The only question was why that approach had not been adopted previously. If the format was adopted, it would constitute an important step forward in ensuring consistency in programs from one country to another. The clear presentation of the main features would facilitate the review of performance of past programs as well as the evaluation of the Fund's overall effectiveness in assisting its member countries. The new approach contained in EBS/81/152, Supplement 1 should contribute toward facilitating greater control of the quality of the programs by the staff, management, Executive Board and member countries together. It should also lay the groundwork that was essential if there was to be any refinement of the technique of programming, a discipline that had shown limited progress in the past ten years.

The Executive Directors agreed to continue 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/81/120 (9/4/81) and EBM/81/121 (9/9/81).

5. ST. VINCENT AND THE GRENADINES - ACCEPTANCE OF OBLIGATIONS OF ARTICLE VIII, SECTIONS 2, 3, AND 4

The Fund notes that with effect from August 24, 1981, St. Vincent and the Grenadines has accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Articles of Agreement.

Decision No. 6948-(81/121), adopted
September 4, 1981

6. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/81/290 (9/4/81) is approved.

APPROVED: February 24, 1982

LEO VAN HOUTVEN
Secretary