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Minutes of Executive Board Meeting 81/128

3:00 p.m., September 16, 1981

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

Executive Directors	Alternate Executive Directors
	O. Kabbaj
	C. T. Taylor
	J. F. Williams, Temporary
	L. Feito, Temporary
	O. Üçer, Temporary
R. D. Erb	
	M. A. Janjua, Temporary
	A. Nagashima
	R. T. Salazar
	M. Casey
	G. Jauregui, Temporary
	J. R. Novaes de Almeida, Temporary
B. Kharmawan	
S. Kiingi	
G. Laske	C. P. Caranicas
	A. Le Lorier
	A. B. Diao, Temporary
M. Narasimham	D. L. Kannangara
	S. El-Khouri, Temporary
J. J. Polak	T. de Vries
A. R. G. Prowse	
	K. V. Jännäri, Temporary
	Tai Q.

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

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Also Present

M. Stojiljkovic, Alternate Executive Director, IBRD. African Department: O. B. Makalou, Deputy Director; P. A. Acquah, C. N. Egwim, C. Enweze, D. J. Goldsbrough, S. N. Kimaro, R. Pownall. European Department: M. Dakolias, L. G. Manison, A. Mountford, J. Odling-Smee, G. Tyler. Exchange and Trade Relations Department: S. Mookerjee, Deputy Director; G. Begashaw, S. Kanesa-Thasan, N. Kirmani. Fiscal Affairs Department: O. Pettersen. IMF Institute: G. Mars, Participant. Legal Department: Ph. Lachman, A. O. Liuksila, J. V. Surr. Treasurer's Department: A. M. Al-Samarrie, K. Boese. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: E. A. Ajayi, C. J. Batliwalla, J. U. Holst, A. K. Mullei, P. D. Peroz, Wang E. Assistants to Executive Directors: A. F. P. Bakker, R. J. J. Costa, F. Guena, J. M. Jones, P. Kohnert, J. E. Leimone, J. S. Mair, V. K. S. Nair, Y. Okubo, J. G. Pedersen, C. N. Pinfield, A. Yasseri, A. A. Yousef.

1. YUGOSLAVIA - STAND-BY ARRANGEMENT - REVIEW OF DEVELOPMENTS, AND CORRECTION OF TEXT

The Executive Directors considered a staff paper reviewing developments in Yugoslavia under the stand-by arrangement (EBS/81/170, 8/17/81; and Cor. 1, 8/20/81), and a proposed correction in the text of the stand-by arrangement for Yugoslavia (EBS/81/5, Supplement 3, 8/27/81).

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

The staff representative from the European Department explained that there was no obligation on the Executive Board to review the stand-by arrangement with Yugoslavia at present; however, in view of the size of the stand-by arrangement and since the Executive Board would not otherwise have the chance to discuss developments in Yugoslavia for a further 6 months--12 months after the stand-by arrangement had been agreed upon--it had been felt appropriate to give Executive Directors the opportunity to express views about developments in that country. The Yugoslav authorities were in agreement with that view. Executive Directors' observations would help the staff in its preparations for negotiations with the Yugoslav authorities during the last quarter of 1981.

Some steps had been taken recently to permit an increase in interest rates, the staff representative commented. The staff welcomed those steps, although it had been disappointed that the rates would not be raised until the beginning of 1982 and, even then, might not go as far as desirable. As to the exchange rate, there had been a sharp depreciation of the dinar over the past three months. Considering current price trends and the effective appreciation of the dinar in the early part of the year, the staff hoped that the depreciation would continue.

Trade data for July and August were rather difficult to interpret, the staff representative continued, but they suggested that there were still problems with exports to convertible currency areas. However, invisibles were making an increasing contribution and there seemed to be reasonable prospects that the country's current account target for 1981 would be achieved. With respect to prices, which had accelerated much more rapidly than had been expected during the first half of the year, there had been a significant slowdown over the past few months, particularly at the retail level. Industrial production appeared to have accelerated during June and July, and if that trend continued there could be a larger demand for imports than was planned at present. Finally, work with the World Bank in formulating a plan for 1981-85 was proceeding. Since it was hoped that the plan would be very comprehensive, and since some of the republican plans had not yet been finalized, it was probable that work on it would not be completed until the beginning of 1982.

Mr. Polak explained that the staff had held productive discussions with the Yugoslav authorities in June and July 1981. The material in the staff paper indicated that although the authorities had not used all of the instruments described in the stand-by arrangement, they had nevertheless made good progress toward achieving the objectives of their economic program. Output appeared to be approximately on target; necessary cuts had been made in real income, in investment, and in government expenditures--with a clear willingness to do more in those areas if that should prove necessary; the current account target for 1981 appeared to be in reach, with the trade balance slightly below and the invisibles balance slightly above target; and monetary targets were being observed in spite of the quite disappointing increase in prices.

Inflation had reached an unsatisfactory level during the first part of the year, Mr. Polak remarked. Enterprises had increased their prices quickly before becoming subject to the agreement on permitted increases that came into effect in March 1981. The exchange rate for the dinar had been allowed to move, but not enough to offset the pace of inflation. In fact, the effective real exchange rate in June 1981 was no more favorable than it had been before the sharp depreciation of June 1980. The possibility of raising interest rates was being actively discussed, but thus far no changes had been made and rates were still at the same low level as in 1977.

The Yugoslav authorities attached great importance to the Fund's opinions, Mr. Polak continued. They agreed in large measure with the staff views regarding the country's exchange rate and interest rates and had taken some action on both of those fronts since the staff's visit in June 1981. Over the past two months, the nominal effective rate for the dinar, which had depreciated by only 0.8 per cent during the first half of the year, had dropped by a further 9 per cent. The Board of the Yugoslav Bankers Association was meeting that day and was expected to recommend increases in maximum rates for time deposits, which applied to enterprise funds, from 6 per cent to 12 per cent; maximum rates on savings deposits for households, from 10 per cent to 14 per cent; and actual rates for consumer credit, from 12 per cent to 16 per cent. Those rates would still need to be accepted by individual banks and were not, therefore, expected to go into effect until the end of the year. The authorities were due shortly to consider proposals by the National Bank for increases in its interest rates. It should not be forgotten that, unlike the residents of many other countries where the Fund had urged the adoption of more realistic interest rate policies, those of Yugoslavia held large sight and savings deposits expressed in foreign currencies, and those deposits carried an interest rate of 10 per cent. That rate had proved adequate, because remittances from abroad remained at a satisfactory level.

Mr. Erb said that he was pleased to note that the improvement in the overall balance of payments situation registered in 1980 was continuing, and that Yugoslavia appeared to be moving toward a lower current account deficit. However, the less than expected improvement in trade with the convertible currency area was disappointing, given the country's need to earn hard currency to service its large debt in that area. To achieve further balance of payments improvement, the authorities would have to take action in two fields--exchange rate policy and prices policy.

He welcomed the recent depreciation of the dinar and hoped that that trend would continue, so that changes in the exchange rate would at least reflect underlying domestic inflation, Mr. Erb continued. Perhaps the staff could propose to the Government procedures for making such adjustments on a more regular basis in contrast to the traditional resort to large and infrequent devaluations.

More needed to be done to bring the continued rapid rise in inflation under control and to retain external competitiveness, Mr. Erb remarked. He urged the authorities to consider a more restrictive monetary policy as a means of attacking inflation. The rapid growth in trade credit, despite attempts to constrain bank lending, suggested that enterprises retained a considerable amount of liquidity. He was concerned about the increasing resort to price controls to suppress inflation. Such controls, if pursued for long, would lead to significant distortions in resource allocation, and would make the task of achieving balance of payments adjustment more difficult. Finally, he had been pleased to hear of the proposals for interest rate increases and hoped that they would be implemented. The staff should encourage the authorities to concentrate not only on interest rate changes designed to bring about a positive real rate, but also on ways of building more flexibility into interest rates, so that they could shift more easily with underlying conditions.

Mr. Taylor said that he strongly endorsed the suggestions made in EBS/81/170 with regard to the exchange rate and to interest rates. He welcomed the fact that the authorities had thus far managed to meet all the performance criteria; however, he was not convinced that the program retained its original drive and direction. In some important respects the economy was making poor progress in relation to the original objectives of the stand-by arrangement. The fact that all performance criteria had been met did not justify complacency about the nature of the adjustment efforts being undertaken. Large internal and external imbalances and price distortions persisted and called for an early implementation of vigorous corrective measures. He had been encouraged by the information about proposed interest rate increases, but he still felt that the authorities needed to adopt robust measures to tackle the distortions in their country's economy.

He found it extremely difficult to discern the thrust of the authorities' monetary policy, Mr. Taylor commented. Monetary restraint had a central role in the stand-by program, and it was fortunate that the authorities appeared to have been successful in limiting the growth of monetary and credit expansion. The staff had implicitly accepted the authorities' quarterly ceilings on bank credit as performance criteria until the end of the year. Did the staff feel that those ceilings remained appropriate and that no further tightening was desirable?

The staff's reply would be particularly interesting in the light of its statement on page 8 that the authorities' policy of credit restraint did not appear to have been very burdensome thus far. As to interest rates, it was disappointing that they remained substantially below the prevailing and anticipated rates of inflation. Even the proposed increases would leave real interest rates at substantially negative levels. He would be grateful if the staff or Mr. Polak could explain the role that interest rates played in the Yugoslav economy, which, after all, was not a market economy in the usual sense of the term.

A rise in real personal income was expected in Yugoslavia in the second half of 1981, Mr. Taylor noted. He wondered what factors would contribute to that movement. For instance, would it in part be attributable to the effect of price controls? Would the growth in personal incomes make measures necessary to keep domestic demand in check? He was rather afraid that consumption might perhaps move ahead rather too sharply and jeopardize further the already optimistic projections for inflation.

Export performance in both the convertible and nonconvertible currency areas had been disappointing, Mr. Taylor observed. Admittedly, Yugoslavia had to meet the increasing costs of importing oil and raw materials from the nonconvertible area, but there seemed to be a tendency for exporters to seek easy markets for low quality goods. If a sustainable increase in export growth was to be achieved, the authorities should reverse the shift away from the convertible area. A number of enlarged quotas in the European Community, for example, remained relatively underutilized. Could the staff say whether the projected expansion of exports of some 18 per cent to the convertible area in the second half of 1981 was really a practical prospect, given the fall in the level of exports to those markets that had recently occurred?

Doubts about export performance pointed to the desirability of having an appropriately managed exchange rate, Mr. Taylor continued. The appreciation in the real effective rate during 1981 had had adverse consequences for competitiveness. It was likely that the recent depreciation would have done no more than partially reverse that appreciation. The authorities should recognize the importance of maintaining competitiveness by allowing the exchange rate to move. He hoped that the program to be negotiated in the second year of the arrangement would include some simplification and liberalization of the complex exchange and payments system.

The authorities were to be congratulated on their success in financing the convertible currency deficit, Mr. Taylor concluded. Yugoslavia's convertible currency debt service ratio, which was projected at some 21 per cent in 1981, was not excessive and the authorities should be able to continue to finance it without any major difficulty. However, it should not be forgotten that the willingness of commercial banks to continue providing finance on a substantial scale would no doubt be largely dependent on clear progress being made--and being seen to be made--toward achieving the necessary adjustment in the balance of payments and inflation. It was essential that adjustment efforts be pursued vigorously and that progress be achieved rapidly, so that any uncertainties or risks about future financing could be minimized.

Mr. Laske remarked that from the point of view of performance criteria the Yugoslav program had not been unsuccessful. However, the economy was characterized by a number of disturbing elements: the rate of inflation had risen beyond projections; there had been a significant shift in exports from the convertible to the nonconvertible currency area; the competitive gain that had been won with the exchange rate adjustment of June 1980 had by and large been lost; and there had been a large increase in the public sector deficit in 1980.

It was not completely clear how price increases could get out of hand with the system of price regulation employed in Yugoslavia, Mr. Laske commented. It was rather surprising that the authorities were still hopeful of achieving price targets for the year after the rapid rise in prices during the first half of the year. Perhaps the anticipatory price rises enacted by the enterprises before the detailed price regulations came into effect would enable them to forgo any further adjustments in the months ahead. He doubted whether the price controls recently introduced would have the restraining effect anticipated. Very often price regulations and controls had only led to pent-up inflation; once the controls were relaxed or removed a sudden surge of price increases could destroy the illusion of price stability. The price controls introduced in June 1981 provided for subsidies on certain basic foodstuffs. Those price support payments concealed a distortion of supply/demand relationships and would have a fiscal impact on the federal and republican or provincial governments. It was disturbing that the authorities had not yet decided how long the price controls would remain in effect; their early relaxation combined with continued restraint in monetary policy and the adoption of tighter fiscal policies by the Federal Government would help to prevent the emergence of new distortions.

Developments in the fiscal field during 1980 had not gone well, Mr. Laske noted. The deficit of the Federal Government and of the entire public sector had been much larger than those recorded in each of the three previous years. As Table 8 in EBS/81/170 revealed, that deterioration had been caused uniquely by the performance of the federal authorities. In fact, the finances of the republics and the provinces had probably improved quite significantly in 1980, since the increase in the federal deficit had been almost twice as large as the increase in the overall deficit of the public sector. That relationship might be deceptive, however, since as much as half of the rise in the federal deficit seemed to have been caused by increased transfer payments to other parts of the public sector. The figures for the Federal Government's fiscal performance in the first five months of 1981, provided in Table 9, did not provide much comfort. Even when the probability of seasonal variations in revenues and expenditures had been taken into account, the large deficit accumulated over the first five months was more than twice as high as that projected for the year as a whole. His concern would only be mitigated if there were some reassurance that the seasonal pattern of revenues and expenditures was such as to bring that deficit down to planned levels by the end of the fiscal year.

The financing pattern was equally disturbing, Mr. Laske observed. While the admittedly large deficit of 1980 had, to a considerable extent, been financed by bond issues, the deficit for 1981 had thus far been financed exclusively by recourse to the National Bank. The expansion of the net domestic assets of the banking system had been kept within the ceilings of the stand-by arrangement at the end of June 1981; however, in June 1981, to keep credit expansion within the ceilings, the National Bank had asked the commercial banks to restrict the availability of credit. He assumed that seasonal credit requirements were taken care of in the ceilings, so that the restriction might well result in a more rapid expansion in subsequent months. He wondered whether the staff had any indication yet of what credit developments had been since June 1981.

One element of the adjustment program was the intention to bring interest rates up to a positive real level, Mr. Laske continued. It was disappointing that the authorities had not yet taken action in that area. Apart from very minor upward corrections, interest rates had remained at 1977 levels. In some cases, for example, credits for housing construction, nominal interest rates were even lower than they had been in 1977--and it would seem from the information given by the staff at the beginning of the meeting that no change in that particular area was being contemplated. The switch of household savings out of dinars into foreign currency deposits might well be a response to the regrettable immobility that the authorities had shown with regard to interest rates in recent years.

The central objective of the adjustment program was the restoration of a viable balance of payments position, Mr. Laske commented. The overall balance of payments position had been strengthened by the favorable performance of workers' remittances. In the trade account, however, the deterioration of the trade deficit with the convertible currency area was extremely worrying. The staff had explained that the disappointing export performance could be attributed in part to the need for increased exports to the nonconvertible area as a means of paying for the higher costs of oil imports. However, the staff had also suggested that price and quality might account for the sluggishness of exports to the countries in the convertible area. The level of the exchange rate was relevant in that context; despite the adjustment of the first six months, in real terms the dinar had appreciated; the competitive gain achieved with the devaluation of June 1980 had thus been lost. The authorities had approached exchange rate determination with excessive caution and had not been sufficiently flexible. He sympathized with the authorities' concern about the potential inflationary impact of a dinar depreciation, but they should recognize that the disadvantage of increasing prices for imports would be offset by the beneficial effects on the flow of remittances and the increased attractiveness of Yugoslavia for foreign tourists.

Mr. Casey considered that the Yugoslav authorities had made progress on many fronts, especially in the area of monetary and fiscal policy and in import liberalization. In their attempts to stabilize their economy they had had the courage to sit out a temporary slowdown in growth. It was surprising, however, that the rate of inflation had accelerated to some 50 per cent a year compared to the target of 20 per cent a year. Expansion of demand did not seem to have been responsible for the worsening of inflation, and neither did import prices or wage-push factors. He realized that some enterprises had raised their administrative prices in order to make higher profits, but did that really fully explain such a marked acceleration in inflation? If it did, the Yugoslav experience might reveal a rare case of profit-push inflation. In that context, he wondered whether the enterprises had raised their prices as a means of restoring or increasing normal profit levels. Whatever the causes, the inflation rate had to be a considerable source of concern to the authorities. Apart from the normal adverse effects of inflation of that magnitude, additional problems could arise following the authorities' attempts to cope with inflation by reimposing a wide range of price controls and subsidies. Such measures would only have a temporary beneficial effect and would probably lead to a misallocation of resources in the future. Ironically, it was precisely that kind of structural problem that the three-year stand-by arrangement had been meant to solve. He wondered whether the more recent moderation in inflation had resulted from price controls rather than from an improvement in the underlying rate. On the positive side, the authorities were acting responsibly in not indexing government expenditure, money supply, or wages to the higher than expected rate of inflation.

While the federal fiscal situation was broadly on track, Mr. Casey remarked, it was not clear whether the republics and provinces would be able to achieve balanced budgets by trimming expenditure. If that proved impossible, the problem of federal transfers mentioned by Mr. Laske would become serious. The revenue base seemed rather narrow, and there was a noticeable tendency for consumers to shift to goods that were taxed at lower rates. He wondered whether any consideration had been given toward broadening the revenue base.

It was rather difficult to understand the broad thrust of the authorities' monetary policy, Mr. Casey said. For example, it was not clear why velocity had increased so much while a tight policy stance had been in place. Perhaps more attention should be focused on the broader monetary aggregates, where the accommodating increase in velocity had been less pronounced. As to interest rates, he agreed with previous speakers that they were clearly too low in real terms and rather inflexible. Apart from the normal adverse effects of negative real interest rates on savings and resource allocation, further complications might arise in the circumstances of Yugoslavia. Without the rationing and allocating effects of realistic interest rates, it was difficult to see how the five-year program could succeed in lowering the investment ratio and making existing investment more productive. Mr. Polak's comments on recent movements with respect to interest rates were encouraging, but he wondered whether the banks would accept the latest proposals. The World Bank had expressed a preliminary view that the official investment targets might be attainable. However, he had not been able to find any World Bank statement about the cost effectiveness of the investment program.

Given the high rate of inflation and the obvious erosion of competitiveness, a more flexible exchange rate policy was needed, Mr. Casey observed. He welcomed the moves that had been taken to bring about a depreciation of the dinar, and he welcomed the establishment of a new base rate against the dollar, which should prevent the re-emergence of broken cross rates. He had noted the expectation that real consumer spending would grow by perhaps 2 per cent in 1981 as a whole, despite a fall in real personal incomes. Would the increase in workers' remittances make that possible, or was it expected that the savings ratio would fall? More generally, how did the savings ratio behave in response to inflationary expectations in a country like Yugoslavia? A related question was whether the growth in real consumption would simply reduce the high level of consumer good inventories or whether it would lead to further imports or domestic production. In conclusion, he agreed with the staff that Yugoslavia needed to export more to the convertible currency area; competitive pricing and quality, as well as a strong marketing effort were important in that regard.

Mr. Narasimham commended the Yugoslav authorities for their determination in implementing the stand-by program. It was evident from the review of developments presented by the staff that severe strains had developed and that the economy was moving through a difficult phase. However, despite setbacks in certain areas, the authorities had been successful in meeting all the quantified performance criteria and several of the objectives set out in the program. Those results were evidence of the authorities' resolve to adhere to the conditionality they had set for themselves under the program. Although the objective of price stability had eluded the authorities and prices had continued to rise--a matter that remained a cause for concern--the review demonstrated that the program had remained on track in several important respects. Both industrial and agricultural production had been around the target level, and the program target of a current account deficit of $1.8 billion for 1981 still seemed achievable. In the area of exchange and trade systems, the authorities had taken steps toward a more liberal import regime, and that at a time when the exchange rate had been under some pressure.

At the time the credit ceilings had been formulated, some Executive Directors had suggested adopting a flexible approach and the possibility of change if subsequent developments indicated that the ceilings were too tight, Mr. Narasimham recalled. The authorities had done well to live within the ceilings, particularly in the areas of income and consumption. Especially noteworthy was the degree of fiscal restraint that had been displayed at all levels of government. Fiscal discipline had been maintained and nominal expenditure limits had been adhered to even in the face of accelerated inflation.

Although the authorities had had much success, some trouble spots remained--particularly with regard to price and exchange rate stability--Mr. Narasimham remarked. Price performance was particularly disappointing since price trends had been indigenously induced and had not been greatly influenced by external factors. It remained to be seen whether price controls and price legislation would help to limit the price increases. Although the authorities remained hopeful that continued tight financial policies, restraint over the growth of personal incomes, and deceleration of import costs would all reinforce the moderating effects of price control and bring about a reduction in prices and inflationary expectations, he feared that there might be some factors upsetting those hopes. The depreciation of the dinar was but one example.

In the present vulnerable domestic price situation, the authorities' stance of adopting a policy of gradual depreciation of the dinar was understandable and possibly required, Mr. Narasimham continued. In the face of protectionist tendencies in the industrial countries and weak external demand for the products of developing countries, he wondered whether a sharp increase in exports could be realistically envisaged. It was understandable, in the light of the large increases in the value of imports--including oil imports--from the nonconvertible area that exports to that area had grown. The staff indicated that the prospects of bilateral account imbalance were now less and that an increase in exports to the convertible area could be expected. Improved receipts from invisibles were expected to lend strength to the underlying payments situation. In that context, it was noteworthy that workers' remittances had continued to flow in and were expected to remain buoyant in the second half of 1981. With regard to interest rates, the measures described by Mr. Polak provided further evidence of the close attention that the Yugoslav authorities paid to the views of the Fund.

Mr. Tai remarked that Yugoslavia had made strenuous efforts in implementing its relatively restrictive domestic management policies in the first half of 1981 and had achieved some success in various sectors. All the quantified performance criteria under the stand-by arrangement had been met during the first half of 1981, and real output for the year as a whole was likely to be close to the target. The authorities' planned investment targets for major sectors appeared attainable. Excess demand had continued to decline in the first part of 1981, and during the second half the balance of payments situation was expected to strengthen while the rate of inflation declined.

He wondered whether the difficulties that Yugoslavia had encountered in exporting to the Western European markets had been due to trade restrictions in those markets, Mr. Tai commented. He hoped that the authorities would continue their efforts to carry out necessary adjustment measures and to overcome the difficulties they would face in their socialist economic construction program.

Mr. Prowse expressed some surprise at the critical flavor of some of the comments of previous speakers. The Yugoslav authorities seemed to have done rather better than might have been expected in view of the gravity of the problems they had faced early in 1981. The seriousness of the situation should always be borne in mind when reviewing the progress made under a stand-by arrangement. He agreed with many of Mr. Narasimham's comments about the present situation.

Looking on the positive side, Mr. Prowse continued, the authorities had met all of the performance criteria and no changes were being suggested. While it was obviously too soon for anything other than a preliminary view of performance under the stand-by arrangement, present developments were, on balance, encouraging. Nominal levels of credit expansion, government expenditure, and the current account deficit appeared to be consistent with the targets for 1981 as a whole. Volume targets appeared within reach, and real output for the year as a whole was likely to be close to target.

On the negative side, prices had risen beyond projected levels, Mr. Prowse noted. However, the staff were of the view that the rate of inflation should drop sharply in the second half of the year. Perhaps the staff could explain why it held that view. With the difficulties the economy faced, price performance had to be seen at the heart of any adjustment program. The complex price control system currently in effect did not seem to be working well. It had not coped with the effects of the anticipatory price increases that had taken place shortly before the system had been put into operation, or with the effects of the large devaluation in June 1980. Attention needed to be focused on the system of price controls; they should be made more efficient, or some more wide-ranging alternative should be considered.

Could the staff explain whether it would prefer to see a large, discrete change in the exchange rate rather than the moderate sequential changes that were now occurring, Mr. Prowse inquired. If so, he would be interested in hearing the justification for such a view. With regard to interest rates, he agreed with previous speakers that some action seemed overdue. However, the Yugoslav economy had an unusual institutional structure, and it was difficult to be dogmatic about what the proper course for interest rates should be. Finally, with reference to the view expressed by some speakers that an extended arrangement might have been more appropriate than a three-year stand-by arrangement for Yugoslavia, perhaps in future, whenever it felt it to be appropriate, the Executive Board should take a firmer stand and encourage countries to enter into extended arrangements even though they might prefer a stand-by arrangement. It would not be appropriate, however, to consider the question again for Yugoslavia.

Miss Le Lorier noted that the first year of Yugoslavia's stand-by program had thus far been largely successful, and that the financial program for 1981 had developed according to expectations. However, the authorities would need to monitor all aspects of their economic program and overcome any problems that might put a successful final outcome at risk.

The rate of inflation had risen rather more than expected, particularly in the area of retail and industrial producer prices, Miss Le Lorier observed. The authorities had justified the introduction of price controls in June 1981 by reference to the increasing gap between the price targets set in March 1981 and the rate of price increases registered during the second quarter of the year. It seemed obvious that the price targets for the year would only be met if there were a prompt decline in the underlying rates of inflation. The maintenance of strict price controls and possible severe price distortions could only produce adverse effects on the final results of the program.

With that problem in mind, the effectiveness of monetary policy should perhaps be reviewed, Miss Le Lorier continued. The fact that, after allowance for the recent change in the structure of money stock, the velocity of circulation of broad money had on the whole been quite stable and remained somewhat below levels of previous years gave some ground to the argument that monetary policy had, to a large extent, been more accommodating than necessary to sustain economic activity. A review was also needed of the use of trade credit by enterprises. Such credit was estimated to have grown by 49 per cent in 1980. It would be interesting to know to what extent such a loophole in the system of credit control had contributed in 1980 to the overall liquidity of the economy. In that connection, she wondered whether the 20 per cent annual rate of growth of money supply projected for the second half of 1981 was entirely appropriate, on the assumption of a 14 per cent annual rate of growth in prices and an increase in output of not more than 3 per cent.

She agreed with the staff that efforts should be made to balance the costs of imported materials and of easing the servicing of external debt by increasing exports to the convertible area, Miss Le Lorier remarked. During 1980 and 1981 the largest part of the increase in international trade had taken place with the nonconvertible currency area. The increase in trade with that area was not worrying, to the extent that it reflected a need to cover essential imports--such as energy--but it was worrying if the shift in exports had resulted from a lack of competitiveness vis-à-vis the convertible area. In that respect, Table 24 indicated clearly that a rapid erosion had taken place in the effective exchange rates, both real and nominal; like previous speakers she believed that any gain in present market shares was predicated on adequate corrective action in that field. Table 16 seemed to indicate that real trade flows with the convertible area would actually decline in 1981, as nominal exports would only increase by a little more than 1 per cent and imports by about 7 per cent. Those figures, when compared with percentage increases in the total value of exports and imports of 16.1 per cent and 9.7 per cent, respectively, showed the importance of the shift that had taken place recently. It would have been useful to have had in the staff papers a specific balance of payments table for the nonconvertible area. The message was, however, clear: a decisive effort was needed to direct exports toward the convertible area. Some change in the exchange rate would be useful in that connection, but there would need to be parallel improvements in the quality of products and in marketing techniques.

The efforts made by the authorities seemed to be going in the right direction, Miss Le Lorier concluded. Further steps would have to be contemplated during the course of 1982, for example, in the promotion of domestic savings and the allocation of resources. At the moment, the manner in which the authorities were implementing their program did not give rise to major uncertainties about its final success.

Mr. Caranicas remarked that a number of Executive Directors had been rather critical and pessimistic in their remarks about Yugoslavia, while others had taken the country's weaknesses in their stride and had expressed belief that the program would prove to be successful. Although he found the fact that all the performance criteria had been accomplished to be most encouraging, he could not help but be concerned about certain aspects of the economy, particularly inflation, the need for greater competitiveness and improved productivity, and a number of questions concerning interest rates and the exchange rate. He agreed with those speakers advocating a faster depreciation of the dinar to keep it in line with the underlying rate of inflation, but acknowledged that since June 1981 the Yugoslav authorities were on the right track and that probably not much more could be done at present. The authorities seemed to be aware that interest rates were still negative and a constant source of uncertainty.

The shift of exports to the nonconvertible area gave grounds for concern, because it revealed that Yugoslav exports were becoming uncompetitive in quality and price, Mr. Caranicas observed. That was unfortunate, as the demand for imports from the convertible area would probably continue to grow and thus lead to a further depreciation of the dinar. He believed that beyond a certain limit, imports from the nonconvertible currency countries would have to be settled in convertible currencies. Certainly the trend in the direction of Yugoslav exports was rather disquieting and its consequences should be thoroughly examined. With regard to interest rates, he agreed with the staff that some rise was necessary to stimulate domestic savings and to assist in the allocation of funds for investment. Finally, his concerns about the Yugoslav economy had increased somewhat over the past few months, and he hoped that in addition to the steps being considered for 1981, the authorities would persist in their efforts to strengthen the economy during 1982.

The staff representative from the European Department commented that the Yugoslav authorities shared the concerns that had been expressed during the discussion and were anxious to try to improve the performance of their country's economy. However, the fact that the Minister of Finance and the Governor of the National Bank believed that a certain course of action might be necessary was not enough to ensure the quick implementation of their wishes. There were often long and complex procedures that had to be gone through involving different entities at the federal level and in the republics and the provinces, as well as the enterprise sector. In discussing the problems besetting Yugoslavia, it should not be forgotten that real progress had been made over the past year. Real wage rates had fallen by about 7 per cent during 1981, following a fall of from 8 per cent to 9 per cent during 1980. In consequence private consumption had fallen, although some of the impact of the decrease in real wage rates had been offset by the buoyant level of workers' remittances and receipts from tourism by the private sector. There had been a clear improvement in the balance of domestic supply and demand, which had formed the basis for future improvements in the current account of the balance of payments.

It was significant not only that performance criteria under the Yugoslav stand-by arrangement had been met, but that the domestic and particularly the external aims of the arrangement were being achieved, the staff representative continued. The current account target still seemed achievable, even though exports had not grown in the manner hoped for by the authorities. As a final general comment, the authorities were determined to achieve the objectives of their program and were ready to take further measures as necessary.

The views on Yugoslavia's exchange rate policies in the staff paper had been set down before the National Bank had made the recent depreciations of the dinar, the staff representative explained. If the paper had been written later the tone would have been less critical. The dinar had been depreciated quite significantly over the past two months and the authorities planned to continue making gradual depreciations over the rest of the year. The Federal Executive Council had given the National Bank the powers to bring about the depreciations, despite the concern of certain officials who had thought that the major impact of a depreciation would be to induce a resurgence of inflation.

The shift in exports toward the nonconvertible area, and particularly toward the Soviet Union, could be explained in part by the need felt to establish a degree of balance in mutual trade, the staff representative remarked. The authorities had found that the country's exports were much more competitive in Eastern Europe than in Western Europe and the other industrial countries, partly due in part to Yugoslavia's exchange rate policy. It was to be hoped that as Yugoslavia became more competitive again, because of exchange rate changes, the country's exports to the convertible markets would improve, as the authorities wished. There had been a significant simplification of the import system early in 1981, and the authorities planned to take further steps in that direction.

In retrospect it seemed clear that the degree of monetary constraint in Yugoslavia at the end of 1980 had not been as great as either the staff or the authorities had earlier believed, the staff representative continued. The higher degree of liquidity than first recorded might have been one factor permitting enterprises to raise prices sharply at the beginning of the year. Insofar as that was true, both the staff and presumably the Yugoslav authorities would have preferred to have made a more accurate judgment of the monetary situation at the end of 1980. As to the present degree of restraint, there were two conflicting bodies of evidence. On the one hand, the authorities had been able to achieve the rate of growth of output desired--an indication that the monetary burden had not been excessive; on the other hand, there had been a sharp increase in interenterprise debt--an indication that there was a fair degree of tightness in the market for bank credit. In the staff's view, the credit ceilings under the stand-by arrangement were appropriate. By the end of 1981 they should have brought about a substantial degree of monetary tightness within the economy. The authorities foresaw great difficulty in staying within the ceilings, but they had agreed to make every endeavor to do so and not to request any modification at present.

The staff shared the opinion of those Executive Directors who had called for higher and more flexible interest rates, the staff representative observed. The authorities of the National Bank of Yugoslavia were also in agreement; they would have raised the rates already had they not been delayed by the difficulties of reaching a consensus in the relatively fragmented economic policymaking system. Positive real interest rates would encourage personal savings, which, at the moment, were being eroded in real terms. Higher rates would also help those enterprises that had no need of the internal savings that they were generating. By putting those resources back into the system, they would make them available for other enterprises that could perhaps use them more profitably. At the moment, there was no incentive for an individual enterprise to put money into the banking system to be used by another enterprise. Surely, if interest rates were to have any effect on the economy, they must work in Yugoslavia in broadly the same way that they worked in other economies despite the institutional differences.

Neither the Yugoslav authorities nor the staff would disagree that fiscal performance at the federal level during 1980 had been unsatisfactory, the staff representative commented. The Minister of Finance was determined that the performance would not be repeated during 1981 and that, in particular, there would not be a deficit that had to be financed through unplanned borrowings from the commercial banks. He was insistent that the deficit would be no more than the figure that the National Bank had agreed to provide. That determination would put considerable pressure on the federal budget in the months to come. The Minister believed that he was in a position to increase the flow of receipts from the republics, so that revenue would increase in the second half of 1981. If the balance of revenues and expenditures seemed to be leading toward a greater deficit than had been planned for, he was ready to make reductions in expenditures.

The authorities recognized the need to improve the revenue base of the federal budget, the staff representative explained. At present there was a consensus on the subject between the Federation and the republics and provinces, but it had only been reached with great difficulty. It would probably be difficult to achieve the improvements that the federal authorities would like. There was an awareness, however, of the narrowness and inflexibility of the present base and the need to increase revenues so as to cover expenditures, many of which were in areas that were difficult to cut back, such as defense, administration, and grants to the less developed republics.

Not much had been written about the World Bank's study of the 1981-85 Plan, because work on that document was still proceeding, the staff representative explained. On balance, the World Bank's view would probably be that the thrust of the Plan was certainly right, but that the performance would probably not be as good as the federal authorities hoped. The staff of the World Bank and of the Fund would certainly continue to urge the authorities to improve the efficiency of their economy. The World Bank, in considering prospects for sector lending, would particularly urge the authorities to ensure cooperation between the republics, for example, setting up a plant in one republic that would serve not only that republic but others as well.

The suggestion had been made in the discussion that broad money might be a better aggregate for the staff to focus on than narrow money, the staff representative recalled. It was probably inevitable in a period in which there was a real tightness in an economy that the velocity of money would increase. In Fund programs, the staff and the authorities tried to make allowance accordingly. Although it was probably true that in Yugoslavia it might be better to look at broad money rather than narrow money, the econometric studies that had been undertaken did not show a more significant direct relationship between domestic expenditure and broad money. However, there was considerable scope for improvements in forecasting.

The large increases in prices at the beginning of 1981 had been generated by the enterprises themselves, partly in reaction to their unsatisfactory profit position, but also due to a desire to build up an excess profit position before a formal prices policy came into effect, the staff representative explained. After producer price increases totaling more than 13 per cent in the first two months of the year, the rate of price increase had dropped steadily until in July it had been around only 1 per cent. The evolution of retail prices had been even more striking. Although they had increased by 6.9 per cent in January and by 4 per cent in February, the highest increases in any month between May and August had been 1.3 per cent. If price increases could be maintained at that level the yearly inflation level to be measured in March 1982 would be well within the authorities' target. But that objective might be difficult to reach, because the summer months were traditionally those in which fresh food supplies were more abundant and cheaper. The figures for inflation should improve throughout the rest of the year; however, because of the effects of the large price increases in the first two months of 1981, the inflation level for calendar year 1981 would most likely exceed the original targets.

Unfortunately, the Yugoslav authorities had not distinguished between price indices for the convertible and the nonconvertible areas, the staff representative from the European Department said. It would be possible to distinguish between the composition of trade for the two areas, but, inevitably, there would be a long time lag before final figures could be reached. In Tables 18 and 19 of EBS/81/170 the staff had set out figures for total trade according to commodities and to geographical distribution.

The staff would discuss with the Yugoslav authorities whether it would be possible to obtain a more up-to-date combined classification, both by country and by commodity.

Mr. Polak observed that the Yugoslav authorities realized that price controls were not the real answer to the problem of keeping down price levels and containing inflation. They had imposed them in response to the serious volatility of prices that had been experienced in the early months of 1981. They realized that the most appropriate way of containing inflation in Yugoslavia, as elsewhere, would be to control demand. As to the direction of trade, the authorities were far more interested in developing trade with the convertible area than with the nonconvertible area. The increase in trade with the nonconvertible area was attributable to a combination of factors. First, some countries from Eastern Europe had built up creditor positions with Yugoslavia as a result of their exports of petroleum and other products; in consequence, they had been able to buy commodities from Yugoslavia without Yugoslav encouragement. Second, exchange rates had obviously played a role; in that connection, he had noted the view of several Executive Directors that exchange rate policy ought to be more flexible. He had been particularly interested in the suggestion made by Mr. Erb that the authorities should adopt a formula approach to prevent the dinar becoming overvalued for a period before its exchange value was corrected.

Changing interest rate policy in Yugoslavia would be more difficult than changing the exchange rate policy, Mr. Polak commented. Exchange rate policy was settled between the National Bank and the Federal Executive Council. Interest rates, however, were highly decentralized, both geographically and institutionally. The banks were to a large extent controlled by the enterprises, a fact that did not encourage prompt adjustment of interest rates in the present economic situation. In conclusion, in spite of the obvious distortions, much had been achieved during the first half of 1981. He hoped that the staff, in working out a program for 1982, could work on the basis of what had been achieved, taking into account the helpful comments that had been offered during the discussion.

Mr. Caranicas remarked that the answers by the staff representative and by Mr. Polak confirmed his suspicion that, in recommending policy measures to the Yugoslav authorities, the Executive Board would have to bear in mind the difficulties experienced by the Federal Government in gaining the cooperation of the republics. That situation was rather unique to Yugoslavia and should always be taken into account.

Mr. Erb remarked, in response to a comment made by Mr. Prowse, that he had concentrated in his intervention on the problems facing the Yugoslav economy. In so doing, it had not been his intention to appear critical of overall developments in the country. Given the pressure of work on the Executive Board, it would be better if Executive Directors could focus on what they considered to be the main problems facing a country rather than attempting to present a balanced assessment and overview of the economy.

The Executive Board then turned to the proposed correction of the typographical error in the text of the stand-by arrangement, and approved the following decision:

> In paragraph 2.a. of the Stand-By Arrangement - Yugoslavia (EBS/81/5, Sup. 2, 2/2/81), "SDR 544 million" shall be changed to read "SDR 554 million."

Decision No. 6958-(81/128), adopted
September 16, 1981

2. NIGERIA - 1981 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1981 Article IV consultation with Nigeria together with a draft decision concluding the 1981 Article XIV consultation (SM/81/179, 8/25/81). They also had before them a report on recent economic developments in Nigeria (SM/81/183, 9/8/81, and Cor. 1, 9/15/81).

Mr. Kiingi made the following statement:

> The performance of the Nigerian economy over the past two years has been influenced, as in earlier years, to a large extent by developments in the international oil markets. The easing of world demand for oil in 1980 led to a decline in production of crude oil and a 12 per cent reduction in the oil sector contribution to GDP in 1980/81 compared with a 12 per cent increase in 1979/80. The effect of the weakening in the oil sector performance is reflected in the deterioration of the growth rate in real GDP, which declined from 5.7 per cent in 1979/80 to about 2.1 per cent in 1980/81.
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> Government revenue was also affected. In 1980/81, the rate of growth in centrally collected revenues declined to 29.8 per cent from 70.9 per cent in 1979/80 reflecting a sharp fall in the growth of oil revenue to only 34.7 per cent. The rate of expansion in federally retained revenue fell from 54.7 per cent in 1979/80 to 35.0 per cent in 1980/81. The overall budgetary deficit which was reduced to ₦ 1.2 billion or 3.6 per cent of GDP in 1978/79 and to ₦ 0.8 billion or 1.8 per cent of GDP in 1979/80, is estimated to widen to ₦ 3.2 billion in 1981. The increased deficit reflects the decline in revenue associated with the easing of world demand for crude petroleum, and the change in the country's revenue allocation formula under which 41 per cent of the Federation Account is to be distributed among the states and local governments to finance their budgets. Under the formula 38 per cent of federally collected revenue in 1981 will be transferred to the states compared with an average of 22 per cent over the preceding four years.

The Nigerian authorities realize the implications of the country's continued dependence on a single commodity and of the slow growth in the non-oil sector of the economy. They have therefore adopted policies aimed at using oil revenue to expand the productive capacity and promote the growth of the non-oil sectors. Under the Fourth National Development Plan (1981-85), which was put into effect last January, the authorities intend to reduce the dependence of the economy on a narrow range of activities and achieve a better balance in the development of the different sectors. During the plan period, the authorities expect the agricultural sector to grow by 4 per cent annually, the manufacturing, utilities, and communications sectors by an average rate of 15 per cent, while the overall growth of real GDP is envisaged to average 7.2 per cent annually.

In the agricultural sector, the authorities plan to adopt an integrated approach to agricultural development. To this end, they intend to establish agro-allied industries in the rural areas to provide employment opportunities and curb the rural-urban migration of youths. They also intend to shift emphasis from large-scale mechanized farms to small-scale farm holdings which account for the bulk of the domestic food production. They are already assisting small-scale rice farmers to put about 45,000 hectares of land under rice cultivation with a view to producing about 90,000 metric tons of rice annually. They have established guaranteed minimum producer prices for food crops to provide security for the small farmer. They intend to continue to adjust producer prices for export crops as may be necessary to stimulate increased production.

The Fourth Development Plan willo devote 13 per cent of the ₦ 82 billion capital expenditure envisaged under the Plan on agricultural projects. Credit to the sector from the government-owned agricultural bank is to be increased substantially and the commercial banks will be made to expand resources to the sector through appropriate credit guidelines issued by the Central Bank and the continued use of the government's Agricultural Credit Guarantee Scheme. Infrastructural facilities will be strengthened. All-weather feeder roads are being constructed. The Grains Board and the National Grains Production Company are establishing grain processing and storage facilities. The various River Basin Authorities are also embarking on infrastructural projects including construction of dams and bore holes to provide water for, among others, irrigation purposes.

In the industrial sector the authorities have stated that they intend to continue to restructure the composition of imports in favor of capital and intermediate goods necessary to stimulate production and provide adequate protection for domestic industries. While keeping the Nigerian Enterprises Promotion Decree under review, they have meanwhile amended the Indigenization Decree to allow for an increase in foreign equity participation from 40 per cent to 60 per cent in agro-based industries. Recently, they have published the "Nigerian Industrial Policy and Strategy: Guidelines to Investors" to provide information on the country's industrial strategy and regulations governing foreign investment. They stressed the importance of increasing manufactured exports. To this end they plan to give special allowances for capital investments in respect of non-oil exports. The authorities also plan to ease infrastructural constraints to industrial development. In this regard they have, among others, earmarked about ₦ 3.1 billion under the Fourth Development Plan for improvement of water resources.

On the budgetary front, the authorities are aware of the difficulties associated with dependence on oil revenues and of the implications for Nigeria of the current depressed world demand for oil. In order to ensure that the deficit does not widen further, the authorities intend to take action to complement the existing tax measures should need arise. In this regard, they have asked the National Assembly to enact legislation empowering the President to take fiscal policy measures by executive order. They recognize the implications of the increased allocations to the states and have stated that the Federal Government will use its power to issue domestic borrowing guidelines to the states with a view to making them maintain strict expenditure control and tighten financial discipline thus keeping total government spending and the structure of total public debt in line with the overall centrally determined economic objectives. Meanwhile, to offset part of the revenue that the Federal Government lost to the states, the authorities have abolished all grants to the states in respect of the universal primary education scheme and cut back the issue of development stock for on-lending to the states.

The need for state corporations to operate on commercial lines has been re-emphasized. Many of them have increased their prices and tariffs. Where weak management systems hampered the effectiveness of financial operations, the authorities have not hesitated to hire foreign management firms to provide the needed management skills and train Nigerian staff. The authorities also intend to put into effect better expenditure and cost evaluation systems to increase efficiency in the use of resources and in executing capital projects. The authorities intend to continue to reduce the growth in payrolls through rational recruitment policy.

In the monetary policy field, the authorities intend to limit the rate of expansion in domestic credit to 24 per cent and of monetary expansion to 19 per cent and to limit growth in import payments to about 20 per cent. These targets are judged by the staff to be consistent with the objective of achieving a moderate overall surplus in the balance of payments in 1981 and of holding the inflation rate at a level below 10 per cent.

In April 1980 the authorities increased interest rates by 1 percentage point and in January 1981 the minimum lending rate was further increased by 1 percentage point. The minimum rediscount rate now stands at 6 per cent compared with 3.5 per cent in 1977, 4 per cent in 1978, and 5 per cent in March 1980. Savings deposit rates have also risen from 4 per cent in 1977 to 6 per cent and minimum lending rates from 6 per cent to 7.5 per cent, while maximum lending rates moved from 10 per cent to 11.5 per cent over the period.

Despite the decline in the volume of petroleum exports, the overall balance of payments moved from a deficit of SDR 1.6 billion in 1978 to a surplus of SDR 2.4 billion in 1979 and of SDR 3.4 billion in 1980. External assets at the end of 1980 rose to SDR 7.9 billion, sufficient to cover six months' imports. The exchange and trade system has been further liberalized. In April 1980 the advance deposit scheme was eliminated and a number of industrial raw materials and spare parts were exempt from the pre-shipment import surveillance system. Restrictions on payments for secondary education abroad have been removed. The personal travel allowance was doubled, while business travel allowances were substantially increased.

On the naira exchange rate policy, the authorities have stated that the objective is to make the exchange rate reflect the strength of the country's external payments position and assist in moderating the impact of imported inflation. The authorities have also eliminated broken cross rates. While keeping under review the exchange rate policy, they have allowed the naira/dollar rate to depreciate by 12 per cent between April 1980 and July 1981, reflecting the easing in the international oil market.

Mr. Taylor indicated his support for the proposed decision and his agreement with the staff analysis. It was regrettable that there had been an interval of almost two years since the previous Article IV consultation. It was desirable that the Fund should maintain regular annual consultations with members, such as Nigeria, that had availed themselves of Article XIV status and maintained significant trade and exchange restrictions.

Fluctuations in the oil market had had far-reaching effects on Nigeria's financial position and had made economic planning difficult and investment uneven, Mr. Taylor commented. In those circumstances it was important that the authorities should exercise more than the usual amount of flexibility in demand management, so that economic expansion could give way to restraint when, as at present, the world oil market and oil revenues became slack. In the medium term, the emphasis should, of course, be on expansion and a diversification of the real resource base of the economy. He had been glad to hear in Mr. Kiingi's statement that the authorities attached high priority to those objectives.

The concentration in the Fourth Development Plan on the development of agriculture and other productive sectors of the economy was welcome. However, the authorities should also concentrate on broadening the tax base to make revenues less susceptible to the vicissitudes of the oil market.

Some aspects of the present fiscal situation were rather disturbing, Mr. Taylor observed. He wondered whether the new revenue-sharing arrangements between the Federal Government and the state and local governments might not have adverse implications for budgetary control and for demand management policy. Automatic block transfers of resources might run the risk of reducing those incentives to economy and efficiency that seemed to operate best when governments were more directly involved in the raising of the money that they spent. The new revenue-sharing arrangements could also encourage state and local governments to take on functions that might not be essential. Could the staff say whether the Federal Government would be able to monitor the activities of the local governments to prevent that kind of consequence? He agreed with the staff that the authorities' overall fiscal policy stance was expansionary. It should not be forgotten, however, that the substantial increase in the overall deficit had been largely attributable to a reduction in the foreign surplus in the Federal Government. The domestic deficit--a better measure of the expansionary impact of fiscal policy--was not expected to change significantly. In any event, there was a need to continue with tight fiscal control.

About half of the prospective budget deficit would be financed from the domestic banking system, Mr. Taylor noted. He wondered what prospects there were for increasing reliance on the nonbank sector. It might be relevant that, despite the recent increases, interest rates remained substantially negative in real terms. It would be interesting to know whether the staff considered interest rates at their present levels to be adverse in their effect on savings and remittances and resource allocation and what the future role of interest rates in the economy might be.

The tendency of the Nigerian currency to depreciate against the dollar in parallel with sterling had continued, Mr. Taylor said. Perhaps further depreciation of the currency would offer substantial long-term benefits; presumably the staff had such a development in mind when it advocated a flexible exchange rate. Could the staff explain its attitude toward the present value of the Nigerian currency? The authorities had argued that further depreciation would not make sense, because essential imports would be made more costly, and because domestic supply was too inelastic to meet the demand for consumer goods. The authorities probably believed that since the prices of oil and certain other major export commodities were set in the world markets, a depreciation would not enhance export performance. Against that, it could be argued that a further depreciation might encourage some domestic import substitution and help with export performance in the non-oil sector of the economy. Indeed, a lower value for the naira might help the budgetary position because of the higher domestic currency equivalent of oil revenues. Finally, he joined the staff in urging the authorities to continue the liberalization of the trade and exchange rate system, and to move toward removing the remaining restrictions as rapidly as possible.

Mr. Erb expressed his concern that overexpansionary demand policies, in conjunction with the present weakness in the demand for world oil, might place adverse strains on the balance of payments situation, and that the difficulties of 1978/79 might be repeated. He endorsed the staff's view that significant fiscal action was needed to restrain the rapid growth of aggregate demand.

He agreed with the thrust of many of the suggestions made by the staff in its papers, Mr. Erb continued. Primary emphasis should be given to the need for the Nigerian authorities to liberalize their country's exchange rate regime by opening up trading arrangements, reducing import restrictions, and establishing more liberal trading and exchange rate arrangements. Finally, for an economy as large and important as that of Nigeria, he agreed with Mr. Taylor that Article IV consultations ought to take place on an annual basis.

Mr. Jännäri considered that the public sector's heavy dependence on oil sector earnings and the consequent sensitivity to even small fluctuations in the oil market was a striking feature of the Nigerian economy. Oil being an exhaustible resource it was clear that that dependency would have to be reduced over time. Oil earnings, while they lasted, should be directed to building up a diversified base for the economy--a base that could support continued development and growth even when the oil sector's earning power declined. The present situation did not appear promising in all respects. A large part of oil income had been directed into consumption expenditure and the country's non-oil productive base had not been developed at an appropriate speed.

The development of the agricultural sector had not been encouraging, Mr. Jännäri remarked. The authorities' intention to give a high priority to the development of the rural sector was welcome; however, at the same time, special emphasis should be given to developing non-oil-based export industries.

The federal structure of the public sector might cause some problems for overall control of public sector expenditure, Mr. Jännäri observed. He agreed with the staff and the authorities that in the circumstances tight financial discipline and well-defined guidelines on expenditure policies by state and local governments were necessary to keep total government spending in line with overall economic objectives. An improvement in the taxation system was, of course, of equal importance in the effort to bring more stability to the public sector. Inflation in Nigeria seemed, by international standards, to be at a fairly low level. He wondered, however, whether the present system of resale price maintenance did not continue to suppress prices, thereby affecting profitability of the enterprise sector; that might be particularly true following the recent significant increases in wages. The system of subsidies and the level and appropriateness of producer prices in the agricultural sector had also had an impact. In considering price levels, the authorities should not forget to examine the appropriateness of the domestic price of oil products.

He shared the staff's view that an active exchange rate policy could be useful in bringing about satisfactory resource allocation and economic diversification, Mr. Jännäri observed. A more active interest rate policy could serve the same purpose, as would a decrease in the protectionist features of the exchange and trade system. On a final point, he asked the staff to explain why the basket of currencies upon which the exchange rate was supposed to be based had been so little used.

The staff representative from the African Department, responding to the question on whether a new revenue allocation formula would not complicate demand management policies, commented that the problem of bringing financial discipline to bear on all levels of the government was a major problem, above all because of the lack of up-to-date data on state budgets. The only instrument available to the Federal Government with which to control the expenditure of state governments was its power to issue borrowing guidelines to the states. In the past, the federal authorities had issued bonds, the proceeds of which were at present on loan to the states to assist them in meeting their budgetary deficits. The federal authorities had also approved borrowing abroad for specific projects that were considered to be of national interest. Those activities would now be closely monitored, and it was expected that the guidelines would be applied strictly. In any event, state governments would not be allowed to borrow if their debt service burden exceeded about 10 per cent of budgetary receipts for the current year. However, the authorities realized that because of the problems of information gathering, controlling expenditures at state levels would be a difficult task.

Interest rates were at present negative in real terms, the staff representative commented. Formerly the authorities had pursued a policy under which interest rates were adjusted incrementally with a view to bringing them up to a positive real rate of interest. The authorities, however, were concerned that high nominal interest rates might affect the level of investment and had, for that reason, declined to raise them further at present. They believed that extending commercial bank branches would provide the best means for increasing savings in rural areas. They were currently putting into operation a plan under which commercial banks were asked to open a specified number of branches within a certain time period. It was expected that by the end of 1983 some 266 new commercial bank branches would have been created.

With regard to the exchange rate, the staff representative continued, the authorities had in the past considered imported inflation, as well as domestic inflation, to be a major problem. In consequence, when the balance of payments position had been favorable, or when the reserve position could support it, they had engineered an appreciation of the naira in order to counter imported inflation. When the balance of payments position had weakened, they had moved slightly in the opposite direction. Over the past year, a decision had been taken to link the naira to the pound sterling. That had meant, in effect, that the principle of determining the naira rate on the basis of a basket of currencies had been abandoned. The authorities, however, still maintained the basket, but in effect had assigned zero weights to all currencies in it apart from the pound sterling. The most recently available information indicated that in the recent downward movement of the pound sterling vis-à-vis the U.S. dollar, the naira peg to sterling had been maintained until the end of June. In July, there had been a slight break from the pound sterling when the naira had appreciated by 1 per cent against it.

The authorities argued that their country's exports were not sensitive to exchange rate movements and that any depreciation of the exchange rate would mean increases in costs of their imports, the staff representative continued. They saw no guarantee that a depreciation would bring any substantial benefits in the short term to other sectors of the economy. They believed that the policy of using quantitative controls--special investment incentives and other encouragements to investors to promote industry--stood a better chance of promoting industrial development than exchange rate modification. The staff and the authorities had differing views on the question; the staff had incorporated its views in its report.

It had proved difficult to quantify price and cost developments in the economy, the staff representative from the African Department observed. Recent surveys made by the Central Bank of Nigeria indicated that unit labor costs had been rising relatively rapidly. There were some government subsidies on food items such as cereals, and implicit subsidies on the price of petroleum. There were some indications that, due to the quantitative controls in effect, administered prices differed substantially from market prices, and that the measured rate of inflation as reflected in the latest cost of living indices might in fact be too low. More generally there seemed to be substantial cost/price distortions, which could be improved if the trade and exchange system were liberalized and restrictions in the domestic economy eased.

Mr. Kiingi remarked that in view of the late hour he would not add to the clear response to Executive Directors' questions offered by the staff representative. He would report the feelings of the Executive Board to his authorities, however. He felt sure that they would benefit from comments made on the exchange rate policy, particularly during the present period when the demand for and the prices of oil were rather less buoyant than in the past.

The Chairman made the following summing up:

Executive Directors expressed broad agreement with the thrust of the staff appraisal of the 1981 Article IV consultation with Nigeria. Directors noted the heavy dependence of the economy on the oil sector. They also noted that the pace of growth and its sectorial distribution have been uneven. Agriculture, in particular, has not performed as well as it could have done. The industrial sector has been growing at a slow pace behind protective restrictions and the economy has become increasingly dependent upon imports, notably of food. Directors welcomed, therefore, the authorities' renewed determination to reverse the present pattern of investment in order to shift the trend in favor of agriculture and the production of traded goods for domestic use as well as for export. In this connection, Directors stressed the vital role of realistic pricing and wage policies and of a balanced structure of incentives in stimulating supply.

Directors emphasized the importance of an effective program of liberalization of import restrictions combined with a more uniform system of tariffs supported by a more flexible exchange rate policy and appropriate demand management.

Directors noted that in their efforts to promote accelerated growth the authorities have tailored their overall policies closely to their expectations regarding oil revenues; in consequence, budgetary policies have hitherto been expansionary. As a result, during periods of large shifts in the world oil markets, fiscal and external payments difficulties have arisen. Directors emphasized the need for stricter demand management and appropriate long-term financial plans as well as the need to diversify the domestic tax base through increased taxation of the non-oil sector. It was also stressed that the federal revenue-sharing arrangement should not be permitted to affect adversely effective expenditure control in the public sector as a whole. Finally, the importance of regular Article IV consultations with Nigeria was emphasized.

The Executive Board took the following decision:

Decision Concluding 1981 Article XIV Consultation

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

2. Nigeria continues to maintain certain restrictions on payments and transfers for current international transactions as described in SM/81/183. The Fund notes that since the last consultation Nigeria has removed the restriction on foreign exchange allowances for certain types of education abroad and encourages the authorities to remove the remaining restrictions as soon as possible.

Decision No. 6959-(81/128), adopted
September 16, 1981

APPROVED: February 25, 1982

JOSEPH W. LANG, Jr.
Acting Secretary