NOT FOR PUBLIC USE

#8 INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 76/146

10:00 a.m., October 20, 1976

W. B. Dale, Acting Chairman

Executive Directors	Alternate Executive Directors
	C. P. Caranicas
	J. H. Kjaer
S. Y. Cross	
	R. De Beckker, Temporary
	M. A. Wasfy, Temporary
	E. O. de Toledo
B. J. Drabble	D. Lynch
	W. Rasaputram
	W. Temple-Seminario
	R. Masunaga
	S. K. Panya, Temporary
P. Lieftinck	
H. R. Monday	W. D. Mung'omba
E. Pieske	G. Laske
	P. Kent
D. Simone	S. Sevilla
F. Suárez	R. Guarnieri
J. H. Wahl	J. Foglizzo
	R. S. Deane
A. W. Yaméogo	S. Nana-Sinkam

J. W. Lang, Acting Secretary
A. W. Rhodin, Assistant

Also Present

European Department: A. Pféifer, Deputy Director; P. Hedfors, R. P. Hicks, A. G. C. Mountford, G. Tyler, H. Ungerer, C. J. Vogt, J. R. Wein, C. Wollan. Exchange and Trade Relations Department: D. K. Palmer, Deputy Director; M. Allen, M. Dakolias, O. Johnson, J. B. McLenaghan, A. K. Mitchell, B. Nowzad, T. M. Reichmann, M. O. Tyler. IMF Institute: M. Simory, Participant. Legal Department: J. G. Evans, Deputy General Counsel; P. R. Lachman, A. Liuksila. Treasurer's Department: P. Gschwindt de Gyor. Information Office: H. Hartmann. Advisors to Executive Directors: J. K. E. Cole, C. Bouchard. Technical Assistants to Executive Directors: V. Alipui, V. Amiel, D. Berthet, J.-M. Bisson, J. M. Cock Londoño, M. Danusaputro, K. L. Deshpande, B. Goos, T. M. Johansen, C. J. Lohmann, H. Kuroda, G. Meissner, A. G. Morris, A. K. Mullei, C. C. Ozumba, M. Pietinen, S. P. Upasani, A. van Dorssen, L. F. Vilches, P. Zimmer, A. G. Zoccali.

1. EXECUTIVE DIRECTOR

The Acting Chairman welcomed Mr. Wila D. Mung'omba, Alternate Executive Director to Mr. Monday.

2. APPROVAL OF MINUTES

The Executive Directors approved the draft minutes of Meetings 76/89, 76/91, and 76/102.

3. EUROPEAN COMMON MARGINS AGREEMENT

Mr. Pieske noted that on October 17, 1976, the member governments of the seven countries constituting the "snake" had taken a decision to adjust a number of exchange rates between their respective currencies the next day. A communiqué announcing the action had been distributed to the Executive Directors as EBD/76/211.

In accordance with the decision, Mr. Pieske continued, the German authorities had communicated to the Fund a new central rate of DM 1 = SDR 0.316792, which represented an appreciation of 2 per cent over the previous central rate. At the same time, they had stated that the maximum margin of 2.25 per cent would continue to be maintained between the deutsche mark and the other currencies of the "snake." The new intervention points had been published and communicated to the Fund.

The main purpose of the realignment of "snake" currencies was to ensure that the common margins arrangement would continue to operate in an orderly manner, Mr. Pieske said. Substantial interventions had become necessary in mid-August 1976 and again in the second half of September 1976 to keep the exchange rates between those currencies within the agreed margins. The net reserves of the Deutsche Bundesbank had increased by nearly DM 6 billion since August 1976. It had become urgent to halt such excessive movements of funds. The inflows threatened to undermine monetary policy in Germany, and, while the authorities could theoretically have absorbed them through the use of restrictive policy measures, that approach would have led to higher interest rates, which would have been undesirable from both a domestic and an international point of view. The relative calm of the exchange markets following the German elections and the Annual Meetings in Manila had provided a favorable setting for the exchange rate changes.

The moderate realignment of "snake" currencies would probably end speculative expectations, Mr. Pieske remarked, without creating undue inflationary pressures in those countries whose currencies had been relatively devalued. While it was too early fully to assess the results of the adjustment, it was nevertheless remarkable that significant reflows of funds from Germany into other "snake" countries had already taken place. The deutsche mark had fallen abruptly from the top to the bottom of the "snake"; its relationship to the U.S. dollar had, however, been little affected.

The German authorities and those of their partner countries would stress their commitment to maintaining in Europe a zone of monetary stability, Mr. Pieske said, and the recent exchange rate adjustments were likely to strengthen that zone. He understood that the staff was preparing a paper on the matter, and he looked forward to an early discussion of it by the Executive Board.

The Acting Chairman noted that a staff paper on the exchange rate actions to which Mr. Pieske had referred would be placed on an early agenda.

4. ISRAEL - EXCHANGE AND TRADE SYSTEM AND STAND-BY ARRANGEMENT

The Executive Directors considered a staff paper on the exchange and trade system of Israel, together with the staff's analysis and recommendation (EBS/76/443, 10/4/76). They also considered the staff's analysis and recommendation with respect to a request from Israel for a stand-by arrangement equivalent to SDR 29.25 million (EBS/76/442, 10/4/76).

Mr. Lieftinck remarked that since mid-1974 the Israel authorities had been combating advserve economic trends stemming from the impact of the world recession, an unfavorable turn in the country's terms of trade, and domestic overspending. Their efforts had not been unsuccessful; there had been declines in private and public consumption, gross investment and the rate of inflation, while the trade balance and the current account had begun to improve. The authorities remained committed to cautious overall spending policies and they had devised a stabilization program aimed at further reducing the rate of inflation and strengthening the balance of payments. In support of that program, they had applied for a stand-by arrangement equivalent to the balance of their enlarged second credit tranche. At the same time, they were pursuing realistic exchange rate policies.

The achievement of internal and external equilibrium on the basis of Israel's own resources would require considerable structural changes conducive to an expanded export sector, Mr. Lieftinck continued. The growth of domestic spending would have to be contained by cautious wage policies, realistic pricing policies, sound public financing, and restraint on the expansion of credit. The current stabilization program reflected such an approach and fully deserved the support of the Fund.

With respect to Israel's exchange and trade system, Mr. Lieftinck noted that the authorities had expressed their intention to correct existing imperfections as soon as possible. The temporary extension of the import surcharge--which resulted in a multiple currency practice--and of the increase in the travel tax should therefore receive the Fund's approval.

Mr. Cross stated that he supported the proposed stand-by arrangement for Israel. Although he was disappointed by the rise in the rate of inflation, he could understand that it had resulted partly from the reduction in consumer subsidies, the introduction of a value added tax and the depreciation of the Israel pound. Those measures held longer-term benefits for the economy, and their adverse impact on prices was likely to be temporary. The authorities' financial program appeared to be sound; of particular importance was restraint on budget expenditures. It was essential that inflation be brought under control and that resources be shifted to the export sector through appropriate demand management and investment policies. Repeated depreciation of the exchange rate was not an adequate means of maintaining the competitiveness of Israel's exports in the long run.

With respect to the indexation of wages and salaries, Mr. Cross noted that the percentage rate of adjustment had been reduced but that it was now applied to a greater proportion of the total wage. It would be useful to have further comments from the staff on the net effect of the changes and on the prospects for any other changes that might minimize the drawbacks of the indexing system.

The rationale for the proposed decision on Israel's exchange and trade system was not at all clear, Mr. Cross said. The staff's analysis revealed little justification for the exchange restrictions in question, and there was no evidence that measures were being taken to eliminate them.

Mr. Deane stated that he supported both the decisions proposed by the staff, particularly the approval of a stand-by arrangement for Israel. He was concerned by several features of the Israel authorities' financial program, however. Although the drawing that Israel was requesting was not a large one, it would raise the Fund's holdings of Israel's currency to 333 per cent of the country's quota. During the Annual Meetings there had been some discussion of the need to scrutinize conditionality arrangements and to assess the firmness of adjustment programs; he was not convinced that Israel's financial program was adequate to the achievement of a genuine improvement in the country's balance of payments position.

As to the balance of payments itself, Mr. Deane commented that the deficit on goods and services, which had been SDR 3.3 billion in 1975, would remain substantial, declining only to SDR 3.2 billion in 1976 and to SDR 3.1 billion in 1977. The current account deficit was expected to fall from SDR 1.9 billion in 1975 to just over SDR 1 billion, which still seemed high, in 1976 and 1977. Moreover, the improvement in the current account would depend on an increase in government transfers, for which the projections were quite uncertain.

The 1976/77 budget provided for borrowing of I£ 2.7 billion, Mr. Deane commented, as compared with I£ 5.8 billion in 1975/76. The projected decline appeared to represent a significant improvement in the budgetary situation, but because of the transfer of some expenditures from 1975/76 to 1976/77, net borrowing from the Bank of Israel in 1976/77 would be I£ 4.7 billion, an increase from the previous year. How much weight was to be given to the I£ 2 billion disparity was not clear, but it did suggest that the borrowing requirement for 1976/77 was still very large.

The 46 per cent share of defense and debt servicing in total expenditure certainly limited the scope for paring Israel's budget, Mr. Deane observed. The 39 per cent increase in total expenditure from 1975/76 to 1976/77 was nevertheless disturbing, despite the staff's comment that the increase was reduced to 33 per cent if so-called "earmarked loans" were taken into account. Given the size of Israel's balance of payments deficit, one might well ask whether such increases were sustainable, and whether, in fact, public expenditure was not too high already. The debt service ratio, which had reached 29 per cent at the end of 1975, no doubt caused concern to the authorities, and it would perhaps warrant more attention in the Fund's assessments of Israel's economic programs and policy needs.

In their monetary policy, Mr. Deane remarked, the Israel authorities displayed commendable flexibility with respect to interest rates, which had been allowed to rise as high as 30-40 per cent. On the other hand, bank credit was perhaps increasing too rapidly. Credit from the banking system to the private sector was expected to be one third higher in 1976/77 than it had been the previous year, and while the staff had explained that that increase would be less than the nominal rise in incomes during the same period, the question might still be raised of how much less would be appropriate under the circumstances.

The financial program attached to the requested stand-by arrangement extended only until March 31, 1977, Mr. Deane observed. The staff had said that targets for the remainder of the period of the stand-by arrangement would have to be established following a mid-term review because of the many uncertainties of the case. There were perhaps precedents for supporting an abbreviated program which provided for a review, and there was of course no question that a careful review would take place. But Israel's economic problems were substantial, and a longer perspective would seem to be needed if a genuine adjustment was to be effected in the balance of payments. The Fund could surely take responsibility for helping the authorities to define targets for the period beyond March 1977, even though the uncertainties of the situation might necessitate changes in the numbers later on.

The crux of an adjustment in Israel's economy would be a structural change leading to further increases in exports, Mr. Deane said. It was not at all clear, however, that such a change could be achieved by the authorities' present policies, and it would be useful to have further comments from the staff on the structural implications of the financial program. The authorities believed that their strategy would bring about further improvements in the trade account in 1977 and beyond. But according to the figures in Table 5 of EBS/76/442, exports would increase by more than 17 per cent from 1976 to 1977, or substantially less than the 27 per cent increase expected for 1976.

Although the very large cumulative depreciation of the Israel pound should have contributed to a redistribution of resources, Mr. Deane added, its effects had been largely nullified by the linkage between wages and price increases. Unless the indexing arrangement was further moderated, it seemed doubtful whether the authorities would be able to carry out the structural adjustments on which an improvement in the balance of payments would depend.

Mr. Drabble, associating himself with remarks by Mr. Deane and Mr. Cross, stated that he supported the proposed decisions with respect to the stand-by arrangement and the exchange and trade system of Israel. The country's economy had clearly experienced a difficult three years. The pace of adjustment was disappointing, however; despite the considerable sacrifices being made by the Israelis in terms of growth and real consumption, there had been little progress toward strengthening the goods and services account in the balance of payments and reducing the rate of inflation.

The resurgence of inflation in 1976 was in part a consequence of painful but necessary adjustments made by the Israel Government, Mr. Drabble noted, among them the introduction of a value added tax. What disturbed him most, however, was the fact that a high rate of inflation seemed to have been institutionalized; despite sluggish growth, inflation was expected to continue at 25 per cent in 1977. Part of the problem appeared to be the indexation of wages and salaries on price increases. A number of appropriate changes had been made in the indexing arrangements. On the other hand, the wage/price linkage was still backward looking; and when current rates of inflation were high, indexing made an eventual reduction more difficult. Thus, the assumption that a high rate of inflation was unavoidable for the immediate future was implicit in monetary policy, and targets for the expansion of monetary aggregates were designed to prevent that rate from being exceeded. The recent change in Israel's exchange rate had been welcome, but its effect had been offset by the indexing system. The Israel authorities should explore the possibility of an alternative wage policy which, while preserving fair treatment, would also permit the establishment of more ambitious forward looking targets for the reduction of inflation in 1977-78.

The pace of structural adjustments in Israel's economy caused some concern, Mr. Drabble said. In that connection, he noted that a decline in investment had been the unwelcome by-product of overall restraint on demand.

It was true that within the total of investment there had been a shift toward the export sector. Nevertheless, a high rate of investment, which had been the foundation of Israel's growth rate in the past, would have to be re-established in order to broaden and strengthen the export sector in future. Present policies seemed to leave inadequate room for investment. The solution was perhaps a reduction in public consumption, although there were major constraints on such a change, particularly the size of the defense budget. In favorable world trade conditions, Israel could surely expedite the needed structural adjustments.

The midterm review of Israel's performance under the stand-by arrangement would provide an opportunity to examine the authorities' longer-term objectives, Mr. Drabble remarked. A financial program extending beyond 1977 was clearly needed, particularly with respect to the balance of payments, and it would be interesting to know how much further progress the authorities believed would be possible over a somewhat longer time frame.

Mr. Kjaer remarked that although the terms of the stand-by arrangement for Israel seemed rather lenient, he nevertheless supported the proposed decision. As to the exchange and trade system, he, like Mr. Cross, would have welcomed some indication that the export rebates and import taxes would be phased out. The exchange rate policies pursued by Israel during the past two years would seem to facilitate the elimination of those practices. If the periodic devaluations of the Israel pound could be increased by 1 or 2 per cent, a corresponding reduction could be made in the export rebates and import taxes, with little or no effect on domestic prices or on the competitiveness of Israel's industrial exports. He wondered whether the reason why that approach had not been used was that so many financial claims in Israel were linked to the U.S. dollar.

The target for net domestic assets of the banking system allowed for a 34 per cent increase during the year ending March 31, 1977, Mr. Kjaer noted, and it was calculated on the basis of the present exchange rate between the U.S. dollar and the Israel pound. Because a portion of the assets of the banks were linked to the dollar, the use of a constant rate of exchange had practical advantages. The 34 per cent ceiling included a substantial margin for the expected rate of inflation, however, and if allowance was also made for changes in the exchange rate before March 1977, there would seem to be some double counting involved.

Mr. Laske commented that the staff's analysis clearly revealed persistent imbalances in Israel's economy, the most pressing problems being a high rate of inflation and a substantial balance of payments deficit. It had to be recognized that Israel's special circumstances placed unusual strains on both the internal and external sectors of the economy, but even the serious efforts made so far to correct the existing imbalances had enjoyed only limited success.

Unlike the staff, Mr. Laske said, he did not perceive a genuine improvement in the balance of payments. The favorable outturn expected for 1976 and 1977 would be due almost entirely to a very large increase in official transfers. That the balance of payments had failed to respond to the adjustment effort could be explained by two factors. First, a structural weakness in Israel's economy required that more resources be shifted to the export sector, and restrictive demand policies had been employed for that purpose. The needed increase in exports would depend as much on there being sufficient profits for exporters, however. In that connection, he noted that the profitability of Israel's export industries had improved only slightly in recent months, despite the considerable depreciation of the Israel pound. That development reflected the second and more important reason for the unsatisfactory balance of payments situation and the persistence of high inflation as well: the fixed relationship between wage rates and consumer prices. Depreciation could create incentives for exports, but because it also led to higher import prices, production costs and prices would rise, prompting another turn of the classic wage/price spiral. Moreover, the automaticity of the indexing system undermined many an effort to restrict domestic consumption by raising administered prices, as was amply demonstrated by developments in 1976. The recent reduction in the linkage from 100 per cent to 70 per cent was most welcome, but the Government should take whatever steps were politically feasible to moderate the indexation system further. Finally, he wondered to what extent the tax rebate scheme might enhance the profitability of Israel's exports by reducing cost differentials vis-à-vis competitive foreign products.

The persistence of large budget deficits was also disturbing, Mr. Laske considered, and a change in the indexation arrangements would surely help to improve the situation. Because budgeted expenditures had not been adjusted for the higher than expected inflation rate, he wondered whether actual budget performance in 1976/77 could be kept within the projected limits.

He endorsed the stabilization program submitted by the Israel authorities, Mr. Laske said, and he could support the country's request for a stand-by arrangement. The ceilings for domestic credit expansion and government recourse to central bank credit were very generous, however, and he would welcome every effort by the authorities to contain credit expansion as far below those limits as possible.

Mr. Simone, who supported Israel's request for a one year stand-by arrangement, observed that the country was making a vigorous effort to overcome the serious economic problems facing it. In view of the many uncertainties surrounding the balance of payments and budgetary developments, the authorities' financial program covered only the period until March 1977. It seemed likely, however, that the imbalance of payments Israel had been experiencing over the past few years would persist into 1977; specifically, the trade balance would continue to show a deficit of some SDR 3 billion. Given the heavy burden of defense expenditures and the cost of servicing a very large external debt, the policy of small but frequent adjustments of the exchange rate would have to be maintained as long as the inflation rate remained high, and an effort to promote exports would be essential.

The 1977/78 budget would be the key element of Israel's stabilization program, Mr. Simone commented. Despite the progress made toward tax reform and the elimination of subsidies, the public sector had been a major source of credit expansion during the past two years. Because there was little flexibility in government expenditure patterns, revenues would have to be increased by means of additional taxation if an even higher inflation rate was to be avoided. It was also necessary, of course, to encourage private investment in the export sector, but the constraints confronting the authorities had to be viewed realistically. In any event, he hoped that domestic credit expansion under the budget would be consistent with a substantial reduction in the rate of inflation.

The wage adjustment system seemed somewhat inconsistent with other aspects of Israel's stabilization program, Mr. Simone said. As to credit policy, he welcomed the steps taken to establish a positive real interest rate structure. In fact, nominal interest rates had reached 40 per cent per year, which was higher than the actual rate of inflation and far above the expected inflation rate.

Mr. Yaméogo said that he agreed with other speakers that Israel's economic situation was most unfortunate. For the period 1973-1977, net transfers to the country would be entirely absorbed by defense imports. On the other hand, the economy would benefit from a resolution of the political conflict in the Middle East, an objective toward which an international effort would surely be made. In the meantime, he was happy to support Israel's request for assistance from the Fund.

The staff representative from the European Department remarked that the staff could appreciate the concerns expressed by Executive Directors about the slow pace of the improvement in Israel's economy and the extent to which the present financial program would be effective. It had to be recognized, however, that the external difficulties facing Israel were extraordinarily severe, and that numerous measures introduced by the Israel Government during the past two or three years had sharply reduced the growth of disposable income and of consumption, particularly personal consumption.

With respect to Israel's balance of payments, the staff representative observed that if direct defense imports were subtracted from the trade account, the 1977 deficit on nondefense trade would be SDR 1.3 billion, as compared with an SDR 1.8 billion deficit in 1974. Thus the goods and services balance might exaggerate the balance of payments problem insofar as it included direct defense imports but did not include the financing derived from transfers to the Government. All the same, at a projected SDR 1 billion in 1976 and a slightly higher projection in 1977, the current account deficit was undeniably a very large one, even though it had fallen substantially from the SDR 1.9 billion deficit of 1975.

A number of Executive Directors had suggested that the wage indexation system in Israel would tend to neutralize the favorable impact of the depreciation of the Israel pound and of various domestic measures, the staff representative recalled, and the staff would agree with their comments. On the other hand, the system had worked satisfactorily from 1968 until 1972, a period when the external pressures on Israel's price structure had been much lighter; prices during that time had risen slowly, so that the indexation had not added to domestic costs anything beyond sustainable increases in productivity. One might conclude that the system worked well as long as the rate of inflation could be contained within reasonable limits, but that it would become counterproductive when the inflation rate was very high, as was clearly the case at present.

On a number of occasions, the staff representative continued, the Israel authorities had reached agreements with trade unions and with employers on modifications of the automatic wage/price linkage. However, the agreement had always entailed certain concessions to the trade unions as compensation for what they believed to be a sacrifice on their part. The present 70 per cent linkage was a better arrangement than the previous system, whereby 100 per cent of the price increases had been passed on. Against that improvement, there had been a substantial increase in the base wage to which the linkage applied. If the Government could persuade the unions to accept at least a temporary moderation of the system--it would presumably have little difficulty in so persuading the employers--the change would surely help to reduce the rate of inflation and to bring about the conditions conducive to an indexation system that would be more satisfactory to both Government and unions in the long run.

Several Executive Directors had expressed the belief that a financial program extending only through March 1977 might be inadequate to contain Israel's budget deficit and the expansion of credit, the staff representative noted. While abbreviated programs were neither a common feature of stand-by arrangements nor, perhaps, desirable per se, several precedents could be found. For example, the Romanian stand-by arrangement, which would end during the current month, covered a period of some four months, and there had been similar arrangements with Yugoslavia. The need for shorter programs had arisen because the period of the stand-by arrangement had not matched the country's budget year or, in the case of Romania, the planning year. The Israel Government had not felt that it could submit to the Fund in good faith a 1977/78 budget that had not yet been officially prepared or examined by the Knesset. In the circumstances, the staff had agreed that targets covering only a part of the stand-by period would be appropriate.

Israel would be able to draw SDR 12 million as soon as the stand-by arrangement had been approved, the staff representative added, but the balance of the requested purchase would be withheld until actual performance with regard to the 1976/77 budget and borrowing from the central bank for the remainder of the fiscal year could be assessed, and until the Fund had approved the targets for FY 1977/78. The phasing of the arrangement seemed to provide the Israel authorities with an incentive to pursue active policies of budgetary and monetary restraint throughout FY 1976/77 and to frame a budget for FY 1977/78 that would promote a continued improvement in the balance of payments and a reduction in the rate of inflation.

The targets set by the Israel authorities would not be achieved easily, the staff representative remarked. Of particular significance was the potential impact on budget expenditures of a rate of inflation that far exceeded original forecasts, as several Executive Directors had noted. But the Minister of Finance had stressed that the excess inflation would have to be absorbed by maintaining the targeted nominal expenditure and thus reducing the rate of real expenditure, even though there was great pressure both inside and outside the Government to increase expenditures.

With respect to Israel's exchange and trade system, the staff representative noted that the import surcharge had previously been as high as 35 per cent; thus, its reduction to 15 per cent in November 1974, on the occasion of a large depreciation of the Israel pound, could be taken as evidence of the authorities' genuine desire to phase out the measure. However, the Executive Directors had seemed to be saying that the existence of a nonuniform "implicit" exchange rate structure was undesirable, and the staff would certainly agree. The Israel authorities basically held the same view, but they believed that a number of special considerations made it advisable to delay the elimination of the surcharge and a corresponding adjustment in the basic exchange rate. First, a devaluation large enough to obviate the surcharge--at least 15 per cent--would add considerably to the Israel pound value of the remittances in foreign exchange that accrued to many residents of Israel. The increase in income could not be offset by taxes, however, because of an agreement to that effect between Israel and Germany, the source of a large proportion of the remittances. Similarly, a substantial depreciation would increase the Israel pound value of the large volume of foreign exchange deposits--currently amounting to some I£18 billion--in Israel's banking system. The authorities would naturally be concerned that such increases would lead to an expansion in private consumption, with a corresponding deterioration in the country's balance of payments. Moreover, depreciation would have political implications as well as direct income effects. Windfall gains by a limited section of the community would be seen as unjustified at a time when the majority of the population was being asked to shoulder a heavy burden indeed.

At the same time, the staff representative continued, a substantial depreciation of the basic exchange rate would entail higher interest and capital payments on Israel's foreign debt. Given the precarious fiscal situation, the required increase in revenues would probably be difficult to achieve. The authorities might find that the additional debt payments could be financed only by further borrowing from the Bank of Israel, clearly a development to be avoided.

In view of the welcome progress made earlier toward a unified exchange system, the authorities' return to restrictive practices was disappointing, the staff representative said. Nevertheless, the authorities stressed that the new measures were only temporary, and the Board was thus being asked to grant temporary approval. During its discussions with the Israel authorities prior to the mid-term review of the stand-by arrangement--and before requesting the approval of any extension of the restrictions--the staff would bring the various comments made by Executive Directors to the authorities' attention, and in particular Mr. Kjaer's suggestion that larger periodic depreciations could expedite the phasing out process.

Responding to a comment from Mr. Kjaer, the staff representative explained that because certain components of net domestic assets of the banking system were denominated in foreign currency--primarily U.S. dollars--for practical purposes, the credit ceilings established in connection with Israel's stand-by arrangement had been calculated on the basis of a constant exchange rate. Some of those assets and liabilities arose from government borrowing; others were related to export credits and the like. The staff considered that the use of a constant exchange rate was appropriate, and the procedure followed was in fact a modification of the one used for the most recent stand-by arrangement with Israel. The problem had been that depreciations of the Israel pound would raise the book value of public and private debt to the banking system, but no new credit would be created, as would have been the case if the banking system had issued new credit for investment, for consumption, or to finance a higher budget deficit. On one previous occasion an increase in net domestic assets as a result of depreciation had necessitated a modification of the credit ceilings.

Finally, the staff representative recalled that a number of Executive Directors had questioned the extent to which a fundamental improvement in Israel's economy--namely, an improvement in the export sector--could occur. In that connection, it was interesting to note that in the first seven months of 1976 there had been a 29 per cent increase in the SDR value of Israel's exports over the previous year, whereas a 27 per cent increase was forecast for the whole of 1976 under the financial program. It was true that a lower increase was projected for 1977, but as 1976 was only the second year of recovery in world demand, the gains made then would naturally be difficult to sustain. In addition, because of the change in the U.S. dollar/SDR rate, percentage increases for 1976 would tend to be inflated;

the rate was not expected to change in 1977, so that the percentage increase in the SDR value of an equal increase in volume would automatically be less. Taking into account the peculiar features of 1976, the data for Israel's exports did support the authorities' view that a flow of resources from the domestic sector to the export sector was gradually occurring as the authorities promoted the profitability of the export sector and dampened internal demand. On the other hand, the staff would agree that wage increases resulting from the indexation system had eliminated a large part of the additional profitability to be derived from the depreciation of the exchange rate.

The Acting Chairman noted that a staff paper on the outcome of the mid-term review of Israel's stand-by arrangement would be placed on the Board's agenda, assuming, as seemed likely, that agreement was reached between the staff and the Israel authorities.

Mr. Lieftinck thanked the Executive Directors for their observations, which would of course be relayed to the Israel authorities. He wished to provide some further perspective both for the difficulties the authorities had faced in recent years, and the progress they had made. With respect to inflation, for example, one should not forget that the rate of inflation in Israel had been 56 per cent in 1974. It had declined to 24 per cent in 1975 and risen again to 35 per cent in 1976, but a return to a lower inflation rate was expected for 1977. The upturn in the rate of inflation after 1975 had not resulted from excessive demand. It had rather been a product of cost pressures that could be attributed, at least in part, to policy measures that were in themselves commendable: changes in the tax system, including the introduction of a value added tax; the further reduction of consumer subsidies; and the small and frequent depreciations of the Israel pound. Wage increases had, of course, also contributed to the price rise.

Israel's experience illustrated a point raised at the Annual Meeting regarding the effectiveness of devaluations as a remedy for payments imbalances, Mr. Lieftinck continued. Exchange rates had to be adjusted when they became unrealistic, but the favorable effects of depreciation were much smaller in countries with open economies and wage indexation arrangements than in countries that were less open and did not use an indexation system. Depreciation should thus be accompanied by supporting policies, one of the most effective being the moderation or abolition of the indexation system. The indexing arrangements presently used in Israel were more comprehensive than they had been, but the change to a 70 per cent linkage between prices and wages was a promising feature; few governments had as yet had the courage to reduce workers' compensation for cost of living increases to 70 per cent. One might have hoped that the Israel authorities could have made more stringent changes, but the constraints on such measures had to be recognized, and the rate of inflation would gradually decline if the 70 per cent linkage were maintained.

Regarding the budgetary policies of the Israel authorities, Mr. Lieftinck remarked that there had indeed been a huge financing gap in 1975/76 as a result of a supplementary budget. On the other hand, recourse to the Bank of Israel for financing the deficit under the original budget would have been about equal to the Government's net spending abroad, so that the borrowing requirement would not have affected internal liquidity adversely, although it would have impaired the balance of payments. The authorities' intentions for the 1975/76 budget thus represented a significant effort to reduce the rate of inflation. An overflow of budgeted expenditures into the next fiscal year had the effect of reducing the actual net borrowing requirement from the Bank of Israel in 1975/76, but it meant, of course, that the net borrowing requirement would be correspondingly higher in 1976/77. Nevertheless, the financing gap would be much lower in 1976/77 than it had been the previous year, and it was not likely to be much larger than the Government's net spending abroad, so that the inflationary effects of government recourse to the central bank would be minimized.

Several Executive Directors seemed concerned that the rate of investment in Israel might have declined to such an extent that it would be inadequate to sustain the desired expansion of the export sector, Mr. Lieftinck recalled. While it was true that the rate of investment had fallen to -5 per cent in 1975, it had done so primarily as the result of a reduction in stock accumulation and a substantial decline in housing construction. In fact, investment in manufacturing industries had increased by 18 per cent in 1975, indicating that the authorities had succeeded in diverting a larger proportion of resources to immediately productive uses--mostly in the export sector--at the expense of investment in less productive and less export-oriented projects. A shift in the labor force toward export-related occupations in the private sector was also underway, as evidenced by a projected real decline in the Government's wage bill in 1976 after increases in 1974 and 1975.

The establishment of internal and external equilibrium in Israel's economy was far from complete, Mr. Lieftinck remarked. In the absence of a fundamental improvement in the external political situation, Israel could not be expected to attain self-sufficiency in its balance of payments; substantial foreign assistance would continue to be needed. All the same, some progress was apparent. There had already been an improvement in the current account balance, and there was reason to believe that further improvements would be forthcoming. Given the authorities' vigorous efforts to stimulate exports, and the importance attached to exports by the country's entrepreneurs, the rapid growth of exports was likely to continue. A concurrent rise in imports would be unavoidable--outside the agricultural sector, Israel's economy was based on the processing of imported raw materials--but the terms of trade were improving.

Finally, Mr. Lieftinck said that he agreed with the justification given by the staff representative from the European Department for the maintenance of a number of unfortunate exchange measures by Israel. The Israel authorities had cooperated with the Fund in an exemplary manner, and they were requesting an extension of the Fund's approval for the measures only on a temporary basis. He hoped that the Executive Directors, whose concerns would be transmitted to the authorities, would support the decisions proposed by the staff.

The staff representative from the European Department said that a number of technical changes should be made in the text of the proposed stand-by arrangement for Israel. In the fifth line of paragraph 3, the word "the" was to be deleted from the phrase "correspondence and visits of the officials." In subsection (ii) of paragraph 4, the second line was to end after the words "paragraph 5," the words "(a) and (b)" being deleted. In paragraph 8, the comma after the word "proposal" in the seventh line was to be deleted, and in the tenth line, the words "paragraph 7" were to be changed to "paragraph 8." Finally, "October 20" was to be inserted in the first line of paragraph 4 as the effective date of the stand-by arrangement.

The Executive Directors then turned to the proposed decisions, which they approved.

The decisions were:

a. Exchange and Trade System

The approval granted by Executive Board Decision No. 4966-(76/24), adopted February 25, 1976, of the exchange measure described in EBS/76/64 is extended until June 30, 1977. The Fund will review the surcharge on certain invisible payments and the increases in the travel tax described in EBS/76/64 on the occasion of the mid-term review under the stand-by arrangement of October 20, 1976 and in any event not later than June 30, 1977.

Decision No. 5225-(76/146), adopted
October 20, 1976

b. Stand-By Arrangement

The Government of Israel has requested a stand-by arrangement for a period of one year for the equivalent of SDR 29.25 million. The Fund approves the stand-by arrangement set out in EBS/76/442, Supplement 1, and grants any necessary waiver of the conditions of Article V, Section 3(a)(iii) of the Articles of Agreement.

Decision No. 5226-(76/146), adopted
October 20, 1976

5. ROMANIA - 1976 ARTICLE XIV CONSULTATION

The Executive Directors considered the staff report and proposed decision for the 1976 Article XIV consultation with Romania (SM/76/191, 9/3/76; and Correction 1, 9/17/76). They also had before them a report on recent economic developments in Romania (SM/76/192, 9/9/76; and Correction 1, 9/17/76).

Mr. Lieftinck made the following statement:

The performance of the Romanian economy in 1975 was again impressive, taking into account the severe impact on the economy of the floods in July and the subsequent drought in the fall of that year. The Romanian authorities, trying to reduce the setbacks brought about by the adverse weather conditions, made every effort to overshoot the targets in those economic branches that were least affected by the floods; in addition, the foreign trade plan was adjusted--leaving the overall export target unchanged--by reducing the volume of imports and increasing the volume of exports in some branches to compensate for shortfalls in other branches, whereas credit policy was tightened and budget policy slightly adjusted. In part through these measures, the volume of national income rose by nearly 10 per cent, compared with an average annual growth rate of 11.3 per cent during 1971-75. Nevertheless, growth in agricultural output (2.9 per cent) was 20 per cent below the Plan target; industrial output, however, rose 12.5 per cent and was almost in line with planned output.

The sustained and relatively high growth rate in Romania is to a large extent based on an overall growth of productivity, which in turn can be partly attributed to a shift from low productive branches of the economy (agriculture) to those of higher productivity (industry). In 1975 the number of persons employed in the industrial sector amounted to 31 per cent of the total work force, while those in the agricultural sector accounted for 38 per cent; by comparison, these shares in 1965 were 19 per cent and 57 per cent, respectively. The increase in productivity, too, reflects the high rate of realized investment, which amounted to an average annual growth rate of 11 per cent during 1971-75. In 1975 the authorities continued to give investment high priority and, although the growth of total fixed investment was 5 per cent less than originally planned, an increase of nearly 16 per cent remains, by all standards, impressive. The counterpart of the high investment rate has been for many years a high rate of domestic savings (up to 34 per cent of national income) together with a net use of foreign resources in more recent years.

The staff points out in SM/76/192 that it has been an established policy of the authorities that salary increases, in general, are in line with the growth in productivity so as to ensure that the rate of investment increases faster than the rate of final consumption. This policy has, due to high rates of productivity growth, brought about a considerable improvement in the standard of living: during the Five-Year Plan period 1970-75, real income of the population grew at an average rate of 8 per cent. For the present Five-Year Plan period this percentage is expected to drop only slightly to an average of 6-7 per cent. In addition, during this latter period a reduction from 48 to 44 hours is envisaged in the normal work week.

The resetting of producer prices, which started in 1974, was practically completed on January 1, 1976. The purpose thereof had been to reflect more fully external price developments and changes in domestic costs in delivery prices. After a virtual stability of producer prices since 1963 the result of the price resetting will be an estimated increase in the average producer price of somewhat over 3 per cent, along with a reduction in the number of enterprises suffering losses. Although the Romanian authorities recognize the desirability of a more flexible price system in order to achieve greater efficiency in allocation and use of resources, one should not conceal the fact that the socialist system of central planning prevailing in Romania puts practical limits on the extent of such price adjustments. The increase in retail prices--which were not included in the price resetting program--has been 2.6 per cent since 1970.

Despite a substantial reduction, amounting to SDR 188 million, of the current account deficit in 1975, the overall balance of payments deteriorated (to minus SDR 55 million), owing to a decrease in net capital inflow of SDR 238 million. Bearing in mind that the July floods reduced export supplies by an estimated SDR 500 million, the improvement of the trade account is quite remarkable. The decline in capital inflow in 1975, after very high levels in the two preceding years, reflected the policy of the authorities aimed at avoidance of a too burdensome foreign debt position in future years. Gross foreign borrowing was reduced substantially, while at the same time credit extended by Romania to finance exports of capital equipment showed a strong increase. With the intention to diversify markets, these foreign credits are mainly credits to developing countries. Consequently, the share of exports to developing countries rose from 15 per cent of total exports in 1974 to 19 per cent in 1975, whereas the longer term objective is to raise this share to 30 per cent by 1980.

The improvement in the convertible trade and current account balance is expected to continue. A trade surplus of SDR 134.5 million is forecast for 1976, as compared with a deficit of SDR 91.4 million in 1975. Since the deterioration of the current account in all currencies that is forecast for this year is to be attributed to a large extent to a deliberate attempt of the authorities to run down bilateral balances, there is little reason to consider this deficit as worrisome. This will hold as well for the rather sharp increase in the total deficit to SDR 242 million in 1976, bearing in mind that the increase in export related capital outflow should be considered necessary and temporary in nature.

The 1975 budget ended up with a small surplus of about 0.5 per cent of national income. Although law requires that the state budget--comprising both the republican and local budgets--shall always be in balance, in practice the budget regularly turns out to be in surplus. This, however, is mainly due to a less than complete depletion of the reserve fund; moreover, expenditure for investment often falls short of the rather ambitious targets. For these reasons one may consider this an institutional peculiarity rather than a matter of substance. Expenditure of the state budget rose by 14 per cent in 1975, compared with 23 per cent in 1974. A deceleration to 9 per cent is projected for 1976, reflecting the intention of having enterprises provide for a larger proportion of their own resources.

The interest rate in Romania cannot be considered as a yardstick for risk or for the scarcity of liquidity at a particular moment. The use of credit policy is therefore employed directly to improve the efficiency of financial operations--viz., through withholding of credit or by imposing interest penalties--instead of indirectly via the interest rate mechanism.

The expansion of short-term bank credit in 1975, by 9.6 per cent, was considerably less than the originally planned increase of 14.7 per cent. This can be attributed to a successful policy to cut down on stocks and to a smaller than expected demand for credit to finance agricultural output and exports. The pace of credit expansion is forecast to accelerate in 1976 in accordance with a more normal agricultural output, a near doubling of the export growth rate and a lesser impact of the tight credit policy regarding stocks.

On October 3, 1975, a stand-by arrangement for SDR 95 million was approved by the Executive Board. Since then Romania has purchased the total amount under this arrangement. It is evident from Table 5 in SM/76/191 that so far actual developments have amply met the performance criteria under the stand-by arrangement, aiming at reducing the trade deficit in convertible currencies and at consequential changes in the growth of short-term credit.

Finally, I should thank the staff for its excellent report, which provides a clear picture of the economic situation as well as useful information about the characteristics of the economic system in Romania. The aforementioned increase in real income of 6-7 per cent, envisaged for the Five-Year Plan period ending in 1980, is in itself enviable; although this target is ambitious, the Romanian authorities are determined to make every effort themselves--in addition to the financial assistance from the Fund--to reach it.

Mr. Yaméogo observed that Romania used a different accounting system from the capitalist countries that comprised most of the Fund's membership, making it somewhat difficult to compare economic data on Romania with those for other members. Nevertheless, there seemed to be a striking contrast with respect to consumption and investment. According to Chart 2 of the report on recent economic developments--"Main Uses of National Income 1961-80"--about one third of Romania's national income was devoted to investment, a much higher proportion than in capitalist countries. A greater emphasis on consumption might be desirable, so as to enhance the potential contribution of the domestic sector of the Romanian economy to overall expansion and development. As the staff had said, improvements were clearly needed in the pricing system, but a resetting of prices without a change in the pattern of consumption and investment might not be conducive to a better allocation of resources and a closer linkage between the Romanian economy and the rest of the world. Romania presumably saw in its Fund membership benefits that COMECON could not provide, and the Fund might well help Romania to develop more effective links with the international economy and gain the full fruits of its cooperation with the Fund.

The socialist sector of the Romanian economy absorbed 95 per cent of total investment, Mr. Yaméogo added, while investment in the private sector accounted for only 5 per cent of the total. In that connection, he wondered what incentives were available to the private sector, since the primary incentives in a capitalist system--personal preference, profits, supply and demand considerations and pricing--would not apply in a centrally planned economy.

Mr. Wahl remarked that the major economic problem facing Romania was not to reduce pressures on prices--a critical objective for most members of the Fund--but rather to promote price adjustments, including price increases when and where those were needed to prevent the misallocation of resources that could occur despite the existence of a comprehensive planning system.

The authorities had taken adequate steps in that direction since 1974, but the resetting of prices should be a continuing process rather than a "once and for all" operation. That the resetting of producer prices had led to retail price increases of less than 1 per cent per year would suggest that the authorities had succeeded in aligning wages and salaries with gains and productivity, and in maintaining a broad equilibrium among various sectors of the economy.

The growth performance of the Romanian economy in 1975 was particularly impressive, Mr. Wahl said, especially in view of the unavoidable setbacks in agriculture caused by floods. The relatively high level of investment, appropriately financed through domestic savings, would help to sustain a high rate of growth in future, since the shift in manpower from agriculture to industry was likely to decelerate. Adequate labor would, of course, be critical to the achievement of targets for agricultural output in the remaining period of the Five-Year Plan.

The Romanian authorities were to be commended for their achievements with respect to the balance of payments in 1975, Mr. Wahl said, and for the favorable performance expected for 1976. The policy of expanding exports of capital goods to developing countries at the cost of a rapid rise in export credits should perhaps be moderated, however; the difference between the cost of production of an export item and the combined cost of providing both that item and the export credit attached to it might produce distortions. Moreover, in a centrally planned economy, the absence of market mechanisms linking the productive sector and the banking sector meant that such distortions were unlikely to be self-correcting. As to other external policies, the voluntary reduction of the growth of Romania's foreign debt burden would no doubt help to preserve the country's international creditworthiness.

Mr. Lynch commented that Romanian economic performance was impressive in many ways. The country's growth rate had averaged 11.3 per cent annually from 1971 to 1975. Both domestic savings and investment had been as high as 34 per cent of national income in 1975; productivity had grown; and industry had been expanding satisfactorily.

On ther other hand, Mr. Lynch remarked, the pricing system was a major weakness in the Romanian economy. Although there had been some adjustment of producer prices, a wide gap remained between domestic and world market prices, necessitating an equalization system for trade transactions. The authorities' concern with domestic price stability could be appreciated, but even a centrally planned economy would be subject to distortions in its price structure if domestic prices were held constant over a long period. If a misallocation of resources was to be avoided, the Romanian authorities would have to bear in mind that stability in world market prices, which would clearly make the problem less serious, was only a remote possibility in existing circumstances.

Mr. Laske observed that Romania had achieved a high rate of growth in 1975, making possible a further improvement in the living standard of the country's population, even though agricultural production had suffered as a result of adverse weather conditions. The progress of the Romanian economy was largely attributable to the channeling of a high proportion of national income to investment. It had to be recognized, however, that at the outset the level of development had been low, so that the gains made might be less impressive in absolute terms than the percentages would suggest. After a period of remarkable economic growth, the Romanian standard of living still ranked at the lower end of the COMECON scale.

The strengthening of Romania's balance of payments situation--which, as Mr. Lieftinck had said, remained precarious--would depend on an expansion of trade with the convertible currency area, Mr. Laske considered. He wondered whether projections of a sharp improvement in external performance, including the emergence of a trade surplus, were not based on over-optimistic assumptions about agricultural production and exports. Romania's overall balance of payments in convertible currencies was expected to deteriorate as borrowing in international markets declined to the extent that a net capital outflow occurred. His authorities had been told that delays in payments to foreign suppliers were becoming more frequent, and Romania's credit standing had evidently been impaired. There had even been reports that the country had been unable to obtain a medium-term loan in the Euro-currency market. Given, on the one hand, Romania's ambitious development plans, and on the other its high external debt and low monetary reserves, a vigorous effort to expand exports against convertible currencies was imperative.

A further adjustment in Romanian pricing policies, both domestic and external, would facilitate an increase in exports, Mr. Laske continued. While he realized that the authorities were encountering certain structural difficulties, he would nevertheless urge them to institute as wide a price reform as the system would permit. In that connection, it would be useful to know the extent to which Romania paid subsidies in local currency for exports, a common practice in other COMECON countries, where the relationship between foreign exchange and local currency was such that the proceeds from foreign sales did not cover costs.

Mr. Cross said that the continued expansion of the Romanian economy despite problems in the agricultural sector was encouraging. In view of the policies that Romania had pursued under its one-year stand-by arrangement, however, the projected worsening in the balance of payments deficit in 1976 as compared with 1975 was of some concern. The deterioration was due in part to a desirable reduction in foreign borrowing and a lower net capital inflow; nevertheless, greater efforts to expand exports would appear to be needed. More flexible pricing policies would clearly facilitate the expansion of exports, as other Executive Directors had already said. In addition, the authorities might well consider establishing more flexible monetary and fiscal targets for those areas where higher import costs might prevent the realization of predetermined objectives.

The consultation mission had obtained much valuable information about the Romanian economy, Mr. Cross added, but an annual exercise could not fully substitute for the regular submission of data. There was still no information on Romania in International Financial Statistics, and it would be useful to have some comment from the staff on the prospects for a better flow of adequate and timely data from the country. The availability of data would become more and more important as the Fund's surveillance function was strengthened. The arrangements presently followed by Romania were unsatisfactory, and an effort should be made to remedy the problem.

Mr. Kent, who supported the proposed decision, stated that he concurred in the staff's analysis of the Romanian economy. Considering the adverse weather conditions that had prevailed in recent months, the country's growth performance was commendable. It was particularly encouraging to note that the current account position in convertible currency had not been unduly impaired by the effects of floods. The SDR 134.5 million surplus forecast for the convertible trade account in 1976 would seem to be attainable, if optimistic.

Associating himself with remarks by other Executive Directors, Mr. Kent commented that Romanian pricing policies needed to be more flexible. While Mr. Lieftinck had alluded to a philosophical difference in the role assigned to pricing in socialist and capitalist systems, the Romanians themselves, at the Berlin meeting of COMECON, had recognized the usefulness of the price mechanism as a means of assessing the adjustment process. Under the legislation for the 1976-80 Five-Year Plan, a further resetting of prices was to take place on January 1, 1977, although the nature of the change was as yet unknown. As Mr. Wahl had said, however, price adjustment should be an ongoing process, and he hoped that the authorities would take heed of the Executive Board's support for the trend toward greater flexibility, reflected in the new Five-Year Plan.

According to Mr. Lieftinck, Mr. Kent noted, the Romanian authorities hoped to raise the share of exports to developing countries to 30 per cent of total exports by 1980; on the other hand, the growth of exports to developing countries in 1975 had been associated with an increase in export credits. It seemed difficult to reconcile those statements with Mr. Lieftinck's subsequent comment that the increase in export-related capital outflows should be regarded as both necessary and temporary in nature. The possibility of a rapid rise in export credits without compensatory capital inflows or export earnings was a cause for concern.

Mr. Temple-Seminario observed that there were several favorable aspects of recent economic performance in Romania: the high growth rate; the high rate of domestic savings and of investment; and the alignment of wages and salaries with productivity. Like Mr. Wahl, however, he was concerned that the use of rigid price controls might lead to distortions between producer prices and retail prices, a problem that would become more serious over time.

It was disturbing to learn from Mr. Laske that payments to Romania's foreign suppliers were being delayed, Mr. Temple-Seminario said, and it would be useful to have further comments from the staff on that point. He also wondered whether the staff would consider the authorities' projections for agricultural growth in 1976 to be realistic, considering the performance of the agricultural sector during the previous three years.

Mr. Deane commented that he was encouraged by the progress of the Romanian economy. As Mr. Lieftinck had suggested, however, the fundamental differences between a socialist system and other economic systems could not be ignored. A centrally planned economy should be judged on its own merits, not from the perspective of a commitment to the tenets of free enterprise. The staff was to be commended for its clear and evenhanded explanation of the way that an economy like Romania's operated, and of the difficulties in analyzing the problems of such an economy. He hoped that other papers of the same quality would be forthcoming, so that the Board's appraisals of centrally planned economies might rest on a better understanding of those economies.

The staff had said that complete stability in prices for as long as a decade was likely to lead to distortions that might become apparent only after a lag, Mr. Deane remarked. The question then arose of how such distortions could be identified in an economy like Romania's. It would be useful to have a more detailed analysis of that problem in relevant consultation papers in future.

Mr. Kjaer commented that it was difficult to identify imbalances and distortions in the Romanian economy--and thus to appraise the country's performance--because the institutional basis of the Romanian economy differed so greatly from the arrangements commonly applied by the Fund's other members, with which the Board was more familiar. Nevertheless, three positive features emerged clearly from the staff's report. First, Romania had been able to achieve a high and stable growth rate over a long period, although at the stage of development that Romania had reached, the main factor in growth was, of course, the movement of labor from agriculture--a low productivity sector--into the modern sectors of the economy. A second feature meriting attention was the remarkable stability of prices, again over a number of years. Finally, the equally remarkable fiscal orthodoxy practiced by the Romanian authorities might be mentioned. One might well wonder whether the latter two aspects of the economy were related, but it had to be recognized that the functioning of the price system differed greatly between Romania and the capitalist countries.

Regarding the national accounting system in Romania, Mr. Kjaer noted that services were not included in the calculation of national income. The omission partly reflected certain fundamental principles of Marxist economics, of course, but he nevertheless wondered whether such a convention was the most appropriate or useful basis for the analysis and guidance of a centrally planned economy.

In several eastern European countries, Mr. Kjaer remarked, interest-bearing financial instruments were being made available to private enterprises as a means of absorbing temporary surpluses of liquid funds. The experiment would seem to be useful, since there might otherwise be a strong temptation for businesses to build up unnecessary stocks of raw materials. It would be interesting to know whether the Romanian authorities had considered introducing such instruments.

Finally, Mr. Kjaer said that Table 26 of the report on recent economic developments--"Resources of the Banking System"--was unclear to him. He supposed that the table was meant to show the assets of the banking system, but some of the items appeared to represent liabilities instead. Moreover, the table contained percentages alone, and he wondered whether a technical imperfection had prevented the use of absolute amounts or whether the Romanian authorities had not wished to disclose them for reasons of discretion.

Mr. Caranicas remarked that the staff had provided ample evidence of the remarkable progress of the Romanian economy during the past three years, notwithstanding the poor performance of the agricultural sector. On the other hand, the staff had not sufficiently analyzed the distortions produced by artificial price stability, owing perhaps to the scarcity of statistics about the Romanian economy or to an incomplete explanation from the authorities. In that connection, it was instructive to note that the authorities were only contemplating a reduction in the work week from 48 hours to 44 hours at some time in the future; the persistence of a 48 hour work week, with wages linked to productivity--an arrangement hardly acceptable in many countries--might be taken as a measure of the price paid for progress in a centrally planned economy.

The staff representative from the European Department, responding to comments by a number of Executive Directors about the Romanian pricing system, remarked that the problem confronting the authorities was not so much a theoretical one--that completely stable prices would necessarily produce distortions--as a practical one. As long as the pricing system remained rigid, the planners had to have very detailed information about the production of goods, the distribution of investment resources, the composition of domestic consumption and of exports, all in physical terms.

The more that prices could be used as an aid in planning, the more rational would be the central plans drawn up each year, as well as the Five-Year Plan. The authorities were convinced, however, that rapidly fluctuating prices were undesirable per se, and they would no doubt maintain that the free market system produced random fluctuations that did not reflect underlying scarcities or the productivity of the resources used.

The Romanian authorities had evidently come to realize that the most effective pricing policy would lie between the extremes, the staff representative continued. In 1974, they had introduced a price reform that extended over a period of almost three years, and they had also taken a decision to relax in future the rigid system of wholesale pricing that had prevailed for more than ten years. It seemed probable that they would maintain more flexible policies in both the domestic and foreign sectors, the latter encompassing western as well as intra-COMECON trade. As Mr. Lieftinck had said, however, a more flexible approach to prices could not be equated with an adjustment to month-to-month and day-to-day movements in world market prices, particularly if those appeared to result from temporary shifts in supply and demand conditions.

Even in a market economy, the staff representative added, prices did not fully reflect supply and demand and the marginal utility of resources. Many instances of government intervention in the price field--both direct and indirect--could be identified; among them were food subsidies, import duties, and various taxes. While there were fundamental differences between centrally planned economies and market economies, they were perhaps less pervasive in either system than one would tend to think.

The relationship between the pricing system and distortions in the Romanian economy was problematic, the staff representative remarked. There were patent distortions in the agricultural sector, where the underfulfillment of targets had been common. The low prices paid for agricultural products might have been one factor, but there were surely others as well. More generally, it would be reasonable to say that distortions had indeed arisen in the development of the Romanian economy, and that they were attributable in part to the high degree of price stability and its effect on foreign trade prices. At the stage of development that Romania had reached, existing distortions might not yet be extreme, but they were increasing. In the staff's view, the importance of the pricing system as a basis for sound economic decisions would inevitably be magnified as the economy became larger and more sophisticated, aggravating the burden borne by what might be called the "physical planner." To the extent that its price system did not reflect scarcities and productivities, a country faced greater risks of a misallocation of resources in future; like their counterparts in other eastern European countries, the Romanian authorities were more and more mindful of that problem.

Responding to a question from Mr. Yaméogo, the staff representative said that the essence of the Romanian development strategy was an emphasis on investment over consumption in the distribution of present output so that future consumption might be maximized. At the same time, as Mr. Lieftinck had noted, it had proved possible to secure a substantial improvement in the standard of living, even though real income had grown more slowly than total production.

A number of Executive Directors had commented upon the hazards of granting export credits, the staff representative recalled. The Romanian authorities believed that the external sector could no longer rely on exports of agricultural commodities, other raw materials and semifinished products if a viable balance of payments position was to be sustained. In their view, the future lay in a more sophisticated and specialized export trade, and in particular in the development of the country's capital goods industries. At present, however, there was strong competition in the capital goods field, and the use of export credits was almost universal in sales to developing and developed countries alike. The Romanian authorities considered the increased capital outflow that accompanied the use of export credits to be a temporary phenomenon in the sense that the rate of increase was likely to diminish as the repayment of credits reduced the outflow of capital in net terms.

Responding to comments by Mr. Laske and Mr. Temple-Seminario, the staff representative observed that the question of delays in payments for imports had been raised with the Romanian authorities--particularly at the Romanian Bank of Foreign Trade--during the consultation discussions. According to the authorities, neither the National Bank nor the Bank for Foreign Trade had ever withheld allocations of convertible foreign exchange from those enterprises entitled to it. They had attributed the reported delays to misunderstandings about allocation procedures, to premature transactions by enterprises that had not received proper authorization, and finally to lags in completing paperwork both in the exporting countries and in Romania itself. The authorities were well aware that the problem could--and almost certainly would--have serious consequences for Romania's credit standing in world capital markets, and they had a firm policy of discouraging delays in import payments.

As to the role of subsidies in the Romanian export system--a question raised by Mr. Laske--the staff representative remarked that, under the price equalization system, exporters received a kind of subsidy when the domestic price exceeded the foreign price at the nominal exchange rate of lei 20 per US dollar, but they paid a tax, in effect, when the reverse applied. The same would be true for importers of raw materials and certain minor producer goods. While the data available to the staff on the rate structure of exports and imports were incomplete, there was no evidence of an absolute subsidy for exports. The equalization system produced a spectrum of actual exchange rates, but the average fell just below the standard rate of lei 20 per U.S. dollar, so that the "tax" elements evidently counterbalanced the "subsidies." The low level of net payments from the equalization fund would support the same conclusion.

Regarding the flow of information from Romania, the staff representative observed that a much smaller volume of data was published in Romania than in most other eastern European countries. Data were published only on an annual basis, often after a long delay, and rarely in those areas of particular interest to the Fund, i.e., monetary developments and the balance of payments. Moreover, the disclosure of unpublished information to any outside source was a crime under law. Those factors did create some difficulties between the Fund and the authorities. To the authorities' credit, a comparison of the information available at the time of Romania's application for membership in the Fund with that contained in the present consultation documents would show an enormous increase in data supplied to the Fund. Nevertheless, the staff would in no way condone the continued absence of Romanian data from International Financial Statistics, and it would certainly hope that information would be supplied to the Fund on a more frequent basis than was the case at present. The staff would continue its discussions with the Romanian authorities, conveying to them the views of the Executive Board, with the hope that further progress could be expedited.

Responding to Mr. Temple-Seminario's question about forecasts for agricultural production in 1976, the staff representative noted that the Romanian authorities were always ambitious in setting their targets, but that their expectations for the agricultural sector might be unrealistic. The Plan called for an increase in output of between 15.4 per cent and 27.1 per cent. The upper limit was based on the assumption that extraordinarily good weather in 1976 would make possible a large increase over the very low level of actual output in 1975. It was clear from the reports available to the staff, however, that the weather had proved less favorable than the upper target implied, and there was no chance whatsoever that the upper target would be met. The lower target, on the other hand, was thought to be attainable under normal weather conditions, and the newspapers reported that the season had been somewhat mixed but on the whole reasonable. Thus, there was a fair chance that production would approach the lower target. In any event, the staff's information was limited to newspaper reports, and it had to be remembered that some crops had not yet been harvested.

Answering a comment from Mr. Kjaer, the staff representative confirmed that the Romanian concept of output excluded many items that would be included under the national accounting system of the United Nations. The Romanian authorities had taken some steps to reconcile their own system with the United Nations standards, and they had provided the consultation mission with some data that could be compared with that of other countries on the basis of the United Nations system. However, the staff would need to resolve a number of questions raised by that data before making an authoritative assessment of the reconciliation. The United Nations system would seem to be a more logical one, and its use by the Romanians would certainly simplify the staff's analysis. On the other hand, it had to be recognized that the Romanian system was based on fundamental Marxist theories, and the staff's analysis could perhaps be adjusted to any method to the extent that the concepts were clearly defined, and their strengths and shortcomings known.

There had also been a question from Mr. Kjaer about the Romanian financial system, the staff representative recalled. To his knowledge, the authorities had not considered introducing interest-bearing financial assets as an incentive to enterprises to invest in such assets rather than spend their excess financial resources. They would probably argue that in theory those enterprises should not have excess funds, for which the Plan made no provision. In practice, the intensification of controls over the movement of funds and the flow of goods served as an incentive to produce, sell, pay and be paid according to the Plan, so that a relatively small amount of liquid funds would be available for any length of time.

Table 26 in the report on recent economic developments--"Resources of the Banking System"--in fact showed the liabilities of the banking system, the staff representative remarked; the staff had simply used the title provided by the Romanian authorities. Why the authorities had supplied percentages rather than absolute amounts was not clear.

In response to a question from Mr. Yaméogo, the staff representative commented that the basic incentives in the Romanian economy lay in the country's political and social system. The Romanian system was based not on the profit and loss considerations that would be paramount in a market economy but rather on decisions by the central authorities about the best means of encouraging economic growth and maximizing the standard of living of the population in the long run. The intricate mechanisms established by the authorities did provide some incentives. If production exceeded targets under the Plan, for example, enterprises would be able to offer wage increases to their workers, whereas those enterprises whose performance did not meet the requirements of the Plan might well have limited scope for wage adjustments. In connection with export and import targets, there were financial inventives--much the same as those found in a market economy--to maximize what in effect were profits.

Mr. Lieftinck said that he agreed with the staff representative's comments about incentives in the Romanian economy. In addition to the social and political system itself, however, the improvement in the standard of living which resulted from the Government's policies provided another very important incentive. During the period 1970-75, the real income of the population had increased by an average of 8 per cent annually with only minor fluctuations in the trend, an achievement few capitalist countries could match. There would thus seem to be reason for the population to be satisfied. It was perhaps true that people would work less hard and receive better compensation in a free economy, but the overall performance of the Romanian economy could bear almost any comparison.

The Central Plans provided adequate incentives for the reallocation of resources, Mr. Lieftinck continued. After all, no system could achieve the theoretical optimum of resource allocation, and, as the staff representative had said, even the so-called free economies were not entirely free. The Romanian authorities' emphasis on increasing labor productivity by directing labor from less productive to more productive sectors, and on fully utilizing the country's available natural resources, had led to impressive growth in such industries as petrochemicals, related chemicals, steel and other metals, thereby laying the groundwork for further expansion in the capital goods industries. Had the highly productive sectors received less attention, a rapid and substantial improvement in the standard of living might not have been possible. While investment had taken a higher priority than consumption, the increase in consumption in Romania nevertheless compared favorably with the experience of other countries.

Administered prices were common in so-called free economies, Mr. Lieftinck noted, although not to the same extent as in a centrally planned economy, and tariffs were widely applied to the import and export sectors. To take an extreme example, the European Common Market employed a price equalizations system that in no way accorded with free market principles, nor did it differ fundamentally from the Romanian system. Even in Romania, the equalization of import prices applied only to those sectors where foreign supply competed with domestic supply; imports of capital goods and consumer goods, which normally had no domestic equivalents, were not covered.

There was a certain degree of flexibility in Romanian pricing policies, Mr. Lieftinck observed. In 1974, the authorities had introduced a three-year program, now completed, of readjustments that they had deemed to be required; they were able to bring about a more realistic price structure with a very limited rise in the overall price level. A commitment to price stability was inherent in the central planning system, particularly in connection with Romania's trade relations with the other COMECON countries. Planning was directed toward ensuring a steady flow of goods between Romania and its partners on the basis of long-term contracts. Thus, price flexibility in intra-COMECON trade was minimal, and that had its consequences for pricing policies with respect to the convertible currency sector as well.

The shift in Romanian exports from COMECON markets to western European and other world markets was a major achievement, Mr. Lieftinck remarked. In 1975, many Executive Directors had doubted whether it would take place, but in fact there had been a rapid improvement in Romania's current account balance in convertible currencies. The overall balance of payments deficit expected for 1976 would largely be due to movements in the capital account, mainly a decline in capital inflows and an increase in capital outflows to finance exports to developing countries. The authorities did not consider the balance of payments situation to be unduly disturbing at present. The impact of poor agricultural performance in 1975 had yet to be absorbed, but bilateral balances with eastern European countries would be reduced while convertible reserves would rise.

The Romanian authorities were by no means resigned to the persistence of an overall balance of payments deficit, Mr. Lieftinck said. Under the Plan, the trade balance was expected to improve to the extent that equilibrium could be reached despite a reduction in capital inflows. The absolute increase in export-related capital outflows was expected to be temporary, as the staff representative had said. Even more important, projections of a substantial increase in short-term capital inflows meant that the net outflow of capital was likely to be temporary as well.

The Executive Directors then turned to the proposed decision, which they approved.

The decision was:

1. This decision is taken by the Executive Directors in concluding the 1976 Article XIV consultation with Romania pursuant to Article XIV, Section 4 of the Articles of Agreement.

2. The Romanian economy continued to grow strongly in 1975. The growth of agriculture was affected, however, by bad weather. This, together with the world recession sharply reduced the growth of exports, especially those paid for in convertible currencies. The Central National Plan, fiscal, monetary, and other policies have been adjusted to reverse the deficit on goods and services account in convertible currencies through an increase in exports paid for in convertible currencies and a surplus is planned for 1976.

3. The trade and payments system is complex. Domestic price and custom tariff policies were intended, inter alia, to assist in a simplification of the exchange rate structure for foreign trade, but the wide fluctuations in world market prices have reduced the favorable effect of these policies on the exchange rate structure. A more flexible price policy, taking account of developments in world prices, should, however, assist the simplification of the

exchange rate structure. The Fund welcomes the continued policy of terminating bilateral payments agreements with Fund members.

Decision No. 5227-(76/146), adopted
October 20, 1976

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Directors without meeting in the period between EBM/76/145 (9/24/76) and EBM/76/146 (10/20/76).

6. MEXICO - GOLD TRANCHE PURCHASE TRANSACTION

Mexico is making a gold tranche purchase in an amount equivalent to SDR 97,771,179 in the equivalents of SDR 20,771,179 in Canadian dollars, SDR 10 million in Japanese yen, SDR 10 million in Netherlands guilders and SDR 57 million in U.S. dollars pursuant to its request dated September 28, 1976. The Fund notes Mexico's request, including its representation in accordance with Article V, Section 3(a)(i), and its statement that it will comply with the principles set forth in Executive Board Decision No. 102-(52/11), adopted February 13, 1952 (EBS/76/432, 9/28/76).

Decision No. 5228-(76/146), adopted
September 28, 1976

7. ECUADOR - GOLD TRANCHE PURCHASE TRANSACTION

Ecuador is making a gold tranche purchase in the equivalents of SDR 5,556,969 in Belgian francs, SDR 4 million in Irish pounds, and SDR 8 million in U.S. dollars pursuant to its request dated October 11, 1976. The Fund notes Ecuador's request, including its representation in accordance with Article V, Section 3(a)(i), and its statement that it will comply with the principles set forth in Executive Board Decision No. 102-(52/11), adopted February 13, 1952 (EBS/76/435, 10/13/76).

Decision No. 5229-(76/146), adopted
October 13, 1976

8. SOCIALIST REPUBLIC OF VIET NAM - GOLD TRANCHE PURCHASE TRANSACTION

The Government of the Socialist Republic of Viet Nam has submitted a request to purchase the equivalents of SDR 5,000,000 in French francs, SDR 5,000,000 in Deutsche mark, and SDR 5,500,004 in Japanese yen, totaling the equivalent of SDR 15,500,004. The Fund determines that the Socialist Republic of Viet Nam is entitled to make the purchase and notes the statement of the Government of the Socialist Republic of Viet Nam that it will comply with the principles set forth in Executive Board Decision No. 102-(52/11), adopted February 13, 1952 (EBS/76/430, 9/24/76).

Decision No. 5230-(76/146), adopted
September 27, 1976

9. BANGLADESH - REPURCHASE AND VOLUNTARY REPURCHASE

a. Repurchase

Bangladesh has proposed that repurchase in respect of gold tranche purchases equivalent to SDR 156,116 and SDR 302,475 on May 31, 1973 and August 23, 1973, respectively, be made not later than September 30, 1976 by paying Japanese yen. The Fund agrees to the proposal of Bangladesh (EBS/76/428, 9/23/76).

Decision No. 5231-(76/146), adopted
September 27, 1976

b. Voluntary Repurchase

The Fund accepts the offer of Bangladesh to repurchase an amount of the Fund's holdings of Bangladesh taka equivalent to SDR 1,261,367 by paying Japanese yen. The repurchase relates to gold tranche purchases equivalent to SDR 303,003, SDR 304,409, SDR 26,512 and SDR 627,443 on November 27, 1973, February 27, 1974, May 24, 1974 and June 7, 1974, respectively (EBS/76/428, 9/23/76).

Decision No. 5232-(76/146), adopted
September 27, 1976

10. KOREA - POSTPONEMENT OF REPURCHASE OBLIGATION

1. Korea incurred a repurchase obligation under Article V, Section 7(b) of the Fund Agreement as of April 30, 1976 equivalent

to SDR 93,288,000 (EBS/76/408, September 14, 1976), of which the equivalent of SDR 20,000,000 is payable forthwith. This amount includes the equivalent of SDR 280,000 accrued in gold.

2. In a cable of September 6, 1976, Korea has proposed that, in present circumstances, the discharge of the part equivalent to SDR 280,000 of the repurchase obligation payable forthwith in gold be postponed. Korea has also indicated its intention to repurchase with special drawing rights an equivalent amount of the Fund's holdings of Korean won.

3. The Fund notes the intention of Korea referred to in paragraph 2 above and permits postponement of the discharge of the repurchase obligation equivalent to SDR 280,000 which is payable forthwith in gold, subject to review not later than December 31, 1977 (EBS/76/421, 9/22/76).

Decision No. 5233-(76/146), adopted
September 24, 1976

11. LAO PEOPLE'S DEMOCRATIC REPUBLIC - NEW MONETARY UNIT AND REPRESENTATIVE RATE FOR KIP OF LIBERATION

a. New Monetary Unit

The Lao People's Democratic Republic has notified the Fund that, effective June 15, 1976, a new monetary unit called the kip of liberation came into effect replacing the Lao kip at the rate of 1 kip of liberation per 20 Lao kips, and has proposed that the Fund's holdings of Lao kips be replaced by the new currency. The Fund agrees to this proposal (EBD/76/210, 10/15/76).

Decision No. 5234-(76/146), adopted
October 19, 1976

b. Representative Rate for Kip of Liberation

The Fund finds, after consultation with the authorities of the Lao People's Democratic Republic, that the representative exchange rate for the kip of liberation under Rule O-3, paragraph (c)(i), against the U.S. dollar is the official exchange rate of the Banque Nationale du Laos for spot delivery of U.S. dollars. Banque Nationale du Laos will immediately communicate to the Fund any change in the representative rate when it occurs (EBD/76/210, 10/15/76).

Decision No. 5235-(76/146) S, adopted
October 19, 1976

12. CHAD - TECHNICAL ASSISTANCE

In response to a request from the Chadian authorities for technical assistance, the Executive Board approves the proposal set forth in EBD/76/192 (9/21/76).

Adopted September 24, 1976

13. EAST CARIBBEAN CURRENCY AUTHORITY - TECHNICAL ASSISTANCE

In response to a request from the East Caribbean Currency Authority for technical assistance, the Executive Board approves the proposal set forth in EBD/76/194 (9/21/76).

Adopted September 24, 1976

14. CENTRAL BANK TECHNICIANS OF AMERICAN CONTINENT - XIII MEETING - FUND REPRESENTATION

The Executive Board approves Fund representation at the XIII Meeting of Central Bank Technicians of the American Continent to be held in Ottawa as set forth in EBD/76/196 (9/23/76).

Adopted September 27, 1976

15. INTERNATIONAL SYMPOSIUM ON SAVINGS - FUND REPRESENTATION

The Executive Board approves Fund representation at the International Symposium on Savings to be held in Kingston as set forth in EBD/76/197 (9/23/76).

Adopted September 27, 1976

16. RELATIONS WITH GATT - CONSULTATIONS WITH CONTRACTING PARTIES - FUND GUIDANCE

The Executive Board approves the recommendations of the Committee on Liaison with the CONTRACTING PARTIES to the GATT regarding the forthcoming consultation in connection with the Italian import deposit requirement as set forth in EBD/76/204, (10/12/76).

Decision No. 5236-(76/146), adopted October 15, 1976

17. RELATIONS WITH GATT - CONSULTATIONS WITH CONTRACTING PARTIES - FUND REPRESENTATION

The Fund approves the recommendations regarding the forthcoming consultations and Fund representation as set forth in EBD/76/206 (10/13/76).

Adopted October 18, 1976

18. STAFF STUDY PROGRAMS - REPORT AND RECOMMENDATIONS

The Executive Board approves the report of the Committee on Administrative Policies regarding staff study programs as set forth in EBAP/76/235 (9/23/76).

Adopted September 27, 1976

19. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/76/236 (9/24/76) and EBAP/76/238 (10/5/76) is approved.

APPROVED BY THE EXECUTIVE BOARD:
Meeting 77/28, March 2, 1977

H. JOHANNES WITTEVEEN
Chairman

W. LAWRENCE HEBBARD
Secretary