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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/44

10:00 a.m., March 12, 1986

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
	Mawakani Samba
	M. K. Bush
J. de Groote	
	M. Arif, Temporary
H. Fujino	
	B. Goos
Huang F.	
	Z. b. Ismail, Temporary
	J. R. N. Almeida, Temporary
	M. Foot
	H. Fugmann
	G. D. Hodgson, Temporary
E. I. M. Mtei	A. Abdallah
	C. A. Salinas, Temporary
	S. Geadah, Temporary
	J. de la Herrân, Temporary
	S. de Forges
J. J. Polak	J. de Beaufort Wijnholds
	H.-S. Lee, Temporary
	B. Tamami, Temporary
	A. S. Jayawardena
S. Zecchini	

L. Van Houtven, Secretary
J. K. Bungay, Assistant

Also Present

IBRD: R. M. Fernandes, Europe, Middle East and North Africa Regional Office. European Department: L. A. Whittome, Counsellor and Director; N. L. Happe, H. B. Junz, L. G. Manison, H. O. Schmitt, G. Szapary, G. S. Tavlas. Exchange and Trade Relations Department: G. Belanger, J. T. Boorman, J. O. Bonvicini, L. Hansen, W. S. Tseng, E. J. Zervoudakis. Legal Department: F. P. Gianviti, Director; A. O. Liuksila, R. Münzberg. Research Department: T. A. Wolf. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: W.-R. Bengs, S. M. Hassan, G. Nguyen, J.-C. Obame, I. Puro, D. C. Templeman, A. Vasudevan. Assistants to Executive Directors: B. Bogdanovic, G. Ercel, R. Fox, S. King, H. Kobayashi, R. Msadek, J. Reddy, J. E. Rodríguez, L. Tornetta, H. van der Burg.

1. YUGOSLAVIA - 1985 ARTICLE IV CONSULTATION; STAND-BY ARRANGEMENT - REVIEW AND MODIFICATION OF PERFORMANCE CRITERIA; AND REQUEST FOR ENHANCED SURVEILLANCE

The Executive Directors considered the staff report for the 1985 Article IV consultation with Yugoslavia and the review under the stand-by arrangement with Yugoslavia, together with a request for a waiver of performance criteria and Yugoslavia's request for enhanced surveillance for the period May 16, 1986 through the end of 1991 (EBS/86/38, 2/19/86; Sup. 1, 3/7/86; and Cor. 1, 3/11/86). They also had before them a report on recent economic developments in Yugoslavia (SM/86/39, 2/27/86).

Mr. Polak made the following statement:

The staff has focused sharply on policy problems and issues in its report for the Article IV consultation, which is to serve at the same time to conclude the review under the current stand-by arrangement. I welcome this approach and, on behalf of the Yugoslav authorities, I want to thank the staff for delving so deeply into the specifics of the policy issues that the Yugoslav economy presents and for offering imaginative and constructive views on how these issues can best be handled within the economic setting of that country.

The broad outline of the strengths and the weaknesses of the successive Fund arrangements with Yugoslavia are becoming increasingly clear, as the staff report indicated. The successes are especially visible on the external side. A solid surplus in the external account in convertible currencies has been recorded for three successive years--in 1985 under quite unfavorable external conditions (Chart 6). That surplus has been brought about by an impressive rise in the ratio of exports of goods and services to total supply--from 21.8 percent in 1979 to 28 percent in 1985 (Table 1, Appendix IV). The fact that imports are also rising, as the same table shows, further strengthens confidence in the durability of the current account achievement.

These successes owe much to the consistent application of the agreed exchange rate policy that has managed to keep the real exchange rate stable, after bringing that rate down, systematically and substantially, in the course of 1983.

The current account surpluses have permitted Yugoslavia--as few other debtors have--to enter on the road of an absolute reduction of foreign debt. These two external developments, probably more than anything else, have persuaded creditor banks to move toward the normalization of their financial relations with the country: a multiyear rescheduling arrangement with the banks was signed in December 1985--to go into effect later in March 1986--and modest amounts of voluntary bank credit have begun to be granted to Yugoslavia borrowers.

These external achievements have been accompanied by a growth performance that has been disappointing on the whole. While the high growth rates of the later 1970s, built as they were on unsustainable capital inflows, could obviously not endure, the low growth rates of the 1980s, including a negative figure for 1983 and a minimally positive figure for 1985 (Chart 3), were well below expectations, although it is necessary to bear in mind in connection with all GSP or GNP figures and their components that there remains an abnormally large statistical discrepancy in the national accounts that raises question marks about the level and development over time of all such numbers (Table 3).

The low growth rate was attributable partly to the gradual cutback of the fixed investment component, from what was no doubt an excessive fixed investment ratio of over 25 percent in 1979 to what appears to be about a normal figure, in the order of 15 percent in 1985. But the disappointing growth of private consumption, and the underlying steep decline in real wage rates in the socialized sector, are at least in part related to the delays that occurred in making structural adjustments in the framework of the overall adjustment program. As long as price distortions were allowed to persist and uneconomic production continued to draw away resources from the efficient sectors and enterprises in the economy, growth was held back--and indeed had to be held back to achieve the balance of payments targets that required top priority.

In the last few years, the need to tackle the structural weaknesses of the Yugoslav economy has clearly surfaced and policies have been addressed to the problems in these areas. Relative prices of inputs and outputs, whether set by the market or by government decision, broadly reflect supply conditions and the prevailing prices in world markets. Accounting for the cost of capital has been made realistic and interest rates have been, and are being, moved to positive real levels--the most important recent measure being the steep rise in the selective lending rates of the National Bank of Yugoslavia that is to go into effect on April 1, 1986--see the supplementary letter from the Yugoslav authorities dated March 5, 1986. Moreover, the authorities, strongly supported by the Fund staff, have been closing in with increasing effectiveness against the tendency for loss making enterprises to stay alive at the expense of the rest of the economy. Successively, measures have been applied to force the wages in such enterprises below the general wage level, to limit their access to inter-enterprise credit, as well as to accept the consequences of realistic costing of capital. The proposed measure to allow only banks to guarantee promissory notes by enterprises, discussed in the staff paper, is one of the latest moves to squeeze the unprofitable enterprises out of their parasitic role.

With the measures taken thus far, a solid base has been laid for Yugoslavia to regain at least a moderate rate of internal growth and, externally, to earn a large enough current account surplus to serve its indebtedness under the terms of its multiyear rescheduling arrangement with the banks. A further multiyear rescheduling arrangement with respect to governmental debts would, moreover, be of considerable help. Either or both of these multiyear rescheduling arrangements would need to be supported by enhanced monitoring by the Fund, and the Board is being asked to agree formally to the request to that effect contained in the last paragraph of the authorities' letter of February 12, 1986 (Appendix I).

However, it is also clear that the rate of growth of the economy will depend a great deal on the determination of the authorities to bring about further structural changes. The recommendations in this area contained in the staff appraisal could be of great benefit.

On the subject of inflation, the staff notes with justification that it takes considerable time to change the behavior of economic agents--in particular as regards inflationary expectations. Thus far, the gradual adoption of the principle of a positive real interest rate for bank deposits has not seemed to dispel these expectations and a more lasting and stronger implementation of that principle may well be needed to achieve the desired effect. While attention tends to be primarily focused on the interest rate for three-month deposits--which is intended to be 1 percent positive in real terms--higher real rates apply to one-year deposits, 3 percent, and two-year deposits, 5 percent.

More action is needed to build up the role of the banks as true financial intermediaries and to counter the process of disintermediation that tends to develop through inter-enterprise credit. Recent measures have been important in this connection, including the virtual unification of the lending rates of the National Bank of Yugoslavia.

The authorities are also coming to terms with the need to accept the possibility of business failures as an integral part of enterprise discipline--a threat that will become a reality when loss-making enterprises do not succeed in correcting their position. Much more could be done in specific cases--as the staff suggests--to restructure enterprises that can be saved. But a process of <u>triage</u> with this aim in mind would also have to accept the closing down of enterprises that are not judged viable. A more active labor market policy--which the staff also suggests--could then be helpful both to the workers and to the communities directly affected by the elimination of inefficient enterprises.

> When enhanced monitoring succeeds the Fund's program in a few months, the many areas in the economy of common concern to Yugoslavia and the Fund will no longer be the subject of negotiations, understandings, or performance clauses. This will not diminish the Fund's interest in these matters--an interest that is clearly shared by many member countries. The Fund will continue to concern itself with these issues as it gives its half-yearly appraisal of the Yugoslav economy, but it will do so as a concerned, sympathetic, and experienced adviser, and no longer in the context of a credit arrangement between the Fund and Yugoslavia.

Mr. Goos, while agreeing with the staff that there had been some further consolidation of the positive results achieved over the past several years, as reflected most impressively in the reallocation of resources toward the export sector, said that he had nevertheless found the past year's developments quite disappointing. Those developments had fallen short of expectations, notably with regard to overall growth, employment, and the external current account. Moreover, the stronger than expected rate of inflation was a clear and disquieting signal that progress in redressing the underlying structural imbalances had continued to lag behind requirements. That fact was borne out clearly by several observations: to date, investment had had to bear the brunt of the adjustment burden; the enterprise sector remained a source of fundamental distortions and undesirable developments; and the conduct of an effective monetary policy continued to be impaired by serious structural shortcomings in the financial system. Notwithstanding the well-known difficulties in correcting deeply entrenched distortions, the overall record of the authorities in the area of structural adjustment had been very disappointing--all the more so since the urgent need for such adjustment had been stressed repeatedly by the staff and the Executive Board. Against that background, the sustainability of the improvements achieved in the external accounts could not be taken for granted. Accordingly, the maintenance and consolidation of those improvements would remain critically dependent on continued restrictive financial policies that left little room for a lasting recovery of overall growth.

A key measure necessary to tackle Yugoslavia's structural problems was the guarantee of sufficiently positive interest rates in real terms to permit an efficient allocation of resources and to break inflationary expectations, Mr. Goos emphasized. Accordingly, his authorities were deeply concerned about the noncompliance with the performance criterion on interest rate adjustment as of the beginning of the year. The credibility problems with regard to the Government's stabilization effort that had surfaced as a result of such program slippage should be a clear warning against any further deviation from the agreed interest rate formulas.

He endorsed the staff's recommendations on the necessary reforms of the financial system and the enterprise sector, Mr. Goos added. At the same time, he warmly welcomed the recent decisions of the authorities to implement specific steps--in particular, to accelerate the adjustment of the selective lending rates--to bring credit activity back into the banking system. It was difficult for him to understand why an administrative order was necessary to provide remunerative short-term deposit facilities with domestic banks for enterprises in the economic sector. To say that the banks would have no incentive to offer such facilities on their own because some banks were at their credit ceiling could hardly be the whole story, particularly since there seemed to be an active interbank market in such credit ceilings. Accordingly, there must be additional impediments to the voluntary opening of such facilities by the banks--impediments that might work as strong incentives to the banks to circumvent administrative regulations of the kind envisaged. Additional comments from the staff would be welcome.

While agreeing with the general thrust of the staff recommendations for enterprise reform, in particular given the need to make monetary policy more effective, Mr. Goos said that he was somewhat puzzled at the lack of any reference to the World Bank's involvement in the design of the recommended measures, in view of the clearly microeconomic nature of the problems. The authorities, in implementing those measures, should take great care not to weaken the incentive of the enterprises to maintain sound financial policies. Such a counterproductive result might be expected to emerge if enterprises perceived that the proposed establishment of a solidarity fund, for example, was a guarantee that they would be bailed out by the Government in case of financial difficulties. Nevertheless, he strongly endorsed the staff's view that the problems in the enterprise sector had to be resolved by specific measures tailored to particular adjustment needs rather than by recourse to generalized relief that would only undermine the objective of enhancing efficiency. Those measures should also include the option to close down nonviable enterprises--an option that should be employed more rigorously than in the past.

The staff had made appropriate recommendations with regard to the planned changes in tax policy, Mr. Goos continued. He was still concerned about the new foreign exchange allocation system, which was an unfortunate retrogression toward increased administrative control and a perpetuation of inefficient production and trade structures.

Two factors had given rise to his authorities' considerable reservations about Yugoslavia's request for enhanced surveillance, Mr. Goos pointed out. The Fund's guidelines for enhanced surveillance stipulated that the country in question must have shown a good record of adjustment, and there were some doubts about whether that requirement had really been met. Even more worrisome was the lack of assurance of the authorities' commitment to adhere to an appropriate adjustment strategy after the expiration of the present stand-by arrangement. Indications to that effect included recent press reports of an announcement by the Yugoslav Finance Minister that after May 1986, the Government would introduce a new interest rate formula that would deviate substantially from the present formulas agreed with the Fund. Furthermore, the authorities were showing renewed tendencies to delay the implementation of critical adjustment measures in the face of the resulting--yet unavoidable--short-term difficulties, or alternatively to alleviate those difficulties by granting across-the-board relief, such as the budgetary support currently being contemplated to ease the financial problems in the enterprise sector. Moreover, there were reports indicating that the authorities had recently attempted to offset the effects of price increases by granting subsidies to agriculture and to repress inflationary pressures by curtailing access to credit for enterprises perceived as having increased prices excessively. Such administrative interference with the process of free price determination in the markets appeared clearly inconsistent with the basic thrust of the Fund program.

Despite their reservations, his authorities were prepared to go along with Yugoslavia's request for Fund surveillance, particularly since non-approval would probably have very negative, undesirable repercussions on Yugoslavia's relationship with its foreign creditors, Mr. Goos indicated. Of course, that raised the serious question of how the Fund should respond in case the authorities were unable to maintain an appropriate adjustment course while under Fund surveillance. It seemed that in such a case, the Board would have to reconsider the usefulness of providing the special surveillance over the whole period that was currently being envisaged.

It should be clear that his support of the proposed procedure for enhanced surveillance with the commercial banks was not meant to prejudge the rescheduling decisions in the Paris Club, Mr. Goos stated. It was the Paris Club that had to make the final decision whether the requirements for an official rescheduling had been met.

His remarks were admittedly critical, but they had been offered in a positive and constructive spirit, Mr. Goos noted, and he could support the proposed decisions.

Ms. Bush remarked that it was useful to consider the progress that Yugoslavia had made under past programs with the Fund, the outlook for economic stabilization and reform efforts, and the role that the Fund might continue to play in Yugoslavia.

Progress in strengthening the external accounts had been quite impressive under a series of Fund-supported arrangements since mid-1979, Ms. Bush noted. Yugoslavia had reduced its dependence on imports from 33 percent of total supply in 1979 to 23 percent in 1985. There had been a shift in resources toward the export sector, with exports having constituted less than 22 percent of total resources in 1979 but having risen to 28 percent in 1985 (Table 1, Appendix IV, EBS/86/38). The current account of the balance of payments had undergone a substantial turnaround, from a deficit of almost 5 1/2 percent of GSP in 1979 to a surplus of nearly 1 percent of GSP in 1985.

The authorities had also successfully liberalized pricing signals in several areas of the economy, Ms. Bush added. Such liberalization had been, and would continue to be extremely important in terms of providing the appropriate incentives for efficient resource allocation. The liberalization efforts had focused on the prices of labor, capital, foreign exchange, and goods and services. There had been substantial constraint on real labor costs, including those in loss-making industries, so that the share of wages in total national income had declined, opening up the possibility of improved profitability, investment, and job creation prospects. Despite considerable difficulty, the authorities had taken initial steps to make interest rates, both on the deposit and on the lending sides, a more accurate reflection of the scarcity of capital. The exchange rate policy, which had initially resulted in an improvement in Yugoslavia's international competitiveness, had remained flexible. Price decontrol, although having caused some difficulty during the program, had made prices somewhat more responsive to supply and demand conditions.

It was the strengthening of the external accounts and the improvement in Yugoslavia's international credit rating that seemed to account for the decision of the authorities not to seek a stand-by arrangement with the Fund, Ms. Bush suggested. Yugoslavia had achieved current account surpluses in its transactions with the convertible currency area for the past three years, and it was expected that a further surplus would be achieved in 1986. Moreover, the commercial banks had agreed to a multiyear rescheduling arrangement, indicating an increased degree of confidence in the outlook for Yugoslavia's balance of payments. Nonetheless, some questions remained about the sustainability of the external position over the medium term. While the exchange rate policy needed to remain flexible, the primary emphasis had to be placed on domestic cost control and an overall improvement in the growth, diversification, and efficiency of the Yugoslav economy. She continued to be concerned about the new foreign exchange regime, the effect of which might well be to freeze past patterns of international trade and to discourage the growth and diversification of exports. The structure of Yugoslavia's debt had improved, and the level of gross external debt had declined since 1983; those improvements, in conjunction with the relief in the cost of debt servicing that had resulted from recent declines in market rates of interest, had created some breathing room for the authorities. However, the debt burden still seemed large in relation to GSP. The reduction of debt to 42.7 percent of GSP projected for 1986 was a welcome decline from the 47 percent levels of 1984 and 1985, but it was still high, particularly in relation to the 22 percent level of 1979. The pace of debt reduction might merit some reconsideration in view of the contribution that increased imports could make to domestic competitiveness, but the important objectives of debt reduction and higher imports to spur domestic competitiveness should be carefully balanced as long as the debt burden remained at such a high level relative to the size of output.

The disappointing outcome of the struggle against inflation in 1985 also raised serious concerns about Yugoslavia's ability to contain domestic costs and further improve its creditworthiness, Ms. Bush pointed out. She fully recognized that a number of special factors had been at work, such as price decontrol early in the year, the rise of nominal interest rates in an attempt to achieve positive real rates, slow real growth that had limited the supply-side response of the economy, and more realistic costing by some enterprises as a result of reforms in business accounting. However, two particularly important impediments to success had been the weakness of domestic competitive forces and periodic reversals in government policies, which had raised questions about the authorities' determination to combat inflation. That had been particularly true with regard to interest rate policy, and to some extent, administered pricing. To reduce the unacceptably high rate of inflation, the Government should rely particularly on wage restraint, stabilization of government spending, clear policy signals to demonstrate its determination to reduce inflation, and a variety of supply-side measures aimed at strengthening competition in general.

During the Executive Board's discussion of the design of Fund programs in planned economies (Executive Board Seminar 86/4, 2/28/86), it had been recognized that the role of public enterprises was particularly important in such economies because they constituted the largest part of the business sector, Ms. Bush recalled. In Yugoslavia, there seemed to be relatively few public enterprises with substantial losses, but the losses were so large that they jeopardized the fragile financial balance of the entire manufacturing and mining sector. In contrast, export firms seemed to be doing relatively well. The Fund-supported program had included a number of microeconomic commitments aimed at making business enterprises more efficient, but much remained to be done. An increase in managerial responsibility was a key to success; similarly, efforts such as limits on wage increases in loss-making enterprises and reduced financial assistance to ailing enterprises by the Joint Reserve Fund could also play a role. Additional staff comments on the possibility of new budgetary support for public enterprises would be welcome.

Yugoslavia, like other members, placed a high priority on economic growth and employment, Ms. Bush continued. Sustainable growth would be highly dependent upon reforms of the public enterprises. Nonviable enterprises must release labor; the labor market must allow for labor mobility so that workers could be relocated; and additional jobs must be created. She hoped that the authorities would improve job information and foster community efforts to promote business enterprises and job creation.

Part of the Yugoslav reform effort had been concentrated on making monetary policy more effective and market oriented, Ms. Bush observed. Although considerable emphasis had been placed on making interest rates--both on the deposit and the lending sides--positive in real terms, not much progress had been achieved to date. Deposit rates had only briefly been positive in real terms. Moreover, subsidized lending rates had encouraged inappropriate investments and diverted credit from more productive uses. Unfortunately, the difficult negotiations on interest rates between the Fund and the authorities had harmed the credibility of the authorities, both inside Yugoslavia and vis-à-vis foreign creditors. Nevertheless, the authorities had shown a welcome commitment to raise the deposit rate on April 1, 1986 at least to 73 percent and subsidize lending rates to a level two points less than the deposit and discount rates, and she assumed that they remained committed to unify subsidized interest rates at the discount rate in the first quarter of 1987. The authorities were also making welcome efforts to channel credit operations back into the banking system, in part by proposing legislation to prohibit the guaranteeing of promissory notes by nonbanks, and by encouraging the banks to offer an array of remunerative short-term bank deposits that business enterprises could use to invest their liquid funds. If such measures were finally adopted and implemented, they should make it less easy for loss-making enterprises to avoid their financial problems and should improve the effectiveness of monetary policy tools. She hoped that the authorities would give positive consideration to several techniques suggested by the staff to make those monetary tools more effective.

In the fiscal field, it was important that public expenditures, which had been substantially reduced as a share of GSP, continue to be tightly controlled, if not reduced, Ms. Bush advised. In that connection, the data problems in tracking public expenditures were unfortunate. She wondered whether there was any intent to extend the temporary law of October 1985, aimed at limiting nonfederal expenditures and blocking the use of excess revenues. It had been disappointing to learn that tax cuts at the republic and province levels appeared to be less likely.

As the authorities had formally asked the Fund to agree to an enhanced surveillance arrangement vis-à-vis the commercial banks, it was important that the adjustment and reform efforts be continued in the coming years and that close monitoring and midcourse corrections be instituted as necessary, Ms. Bush stated. She was prepared to agree to the proposed enhanced surveillance arrangement, although in relation to commercial bank reschedulings it would still entail responsibility for the Fund, whose credibility could be affected by the success or failure of those arrangements. Thus, debtor countries needed to cooperate closely with the Fund listening carefully and benefiting from the advice that the Fund could offer in order to help ensure the effectiveness of the enhanced surveillance arrangements, enhance the prospects that those arrangements and accompanying credit reschedulings would not be interrupted, and safeguard the Fund's credibility. In the Executive Board's discussion of the general issue of enhanced surveillance (EBM/85/130, 8/30/85; EBM/85/131 and EBM/85/132, 9/4/85), it had been suggested that the Board review the structure of specific enhanced surveillance arrangements periodically, keying in on their effectiveness; that process could be useful.

In the medium-term scenario, the staff had made a number of assumptions about sources of future financing, including an assumption about continued rescheduling by official creditors through 1988, Ms. Bush noted. The implication of the forecast was that some additional official debt relief might prove unavoidable. She did not wish to comment on the particular assumptions made, except to recall that official creditors were in no way bound by such assumptions, and that Mr. Dallara had explained, at the previous review of the stand-by arrangement (EBM/85/171 and EBM/85/172, 11/27/85), that enhanced surveillance which might prove satisfactory to private creditors, might not be satisfactory to official creditors. Her authorities, having reviewed the content of the enhanced surveillance agreement between Yugoslavia and the commercial banks, did not consider it adequate or satisfactory for the Fund to cooperate with Yugoslavia in connection with any new official debt rescheduling. If the Yugoslav authorities were to seek an official debt rescheduling, her authorities would want, at a minimum, an economic program set forth in a process of consultation with the Fund; debt relief could be justified only if Yugoslavia were implementing a comprehensive and satisfactory economic program, which could be verified by quarterly targets and limits. It would be premature to try to spell out the precise content of such an economic program at present, but past experience with stand-by arrangements with Yugoslavia clearly indicated that it would be unwise to focus too narrowly on the external sector. Attention would also have to be directed toward domestic policies; in addition to macroeconomic elements, attention would have to be given to some microeconomic ones, and some quantitative limits would need to be specified. Finally, a written program arrangement would need to be submitted to the Executive Board for its review and endorsement.

In conclusion, she thought that it was possible to look back at the experience under a series of Fund-supported economic adjustment and reform programs with Yugoslavia with a degree of satisfaction, Ms. Bush said. She commended the Yugoslav authorities for the substantial progress that had been made in a number of important areas over a difficult period. Nonetheless, the success was not complete and a determined effort was still required. The Fund could continue to help the authorities in the selection and implementation of sound economic policies and reform measures and could play a catalytic role in helping to obtain continuing financial support from both private and official creditors until Yugoslavia's international creditworthiness was fully restored.

Mr. de Groote remarked that the staff report was most useful because it attempted to rank by relative importance the various factors that had made Yugoslavia's adjustment more complex than initially expected. That complexity could lead to the notion that Yugoslavia's difficulties had arisen because some of the adjustment measures had gone only halfway, or conversely, because some elements of the adjustment had been excessive. In either case, the adjustment was unbalanced. Table 1 in Appendix IV was an innovative useful comparison of the adjustment results achieved by Yugoslavia and those obtained by other countries. The staff had made no claim that the table of comparisons explained fully the differences in the respective adjustment paths, but it had demonstrated how some of the major components of adjustment had combined to produce certain balance of payments and income results.

From the beginning of their adjustment effort, the authorities had aimed to restore the current account position as rapidly as possible in a manner compatible with Yugoslavia's debt reimbursement obligations, and to launch structural reforms of the economic system by means of more efficient resource allocation mechanisms, Mr. de Groote noted. Given the large adjustments needed and the severity of the misallocation of resources, Yugoslavia had succeeded reasonably on both fronts. The adjustment of the current account had required strong demand-management measures, including a drastic reduction of investment and a flexible exchange rate policy. The structural reforms had given a greater role to market-determined prices, which had increased the ability of the economy to adjust and had made demand management more effective. The importance of those results was, however, clouded by three difficult questions that remained: whether future efforts should emphasize balance of payments adjustment or structural reform; how a sustainable rate of growth and a viable balance of payments pattern could be achieved simultaneously in the medium term; and why it had been so difficult to reduce the rate of inflation.

The authorities should not allow the substantial gains of the past several years to be eroded by a slowing down or suspension of the key policies, Mr. de Groote continued. Those gains had come more rapidly than in some similar economies; indeed, one could argue that given the degree of structural adjustment, the intensity of the adjustment had been excessive in the area of the balance of payments. The GSP data were particularly striking. As Mr. Polak and the staff had indicated, the ratio of exports of goods and services to total supply had increased from 22 percent in 1979 to 28 percent in 1985. During the same period, GSP had decreased by one third. The share of domestic resources channeled to the balance of payments had clearly increased too steeply over a short period of time. Moreover, the decrease in the ratio of imports to GSP and the decline, in 1984 and 1985, in total external debt had also contributed to the reduction of domestic resource absorption. Under such circumstances, it would be difficult to expect achievement of a sustainable growth rate supported by internal demand, particularly by private consumption. Furthermore, the continuous transfer of a large share of resources into exports, in combination with the needed correction of relative prices of inputs and outputs, had fueled policy-induced price increases which, in turn, had dampened internal absorption.

A review of those events led him to conclude that the needed external adjustment of the Yugoslav economy, though inescapable, had been pursued faster than expected, and perhaps faster than needed, Mr. de Groote commented. The same was not true of internal adjustment: if that process had been accompanied by the attraction of more external financial resources, within appropriate limits, and if the movement toward structural reform had been more rapid, the efforts of the authorities in the direction of growth and internal adjustment might have been more effective. Therefore, his second conclusion was that policies in the short and medium term should have been centered on increasing the role of market mechanisms and reducing the role of government intervention, in order to increase growth and enhance the efficiency of resource allocation. The ongoing reforms of the price system, financial intermediation, and enterprise management should not be cut short, since they could create the transition conditions for the restoration of a macroeconomic environment that favored growth and a viable balance of payments position. There had been an imbalance in the policy mix--with the balance of payments adjustment being excessive and the structural reform being insufficient.

Monetary policy was another area of great complexity, because it had not succeeded in exerting its expected influence on demand management and domestic savings, Mr. de Groote considered. The automatic increases in M2, owing primarily to a higher than expected rate of inflation, and the substantial amount of credit generated outside the banking system were the two principal factors that had limited the effectiveness of monetary policy. Accordingly, the authorities were to be commended for their intention to create a better financial environment. They also needed to redefine the policy variables for monetary and credit aggregates. Nonetheless, the issue remained complex, because the effectiveness of monetary and interest rate policies in encouraging domestic savings had not been great thus far. Although the staff reports had not included any explanation or data on the behavior of domestic savings, the analysis of data on investment seemed to indicate that the ratio of gross domestic savings to GSP had been decreasing significantly for several years, and staff comments on that point would be helpful. He wondered whether a policy of higher interest rates would have succeeded in eliciting a higher rate of savings or whether internal absorption had been reduced so much that savings were bound to go down in line with disposable income. If that were the case, a further increase in interest rates would have been largely ineffective in inducing a higher rate of savings.

The issues for consideration on the exchange rate were whether Yugoslavia had been well advised to introduce additional administrative measures for the allocation of foreign exchange and whether there were sufficient reasons to go on with the system of continuously adjusting the exchange rate in order to maintain its value in real 1983 terms, Mr. de Groote said. The administrative allocation of foreign exchange was bound to freeze the foreign exchange position of enterprises and thus to hamper further the restructuring of the economy. But it was not sufficient to recommend a rapid elimination of those administrative constraints; it might also be useful to examine the need for more active liberalization of imports and a replacement of the present system of automatic exchange rate adjustment by a discretionary system, so as to achieve a higher degree of exchange rate stability. The extremely vulnerable price situation was weakened by restrictions on imports, artificial foreign exchange allocation, and anticipation of price increases, which the current system of exchange rate determination aggravated even more. The badly needed flexibility of wages and other incomes might be fostered if greater exchange rate stability could be achieved.

He supported the proposed decisions, Mr. de Groote stated. The procedure of enhanced monitoring that had been requested by the authorities could prove extremely helpful to Yugoslavia, a country that had yet to restore its external creditworthiness, despite its strong record of adjustment.

Mr. Foot, indicating that the staff papers had clearly noted the achievements of Yugoslavia in the past few years and the problems that remained to be tackled, said that the most encouraging sign was the improvement in the external position, including the current account surplus for the past three years. The authorities would have to maintain that improved position in order to reduce the absolute level of external debt and to generate the necessary spontaneous commercial bank financing. The past year's convertible currency current account surplus had been below the original forecast; while special factors had been involved, that shortfall emphasized the importance of Yugoslavia's continued efforts to earn an adequate current account surplus. In that context, he would welcome comments from the staff on the key uncertainties in the current account forecast for 1986 and the relevance of different oil price assumptions.

The authorities had made good progress in controlling public finances by keeping expenditure constant in real terms, Mr. Foot noted. Some progress had been made in structural reforms, particularly the greater transparency in the finances of enterprises and the greater discipline to which they were subjected, and reforms in the financial sector. However, much remained to be done and there had also been instances of a lack of both information and resolve; the former was well illustrated by Appendix I in the staff report on recent economic developments on alternative measures of stockbuilding. The staff's new, dramatically smaller estimates of stockbuilding had a logical basis in the reports of enterprises. They were also plausible and implied much higher consumer demand and, perhaps, investment in recent years than official estimates had. What was disturbing was that the authorities had rested content so long with the possibility, or probability, that key macroeconomic figures--not just for consumption and investment but potentially across the board--were heavily misleading. Those figures, which remained misleading, did not provide a good basis either for the authorities' planning or for Fund surveillance.

A lack of resolve could be found in the self-induced need for the waiver on the implementation of the agreed interest rate formula, Mr. Foot considered. The authorities had had second thoughts about their decision not to raise interest rates by the necessary amount on January 1, 1986, but even those second thoughts had rapidly become inappropriate, because within a few days it had become clear that the new level was patently insufficient to ensure positive real rates, given the higher than expected inflation in January. At an important stage of the program, Yugoslavia thus had had heavily negative real interest rates. Perhaps that experience offered some useful lessons about how to frame real interest rate provisions in future Fund programs. Adequate real interest rates--supporting and supported by an appropriate fiscal and monetary stance--were a critical part of Yugoslavia's adjustment policies, and they were essential to promote domestic savings and to provide a basis for rational investment decisions. Delay--lack of resolve--in implementing agreed policy in that area could only cause unnecessary short-term disequilibrium, such as the surge in consumer demand that had occurred when it became clear that the authorities were being unduly optimistic about inflation in 1986 and were reluctant to raise interest rates. More damaging, such hesitation would undermine the authorities' credibility in the long term, and thereby attenuate their own efforts to bring down the inflationary expectations that were of such concern to them.

Fortunately, the authorities had decided to implement higher nominal rates and to undertake supporting financial measures, Mr. Foot observed. Their decision to bring forward the increase in the National Bank of Yugoslavia's preferential lending rates was a welcome step toward a sensible system of financial intermediation, although the prospective jump in interest rates--of the order of 20 percentage points--was far greater than the recent increase in deposit rates that had caused the authorities so much difficulty. Similarly, the authorities' restriction of the guaranteeing of promissory notes to commercial banks, and their decision to recommend to the Bankers' Association that commercial banks provide remunerative deposits with maturities of less than 90 days should have a significant effect in reducing the prevalence of inter-enterprise credits. He hoped that those measures could be completed and reported before the end of the program.

Yugoslavia, having consolidated its external adjustment, needed to emphasize structural adjustment policies, and therefore he was concerned about growing domestic pressure to abandon structural adjustment and other related developments, Mr. Foot said. To turn away from structural adjustment efforts would be entirely the wrong response to the high rate of inflation that was understandably one of the authorities' main concerns. In response to the problems of the enterprise sector, the authorities had taken measures to liberalize prices and to instill realism into the financial operations of the enterprises. However, those steps, by surfacing the real costs of investment and production, had released the accumulated inflationary pressures that had been repressed for a long time. Although those measures had had an immediate impact on inflation, their long-term benefits had not had time to accrue, and thus the appropriate response was not to abandon them to bring down the rate of inflation but to continue with the policies that had been devised in close collaboration with the Fund over a number of years. However, such policies would not work unless the economic agents were confident of the authorities' resolve. It would therefore be vital for the new Federal Executive Council, which would be taking office just when the stand-by arrangement expired, to intensify the adjustment efforts.

Vital though those structural measures were, however, it was important not to overlook traditional macroeconomic policies, Mr. Foot continued. Appropriate fiscal and monetary policies would be essential if inflation was to be brought down while the structural adjustment effort was being intensified. Staff comments would be welcome on whether the fiscal stance would have to be tighter than the authorities currently expected and whether the scope for tax cuts would be narrower. He was surprised that the authorities were contemplating budgetary support to relieve the financial pressures on enterprises, including export industries, whose profits had actually held up quite well in 1985. The loss-making enterprises were concentrated in the food, electricity, and basic chemical sectors, and losses in the first two sectors had resulted from a political decision to subsidize their products. The authorities should make such subsidies explicit in the government budget, so that the consequences of their decision would be clearly itemized. Nevertheless, there was an urgent need for the authorities to implement the measures to reduce the absorption of resources by the loss-making enterprises, and it was unfortunate that monitoring the impact of recent policies in that area was being hampered by inadequate data.

The new foreign exchange law represented a step backward from the goal of a fully market-determined exchange rate in that it entailed more, not less, administrative interference, Mr. Foot advised. Regardless of the system, the authorities should ensure that the exchange rate preserved competitiveness and should therefore not rule out an active policy in that area if external circumstance so dictated in the future.

He could support the proposed decision on enhanced surveillance by the Fund in connection with the multiyear rescheduling arrangement with the commercial banks, Mr. Foot stated. However, a five-year period of enhanced surveillance was a substantial commitment for the Board, and the exact modalities of Fund involvement would need to be kept flexible. Flexibility was necessary because the next step in Yugoslavia's normalization of its external relations could involve an official rescheduling of debt, with Fund involvement both in the formulation and monitoring of the agreement, and any such arrangement would probably involve a system of enhanced surveillance that went beyond the system envisaged with the commercial banks while in no way conflicting with it. His authorities believed that it would be unwise to assume that what had suited Yugoslavia and its commercial bank creditors would be appropriate for its official creditors. If Yugoslavia decided to request an official rescheduling, with enhanced surveillance, he hoped that the Fund would respond quickly to help prepare an appropriate agreement and develop a harmonized system of enhanced surveillance for the two groups of creditors that minimized the resources needed for its implementation. The authorities should not hesitate to take the next steps, both domestically and with respect to their negotiations with official creditors; if they promptly met all the requirements for the last drawing under the current stand-by arrangement, the enhanced surveillance would be given the best possible start.

Mr. de la Herrân said that he supported the proposed decisions, including the request for enhanced surveillance. The economic performance of Yugoslavia since the Board's previous discussion (EBM/85/171 and EBM/85/172, 11/27/85) had been mixed. The partial correction of slippages in performance criteria in important areas such as external arrears and real interest rates gave strong evidence of the efforts that the authorities were making. At the same time, however, the authorities seemed to be suffering from a certain adjustment fatigue, which was perfectly understandable after a long and painful adjustment process; but they should reaffirm their commitment and willingness to finalize the reforms already started.

The financial problems of enterprises resulted from a combination of insufficiently reliable statistical data and the need to adapt accounting practices so that all production costs surfaced and were taken into consideration at the time of policy design, Mr. de la Herrân considered. The accounting system still needed to be improved, particularly with respect to inventories. The common practice of deducting increases in the value of producer stocks from current costs contributed to the implementation of inappropriate financial policies. The problems that arose from such irregular inventory value accounting were shown in Table 4 of EBS/86/38 (2/19/86). Moreover, the staff had reported that the proper costing of inventories had not affected the health of any enterprises; thus, there was a strong case for the authorities to resist pressures to abandon the policy of improving accounting methods and revealing hidden costs.

Inter-enterprise credits had accelerated to an annual rate of 90 percent during 1985, compared with 66 percent in 1984, indicating clearly a major disturbance within the field of credit policy, Mr. de la Herrân remarked. The crowding out of banking activity was probably rooted in the policy of privileged credit that was followed by the National Bank of Yugoslavia, combined with unattractive deposit rates offered by the banks. More control by the National Bank of Yugoslavia was needed, together with a more selective system of access to cheap loans from the central bank. There was an understandable need to provide subsidized credits to certain sectors or firms, usually linked to agricultural production, but the generalization of the system was a different matter. He wondered whether there was any well-founded economic reason for export firms to be widely eligible for that type of credit. Indeed, a more rigorous selective credit policy would help to improve the allocation of financial resources, reduce inter-enterprise credit activity, and restore a more banking-based credit policy.

Both credit policy and interest rate policies called for firm financial discipline, Mr. de la Herrân commented. The level of real interest rates had become the major factor in the program, not because of its intrinsic relevance, but because the authorities were having such difficulty in observing the performance criteria, which in turn was closely related to a more general lack of financial discipline in the system. He wondered how the staff interpreted the key role of real interest rates in the Yugoslav program.

It would be useful to know how the trigger mechanism in the agreement designed by the commercial banks would work after the expiration of the stand-by arrangement with the Fund, Mr. de la Herrân mentioned. For instance, would the mechanism be able to provide early warning signals so that corrective measures could be applied quickly after a deviation had occurred, and how would the mechanism be linked to the enhanced surveillance framework? Enhanced surveillance was acceptable, provided that the authorities continued to apply a blend of policies similar to that recommended during the period of the stand-by arrangement. However, formal relations with the Fund would be very different in the future. After the expiration of the stand-by arrangement, enhanced surveillance would provide the appropriate framework for Yugoslavia to maintain a constructive relationship with the Fund. He congratulated the authorities for having reached an agreement with the committee of banks in December 1985. He hoped that the multiyear rescheduling arrangement would be activated soon after the proposed decision had been approved, and that the necessary financial assistance would be forthcoming. Finally, he commended the authorities for the reforms already introduced, and encouraged them to strengthen their commitment to the completion of the reform process.

Mr. Fujino observed that the results achieved to date by the Yugoslav authorities' adjustment efforts were commendable, particularly in the light of the serious difficulties that existed in the economy when those efforts had started. The external balance had improved substantially, and the current account surplus was consolidating at about 1.5 percent of GSP, a dramatic turnaround of nearly 7 percent of GSP from the trough of 1979. The improvement had certainly been helped by the sharp reduction in the excessive and sometimes inefficient imports of capital goods directed to investment. The performance of exports had been healthy; the volume of merchandise exports had grown by 11.4 percent in 1984 and by 8.7 percent in 1985, and the composition of exports had been diversified. Manufactured goods, offering more promise for market growth, were gaining shares in exports. The stagnated economy was finally showing signs of recovery. Although adjustment measures had been taking their toll in terms of growth--the growth of GSP in 1985 was estimated to be less than 1 percent, against the target of 2 1/2 percent--industry was showing a more vigorous recovery, with a 2.7 percent growth.

Against that backdrop, Yugoslavia's most important current problem--as in the past--was inflation, Mr. Fujino noted. The various imbalances in the economy had surfaced in the form of a high rate of inflation, which seemed to be accelerating, with an increase in retail prices of nearly 80 percent in 1985. In part, that price rise was an inevitable symptom of the price liberalization that had been stepped up by the implementation of the new law at the beginning of 1985. However, there seemed to be a number of other factors working to push up prices, including uncertainty about the continuation of the liberalized price policy, which would fuel the price rise unnecessarily; price setting on a cost-plus basis without competition, which might make it easy to raise prices and start a vicious circle of cost-push inflation; and excess liquidity in the economy, which tended to create excess demand and lead to price rises. A comprehensive and credible policy against inflation would be needed to meet all those difficult problems, and the continuation of a firm policy stance was essential to establish the confidence of the people in the new policy direction. The authorities should avoid temporary easing of the adjustment measures as much as possible so as not to undermine the efforts in key policy areas. Constructive measures were being taken to reduce inter-enterprise credit, and their effective and speedy implementation through the provision of lucrative deposits with banks was essential. The easing of monetary control had been reducing the desirable impact of exchange rate changes, and the authorities should exercise due caution in the adjustment of monetary control.

Enhanced cost consciousness on the part of the enterprises was the cornerstone for higher efficiency in the economy, and would remedy the basic cause of inflation, Mr. Fujino considered. However, that basic change in the structure of the economy would not be easy to effect because of Yugoslavia's long-standing emphasis on production results rather than on efficiency and because of the large regional differences within the country. The authorities would need to maintain a flexible but sometimes drastic approach to make the enterprises more viable, and they should take due care to reduce the pain of transition by increasing labor mobility and improving employment conditions.

The decline of fixed investment might not pose an immediate problem and in a way might be facilitating the process of structural change, Mr. Fujino mentioned. However, for sustainable future growth, careful monitoring of investment trends would be required. The projected alleviation of the tax burden of the enterprise sector would be one element that should have a favorable impact on investment. Any further comments from the staff on the prospects of future investment trends would be appreciated.

The requested waiver on the increase of the interest rate was regrettable, Mr. Fujino said, but he could go along with it as well as the waivers on the elimination of payments arrears and the growth of public expenditures. He hoped that the enhanced surveillance procedure, which had been generally endorsed already, could be terminated as early as possible, without running its course through the end of 1991. The future negotiations on official credit rescheduling and possible forms of Fund involvement in that connection would have to be considered separately from the enhanced surveillance procedure being proposed in connection with the commercial banks. Finally, he supported the proposed decisions.

Mr. Zecchini remarked that recent developments, after almost six years of successive Fund-supported programs and on the eve of another form of collaboration between Yugoslavia and the Fund, confirmed that the most important and indeed essential positive factors in the progress achieved so far had been related to the re-establishment of a good balance of payments position. Relatively large deficits on current account at the beginning of the decade had given way to surpluses in the past three years, and moderate surpluses were expected in the years ahead. That turnaround had been obtained through sustained export growth and by import substitution, providing evidence of an important reallocation of resources within the economy. However, progress in some important areas had been slow, if not nonexistent, thus demonstrating persistent systemic weaknesses in the operational efficiency of the enterprise sector, the working of the mechanism for the allocation of financial and foreign exchange resources, and the efforts to control inflation.

Yugoslavia's performance had been particularly disappointing with respect to the rate of inflation, which had increased sharply, rising from about 50 percent in 1984 to about 80 percent in 1985, Mr. Zecchini considered. As the reasons for that inflationary phenomenon remained unclear, a thorough analysis from the staff of the underlying causes would be appreciated. In that context, a study of microeconomic variables, such as enterprise pricing policies, could be integrated with the analysis of macroeconomic variables such as liquidity and credit creation. Until the underlying causes of inflation were fully understood, it would be difficult to find an appropriate remedy.

Economic growth had been more sluggish than expected in 1985, but weaknesses in data--especially related to inventories--continued to hamper an effective, timely appraisal of that development, Mr. Zecchini indicated. The authorities had recently made strides in producing more comprehensive economic statistics on a quarterly basis, but additional rapid progress was still needed.

While the authorities had taken steps to increase the efficiency of the enterprise sector through price liberalization measures and a more accurate computation of costs, further steps were needed to increase competition among nonfinancial firms and to reduce the emergence of improper sources of income from the accumulation of inventories and from the proceeds of financial activities, Mr. Zecchini considered. Accounting procedures permitted an overvaluation of inventories that was deducted from costs in the computation of enterprise income, which, in turn--as shown in Table 4 of the staff report--artificially swelled profits. In 1985 those profits had been as much as ten times larger than they would otherwise had been, and had consequently created incentives for an excessive inventory accumulation and had distorted production decisions and the allocation of resources. Furthermore, if those artificial profits were distributed, the firm's capital base would be diluted. Accordingly, an adjustment in accounting regulations should be considered a matter of priority.

Some enterprises were apparently borrowing heavily from the National Bank of Yugoslavia at subsidized rates and subsequently lending those resources at market rates to enterprises that were not as sound, Mr. Zecchini continued. Thus, the limited stringency of monetary policy was so ineffective that it allowed an extensive mobility of the existing liquidity in the economic system. The higher degree of monetary stringency required to drain liquidity from the system and, consequently, to check undesired credit expansion was still lacking, for reasons that had not been clearly stated in the staff report.

Three sets of measures were being taken to reduce disintermediation of the financial system and to improve the control of monetary aggregates by the National Bank of Yugoslavia, Mr. Zecchini added. The most promising one favored remunerative interest rates on certain types of bank deposits, but it had met with considerable resistance in the banking system, since the ceilings on bank lending and the structure of interest rates meant that the new measure would have negative repercussions on the banks' profitability. The appropriate approach to the problem would be to allow a unification of preferential and normal interest rates and a rise in lending rates. That approach would involve establishing a mechanism whereby interest rate changes, determined by market forces, would govern a more efficient allocation of limited financial resources.

The recent modifications in the foreign exchange allocation system were worrying, Mr. Zecchini stated. By widening the scope for administrative allocation of foreign exchange and reducing the availability to firms of foreign exchange at market prices, the new system would increase rigidities in the economy and worsen the allocation of resources. Furthermore, it would decrease incentives to export, as firms would have to surrender all their foreign exchange earnings at the official exchange rate. Therefore, while exporters had previously been able to sell part of their foreign exchange earnings at a more depreciated exchange rate than the official rate, they were currently subjected to the consequences of a measure that were similar to an appreciation of the exchange rate.

He was not sure of the meaningfulness of the analysis and conclusions relating to the comparison of adjustment results among different countries, contained in Appendix IV to the staff report, Mr. Zecchini said. He pointed out that Portugal had obtained significant and rapid success in its adjustment efforts, as its current account of the balance of payments had passed from a deficit equal to 7.9 percent of GDP in 1983, to equilibrium in 1985, and that Greece had only recently embarked on adjustment efforts.

The reasons for granting a waiver on the adjustment of interest rates were not clear to him and were not consistent with the Fund's guidelines, Mr. Zecchini commented. The relevant performance criteria had called for an increase in interest rates from 61 percent to 73 percent as of January 1, 1986. The increase had been delayed until February 1, and even then it was only partial, as interest rates had been raised to 68 percent and still appeared negative in real terms. His understanding of the guidelines on waivers, based on the Chairman's concluding remarks at EBM/81/122 (9/9/81), was that "the Fund should approve waivers and modifications of performance criteria only when the basic thrust of the program remains unchanged and when the deviations from the initial targets are not very substantial." Of course, waivers and modifications had been approved in circumstances beyond the member's control, but that was not the case with Yugoslavia's request for a waiver on interest rates. Consequently, if the interest rate policy was not considered an important element of the adjustment program, it should be excluded from the performance criteria. On the contrary, if it was considered important for the program's success, the agreements reached by the country with the Fund should be strictly implemented. Otherwise, a dangerous precedent could emerge which could undermine the effectiveness of performance criteria in future cases. In spite of those reservations, however, he did not wish to stand in the way of the approval of the waivers.

The criteria for the adoption of enhanced surveillance specified that the procedure could be granted only on the basis of a good record of economic performance and adjustment efforts, Mr. Zecchini recalled. However, it was not clear whether Yugoslavia's record of adjustment met that criterion to a satisfactory extent. Furthermore, the proposed enhanced surveillance procedure seemed to be centered on the assessment of Yugoslavia's Annual Economic Program and particularly on the monitoring of the levels of net external reserves and export revenues. Although that assessment satisfied the commercial banks, inasmuch as it focused on the external solvency of the country, the focus of the Fund's surveillance was much broader, since it dealt with internal as well as external imbalances and, more important, with the underlying policies. Only the appropriateness of the underlying policies could guarantee a lasting solvency of the country. The Fund should pay more than marginal attention to Yugoslavia's need for extensive improvements in monetary and financial management, financial structures, the allocation of resources to different uses, and the efficiency of its productive sectors. Given those considerations, he supported the request for enhanced surveillance, on the understanding that the authorities would make a firm, precise commitment to make improvements in the broader areas that he had mentioned; that those improvements would be monitored beginning with the next review in September 1986; and that the staff appraisal would be comprehensive enough to cover those additional areas, and be presented in the same candid language that had been used for the first time in EBS/86/38.

Mr. Jayawardena said that because the issues involved in Yugoslavia's adjustment efforts were so numerous and complex, it was difficult to understand fully what was happening. Moreover, the lack of explanations in the staff report of some fundamental issues had hindered an understanding of how well the adjustment process was faring. It would have been preferable if the staff report had been presented in the context of previous discussions, as the Board had agreed should be done, in order to improve surveillance.

After an expansionary phase in the 1970s, Yugoslavia had found itself with an adverse external position and a high level of external debt by 1982, despite stand-by arrangements in 1979 and 1980, and a three-year stand-by arrangement initiated in 1981, Mr. Jayawardena remarked. The authorities had introduced strong adjustment measures in 1983 that appeared to have been successful in turning around the external current account and in reducing external debt. However, that success had been gained at a cost. Economic growth had apparently been sacrificed, and he wondered how long Yugoslavia could maintain such a strong adjustment process without signs of a revival of the economy.

The adjustment had been engineered primarily by a highly flexible exchange rate policy and by measures to liberalize financial and other domestic markets, Mr. Jayawardena continued. Whereas the exchange rate had been strongly depreciated, which had contributed in no small way to high levels of inflation, the full reform of the domestic economy seemed to have been less enterprising. Apparently there were structural difficulties in the enterprise-dominated economy that inhibited the promotion of greater autonomy among economic entities.

He wished that the microeconomic aspects of structural adjustment had been more thoroughly examined in the staff report, Mr. Jayawardena said. Numerous questions remained, including what impact inter-enterprise lending had had on the thrust of monetary policy; how enterprises borrowed their maximum entitlement under selective credit windows and lent to each other, rather than using the banking system to manage their cash and working capital requirements; why the banks did not offer adequate incentives to attract surplus funds of the enterprises; what created the discontinuities in the money market that made economic management so difficult; whether the slow supply responses--despite attempts at liberalization of the economy--were attributable to the oligopolistic nature of the market, the selective direction of credit, or the regulatory system; and what Yugoslavia should do to encourage greater autonomy and liberalization to generate economic growth. Particular emphasis should be placed on the microeconomic aspects of structural adjustment, such as an effective reform of accounting, costing, and price systems; a thorough review of inventory building; and even the inter-enterprise lending system. It was important to identify and try to rectify the bottlenecks that seemed to hinder the growth of the economy, because a recession could subvert the adjustment process. Since it was widely recognized that adjustment measures directed at stabilization of the economy should be tempered by measures to encourage growth, more attention should be given to the obstacles to growth.

Yugoslavia's external adjustment had been remarkable, with a buildup of surpluses in convertible currencies, an impressive rise in the ratio of exports to total supply in recent years, and a pickup in imports in 1985, all of which provided evidence of confidence in the durability of the current account achievement, Mr. Jayawardena commented. That success was largely attributable to the consistency of the authorities' pursuit of a highly flexible exchange rate policy, supported by generally restrictive fiscal, monetary, and incomes policies. However, unless the economy revived under the new policies, the years ahead would be difficult. Thus, it was important to look carefully at the macroeconomic and microeconomic aspects of supply-side policies in order to remedy some clear structural problems and to get the economy moving so that inflation could be brought down, interest rates could be moderated, and general confidence in the economy could be restored. Finally, he supported the proposed decisions.

Mr. Hodgson thanked the staff for having expanded the staff report to include a number of pages on structural issues, particularly at the enterprise level, thereby helping to portray some of the institutional characteristics and weaknessess of the Yugoslav economy. The considerable deviation in Table 3 between official statistics and the staff's alternative estimates demonstrated clearly just how badly institutional reform was needed and where it should be introduced. The detailed discussion in the staff appraisal of how to strengthen the enterprise sector provided a useful blueprint for the authorities.

The authorities should be commended for the improvement over the past three years in Yugoslavia's external accounts, Mr. Hodgson continued. The shift to continuing surpluses in the convertible currency current account had brought Yugoslavia to the point of regaining access to international capital markets on a more normal basis. Laudable efforts had also been made to correct distortions in the price structure, although it was a slow, difficult process because it demanded changes in economic behavior--both at the individual and enterprise levels--that did not take place overnight.

Some troubling areas remained, however, and the sharp acceleration in the rate of inflation in the final quarter of 1985 had been particularly disturbing, Mr. Hodgson commented. While much of the upward pressure in prices was inevitable because of necessary corrections in relative prices, the authorities had, unfortunately, contributed to uncertainty by transmitting contradictory signals about inflation. Rather than stemming inflationary expectations, the adoption of an inflation target for 1986 of 42 1/2 percent--unlikely to be attained--had only reduced the authorities' credibility and, in the end, fueled inflationary expectations. To be effective, policies and targets had to be credible, and growth, price, or other projections that were clearly unattainable served no one's interest.

As the authorities' efforts to achieve positive real interest rates continued to be frustrated by persistent high inflationary expectations, it was disappointing that they had not adjusted interest rates in line with price developments in January 1986, Mr. Hodgson indicated. The recent favorable developments in the personal savings rate made it all the more important that the correct interest rate signal be provided. He was encouraged that appropriate action on interest rates had been taken recently and that they had been increased further in view of the higher than expected price developments during the first few months of 1986; he urged the authorities to continue with the policy of positive real interest rates.

Slow progress in stemming financial activity outside the banking system continued to constrain the authorities' efforts toward more general monetary control, Mr. Hodgson observed. Despite tight control over bank credit by the central bank during 1985, the heavy use of inter-enterprise credit had allowed a sharp increase in the velocity of broad money. In addition to dissipating the effects of tight monetary and credit policies, inter-enterprise credit had permitted uncreditworthy enterprises to survive. In that light, he welcomed the measures that the authorities planned to implement quickly to gain tighter control of credit activity.

It was important to maintain the fiscal stance of the past few years that had aimed at keeping real expenditures stable, Mr. Hodgson noted. The planned increase in contributions by the republics and provinces to the federal budget in 1986 made tax reductions at the republic level unlikely, which was disappointing. He was also disappointed that measures to broaden the tax base and shift the burden of taxation away from enterprises toward individuals had yet to be given substance, because those changes were required to support incomes policy and, more particularly, to ease the positions of viable enterprises and thereby contribute to balanced growth. Therefore, the authorities should move strongly to implement tax reform.

The authorities' maintenance of a competitive exchange rate policy had clearly been an important contribution to Yugoslavia's improved external position, and they would need to continue their exchange rate flexibility in order to preserve competitiveness over the medium term, Mr. Hodgson stated. However, their failure to develop a properly functioning foreign exchange system was disappointing. The new foreign exchange system, which was supposed to facilitate transition toward full convertibility of the dinar, exacerbated existing rigidities and administrative control and provided even less scope for alterations in the economy's productive structure, thereby constraining potential export growth. As the staff had been surprisingly cautious in its assessment of the new system, further comment would be appreciated, as would any assurances from the staff or Mr. Polak that the system would indeed be temporary and transitional.

He could support the request to provide enhanced surveillance for the benefit of the commercial banks if that was what the authorities deemed appropriate in their evolving relationship with the banks, Mr. Hodgson said. Yugoslavia had also suggested that the Paris Club provide a multiyear rescheduling arrangement; his Canadian authorities were prepared to examine the Yugoslav case on its own merits within the context of the Paris Club, but did not currently wish to take a firm stand on the specific form and/or conditions of future rescheduling arrangements with Yugoslavia. As a general rule, his authorities felt that Paris Club rescheduling arrangements should be concluded only after a country had reached agreement with the Fund on a stand-by arrangement. That procedure had offered the best assurances to creditors that a country was indeed implementing the planned measures, as well as providing creditors with the best means of monitoring progress, given the statistical inadequacies in the data base. Finally, he supported the proposed decisions.

Mr. Huang noted that the authorities had made enormous efforts to implement the adjustment program. Their achievements in the external sector were most commendable. The surplus on current account for the past three years had started to reduce Yugoslavia's foreign debt, and the outturn of the external adjustment had gradually led to the resumption of capital inflows. While the performance of exports had been continuously improving, imports were also on the rise, which indicated a growing potential for reviving Yugoslavia's economic expansion. Internally, however, further efforts in the adjustment process were needed. He was pleased that the authorities were aware of the existing problems and had taken the necessary measures to cope with economic stagnation and high inflation. It should be stressed that the thrust of the policies to ensure better economic performance was based on the enhanced operation of the market mechanism, with an accent on economically viable enterprises. Relative prices were currently more closely related to demand and supply conditions in the domestic and international markets. Interest rates were being raised to a positive level, and the gap between preferential and discount rates was being closed. Moreover, important measures had been taken to differentiate between economically sound enterprises and loss-making ones, and to reduce the scope for loss makers to absorb resources. With all those measures firmly taken, he assumed that Yugoslavia was on the right track toward healthy economic growth.

In the light of Yugoslavia's unique social and economic system, structural policy played an important role in tackling inflation, along with the orthodox demand-management policies, Mr. Huang commented. Increasing competition among enterprises might be an effective way to reduce the real cost of production and prevent the enterprises from passing on the cost to the consumers through price increases. Besides, greater efforts might be needed to assure civilians that government policies were credible. Such a strengthening of the people's confidence toward government policies would help to lower inflation expectations and, therefore, reduce inflation.

The staff's recommendations with regard to job creation merited serious consideration, Mr. Huang advised. Rising unemployment was a problem that could not be overlooked, and he hoped that measures would be taken to reverse the situation.

The competitiveness of Yugoslavia's exports had improved mainly through the depreciation of the exchange rate, but the depreciation had exerted significant upward pressures on inflation, Mr. Huang observed. Raising productivity might be a better way to further enhance competitiveness. To that end, the elimination of structural rigidities would also be conducive to achieving external balance.

In conclusion, he supported the proposal for enhanced surveillance and the proposed decisions, Mr. Huang stated. After six years of Fund programs and a good track record, Yugoslavia appeared to be in a suitable position to undertake such an arrangement.

Mr. de Forges commended the authorities for the positive results achieved in important areas. In particular, the success of the external adjustment had placed the external balance on a relatively stable footing, as had been recognized by the international financial community, thus allowing public and private debt reschedulings to be agreed upon during the past year. As Mr. Polak had explained, that success was attributable to the stability of the real exchange rate after the depreciation of 1983, the subsequent reduction in the foreign debt, and the new confidence sparked by those developments among creditors. Another recent policy success was the broad liberalization of the price system, which had permitted the evaluation of real operating costs and had helped to promote a better allocation of resources.

However, some uncertainties remained, and the commitment of the Yugoslav authorities to the reform process might be weaker than hoped, since the implementation of the policies had not been sufficiently vigorous and determined, Mr. de Forges noted. Indeed, the badly needed interest rate increases had been introduced with undue delays, and the authorities had seemed reluctant at times to come to the logical consequences of price liberalization, notably with respect to the management of enterprises. The adjustment effort had yielded its short-term fruits, as dramatically shown by the external position, but the most useful benefits would be reaped in the structure of the Yugoslav economy and in the recovery and balanced growth of its productive sector. Unfortunately, the weakness of the available data had made it difficult to assess total demand and output accurately, and it was thus difficult to evaluate the real situation of the enterprises and their margin for maneuver, even though noticeable progress had been made in the accounting system. Furthermore, at the current stage of the adjustment process, it was necessary to diffuse the adjustment to ensure that the available resources were committed only to the most efficient users.

He thus supported the broad scope of the authorities' measures because they tended to ensure real positive interest rates, to strengthen the usefulness of monetary policies and to improve the efficiency of the financial system, Mr. de Forges continued. While noting that some of the recommended measures were indeed aimed at diminishing inter-enterprise credit, he wondered whether the disintermediation was really an objective in itself. The most worrying end result of the current practices was the permitted diversion of credits, which led to the relative insufficiency of the overall monetary policy. The practice of inter-enterprise credits itself, which was widely accepted in a number of countries, did not lead to an inadequate monetary policy, provided that that policy was built upon interest rates set at a remunerative level for deposits and at an efficient level for credits. Given the rigidities of the Yugoslav banking system, the question was whether a massive reintermediation was the best way to convince enterprises that they must improve their management. The staff's response to that question would be helpful.

The fiscal position, the employment rate, and the exchange system continued to pose problems, but of greatest concern was the authorities' inability to halt inflationist trends, an inability that was difficult to understand, given the specific structure of the Yugoslav economy, Mr. de Forges remarked. None of those problems could be remedied definitively as long as the productive sector was not allowed to develop unhampered by the burden of a large number of enterprises unable to operate with their own resources. Thus, the adjustment process needed to be continued. Those important reservations notwithstanding, the results of the policies implemented by the authorities appeared generally adequate, with one exception: a clear, unambiguous manifestation of the authorities' commitment to implement those policies that would not give the wrong signal to economic agents.

The enhanced surveillance arrangement requested by Yugoslavia differed in many ways from the general mechanism decided upon by the Board (EBM/85/131 and EBM/85/132, 9/4/85), Mr. de Forges pointed out. Nevertheless, the case of Yugoslavia had been presented to the Board already in July 1985. It was important to remember that although Yugoslavia's requested arrangement differed, especially with regard to its length, it should not, under any circumstances, establish a precedent. However, he did not intend to call the agreement into question; he fully shared the staff's opinion that it was important to assess economic development on a current basis against the policy targets so as to enable effective mid-course corrections to be taken because that was the thrust of the enhanced surveillance process. The policy targets that had been set appeared to span the Yugoslav economy rather broadly, yet their scope was not consistent with the "triggers," which appeared to be particularly narrow. Although the responsibilities incumbent upon the Fund in the event of noncompliance with those policy targets remained ambiguous, the basic principle should be that the Fund would make available the clearest and most detailed information possible about its assessment of the situation, because it would be left to the creditors to draw their own conclusions. Finally, issues relating to any possible official rescheduling should be left to the creditors' group on Yugoslavia--including the definitions of the conditionality to be applied--should Yugoslavia present that group with a request for rescheduling. The conditionality that was currently under consideration had been designed exclusively for the implementation of an agreement with the commercial banks. In conclusion, he supported the proposed decisions.

Mr. Fugmann observed that staff reports such as the one on Yugoslavia, with its candid exposition of issues and problems, would be essential to the success of enhanced surveillance arrangements that involved a role for the Fund.

The current Board discussion was the third one on the Yugoslav economy in 12 months, which gave a strong sense of déjà vu to the discussion, Mr. Fugmann remarked. Unfortunately, the feeling of repetitiveness was marked by the continued uncertainty with respect to the authorities' ability and determination to strengthen and broaden their adjustment policies. The main objective of the current stand-by arrangement had been to consolidate progress made in 1983 and 1984 in restoring external equilibrium vis-à-vis the convertible currency area and in laying the basis for sustainable economic growth. While the authorities had consolidated their successes on the external side in 1985, several developments made him doubt whether the basis for sustainable growth had been laid. The continued acceleration of inflation was alarming and might be getting out of hand. It was important for the authorities to take a more coordinated approach to structural reforms in order to reap the benefits of price liberalization. Such reforms should preferably aim at increasing competition in the economy, and there was a clear need for further steps in the financial discipline of enterprises, money and credit policies, and the politically sensitive foreign exchange allocation system. While he agreed with the staff recommendations in those areas, he found it difficult to judge how far those reforms could be taken in the Yugoslav context, and the authorities had not given any indication of possible useful alternatives to the recommended changes. The domestic debate on those issues underlined the importance of getting a firm control on inflation.

The issue of the exchange rate policy also needed to be examined, Mr. Fugmann continued. The question was whether the time had come for the authorities to change the policy by undertaking a large discretionary devaluation of the dinar and then keeping the nominal exchange rate stable. Although there had been undeniable benefits from the exchange rate policy pursued to date, such a devaluation would serve to indicate that a new phase in the adjustment process had begun--namely, one in which inflationary expectations had to be broken and in which those enterprises that could not survive with the ensuing higher costs would be allowed to die. Staff comments on that issue would be welcome.

The problems in the money and credit system were evident from Chart 3 of EBS/86/38, which showed the developments in the real money supply, Mr. Fugmann noted. In the light of such developments, one might ask how any economic activity persisted in Yugoslavia, the answer to which lay in a continued relatively high degree of liquidity made possible by the obvious disintermediation in the system. He welcomed the first steps that the authorities had taken to alleviate the problem.

Given that the domestic economic problems of Yugoslavia were dominated by structural impediments, he was disappointed that no agreement had been reached between the authorities and the World Bank in the negotiations that had begun a year ago on a second structural adjustment loan, Mr. Fugmann stated. Such a loan could strengthen the prospects of success of an enhanced surveillance arrangement with Yugoslavia. Information from the World Bank representative as to the main problems, the likely results, and the timetable would be helpful.

The authorities had requested enhanced surveillance from the Fund, but it was not a good start in terms of credibility that the current review of Yugoslavia incorporated three requests for waivers, Mr. Fugmann commented. Moreover, there was some question whether the public expenditure target for the first quarter of 1986 would hold. The staff qualified its views of the prospects for success of an enhanced surveillance arrangement. For example, the consolidation of Yugoslavia's external position had been described as the "apparent consolidation"; serious data problems had been mentioned with respect to gauging the efficacy of restrictions on use of resources by illiquid and loss-making enterprises, and note had been made of the continuing difficulty posed by the regional concentration of ailing industries; concern had been expressed over the authorities' tendency to delay or "temporarily" suspend implementation of key policies; and the staff had given a negative evaluation of the effects of the new foreign exchange and trade regime. Furthermore, it was evident that the authorities clearly needed to improve their ability to track the economy and to monitor responses to policy measures on a current basis if the envisaged enhanced surveillance arrangement was to fulfill its purpose. In that context, he disagreed with the staff that the provision of quarterly national accounts data was a welcome development. In view of the often shaky quality of such data--even in most industrial countries--and the general quality of Yugoslav economic statistics, he did not see any benefit in quarterly data.

Most of the issues that he had cited touched both on substantive economic problems and on the ability and determination of the authorities, Mr. Fugmann mentioned. In respect of the latter, one had to recognize that the complex institutional setup in Yugoslavia vastly complicated the task of the Federal Government. However, it was the Board's task to convey to the authorities that if an enhanced surveillance arrangement was to succeed, it was of vital importance that the "spirit of 1984"--when the quality of economic policies had been clearly improved through commendable measures undertaken by the authorities--be revived and strengthened in 1986 and later years. If that could be accomplished, the point of departure for the authorities was not bad: the external situation was acceptable, and in macroeconomic terms, the economic problems of Yugoslavia were not particularly large compared with those of other countries. He believed that both the Yugoslav authorities and the Fund would be well served by a period of a less stringent relationship, and on that basis, he was prepared to support the proposed decisions and the request for enhanced surveillance.

The staff representative from the European Department, responding to the question of whether it was possible to have the relatively large shift of resources into the export sector and the considerable adjustment on the external side at the same time that efforts were being made to attain better internal balance and a lower rate of inflation, said that greater internal adjustment ought to support a permanent, fundamental external adjustment rather than give rise to the dilemma of having to sacrifice one part of the adjustment process for another. However, because of the problems that arose when basic, systemic measures were being taken--but had not yet been completed--the authorities found themselves in a half-way position in which they bore the costs of the adjustment but did not yet reap the benefits. That fact also answered the questions that had been raised about the efficacy of monetary policy and explained why credit policy--although apparently stringent--had not yet produced the expected effects on credit expansion, on the operations of loss-making enterprises, and on inflation.

Incomplete policy implementation was also responsible for the continued growth of inter-enterprise credit that interfered with the effectiveness of monetary policy, the staff representative continued. As Mr. de Forges had observed, if the monetary authorities relied basically on quantitative credit ceilings for monetary control but did not implement a relevant interest rate policy at the same time, then it was clear that the effectiveness of monetary policy would be at least constrained and possibly even compromised. The authorities' continued inability to follow through on their own wish to institute a policy of positive real interest rates was at the heart of the adjustment problem, and thus interest rates had become the focal point in the relationship between the authorities and the Fund. The authorities had taken courageous steps in the fundamental policy areas of financial discipline on enterprises, price liberalization, and bank operations. However, all those policies had to be mutually supportive in order to be effective, especially in view of the depth of the dislocations that existed in the internal economy, and any problems with implementation in one area would have a negative impact on the effectiveness of other policies.

Given the extent of the imbalances, the authorities had sometimes given the impression that they would not be able to face the actual consequences of their policy orientations, the staff representative added. While that behavior was very natural, it had given rise to problems, such as inflation expectations and defensive actions; for example, the risk premium that enterprises had begun to charge after price liberalization had been effected. Such defensive behavior, together with the repression of inflation in the past, were major causes of the inflation that was currently being experienced.

Another factor exacerbating inflation was the continuous, large absorption of resources by the loss-making enterprises, the staff representative mentioned. While it was important that some of those enterprises be allowed to die, they seemed to be concentrated in a number of declining industries, which in turn were also concentrated regionally, thus creating a sociopolitical and economic problem that was difficult to resolve. Nevertheless, unless the authorities demonstrated that some of those enterprises were indeed going to be allowed to die, the public would have little confidence in the determination of the authorities to force more efficient behavior on enterprises. Experience had shown that the socialization of losses in Yugoslavia had worked negatively on managerial behavior and unless managerial responsibility was increased, it was not likely that the positive effects of the authorities' measures would be as great as they needed to be or as the authorities hoped that they would be.

The relationship between the financial behavior of enterprises and the effectiveness of monetary policy--for example, the way in which disintermediation by the enterprises interfered with the conduct of monetary policy--was linked, of course, with the interest rate policy, the staff representative observed. It should not be overlooked that enterprises were earning a very small return on their deposits in the banks. Whereas their total interest receipts constituted about 2 percent of all revenue, only one tenth of that amount was earned in the banking sector and the rest through the extension of interenterprise credit. That situation was tied directly to both the institutional arrangements as well as to the reluctance of the banks to accept deposits from enterprises in maturities carrying inflation-related remuneration.

Institutionally and philosophically, of course, the banking sector in Yugoslavia did not resemble that in many other countries, in that banks were not supposed to make profits but instead worked somewhat like credit unions, in which members, as shareholders, put up capital as needed, the staff representative from the European Department went on. Thus, there was some reluctance to charge the shareholders high interest rates, which would simply go from one pocket to another. Moreover, it would take some time to change the attitude toward the allocative function of the interest rate, which had been played down for a long while. The adoption of the new banking law, together with the prevailing policy orientations, had provided an incentive to view interest rates more broadly. Nevertheless, the banks had not been working hard to gather deposits in excess of the perceived credit needs of their members, in view of the credit ceilings that had been allocated by the National Bank of Yugoslavia. The staff had considered the surfacing of a trade in credit ceilings to be positive, but the authorities did not agree and, unfortunately, had discouraged a market in those credit ceilings.

The choice between aiding loss-making or marginal enterprises through interest subsidies or through budgetary provisions was a choice between two evils, the staff representative considered. However, the authorities had been moving toward acceptance of the staff's view that if such a need was demonstrated on a case-by-case basis or for a particular sector, such as agriculture, then the costs of subsidization should be made explicit--through budget allocations--so that they would be seen within the policy-making framework as well as by the public, rather than be submerged through interest subsidization. However, the staff was not encouraging the authorities to embark upon wholesale bailouts through the budget; the staff had emphasized that such action should be taken on an individual basis. It was debatable whether governments could make better choices as to the viable enterprises than the market could; but since Yugoslavia did not have a full market test in place, it was better for the governmental entities, together with the enterprises, to determine which ones might become viable, and to explore the ways and means--including budgetary means--to make them viable. It would then be easier to close down some of the others.

It was clear that the exchange rate changes had contributed to--and had established--a floor under the rate of inflation, the staff representative commented. Although there were arguments on both sides, it was her view that an automatic formula, if continued for too long, did diminish the cost consciousness of the export sector. Moreover, in the Yugoslav context--with its preponderance of oligopolistic and perhaps monopolistic organization, and the heavy weight of the trade organizations in the overall market--there was indeed an incentive to declare price increases. Since the price increases would then translate into exchange rate changes and higher profitability of exports in terms of the dinar, there was an understandable incentive to manipulate the price mechanism even if the softness of domestic demand interfered with making those price levels effective at home. It was important to remember the different needs of the internal and the external sectors, and the staff had raised the question of the appropriate trade-off between external debt reduction and increased imports to spur domestic competitiveness. Thus, there was a question whether the ambitious debt repayment policy interfered with the goal of increased competitiveness in the domestic market and perhaps also with the goal of winding down inflation.

Despite problems with the data on savings flows and investment, it was possible to draw some conclusions about those developments, the staff representative noted. It was not clear that interest levels were in fact too low as the quality of investment was more important than the quantity. The latter, as a percentage of GSP, was in fact more or less in line with that recorded in other middle-income countries. The high domestic absorption of the 1970s had been supported largely by foreign savings; unfortunately, the associated excessively high investment activity had produced a capital stock that could not pay its way. In that sense, the reduction of investment as a percent of available resources in the 1980s as well as changes in internal absorption were welcome.

The decline in oil prices might not have a large effect on the current account in the short term, because the authorities had negotiated long-term contracts in order to be assured of adequate oil supplies, the staff representative mentioned. Although the authorities would try to renegotiate those long-term contracts, the possible lengthiness of any such discussions might preclude much relief in 1986. The staff had referred to the "apparent" consolidation of the current account surplus because there might be some erosion of Yugoslavia's propensity to export, given the adoption of the new foreign exchange and trade regimes. Although the authorities' projected current account surplus of $800 million in convertible currencies might be optimistic, the staff thought that a surplus in the range of $500 million should be obtainable unless the short-term effects of the new foreign exchange regime were more detrimental than expected. Those detrimental effects, however, could have serious long-run consequences; in an environment of heavy competition, when fewer of the traditional Yugoslav markets--some of which were in the developing, oil producing countries--were expanding, the maintenance--or further improvement--of Yugoslavia's market shares in the developed world, and particularly in the OECD world, was very important.

Of course, that raised the question of what constituted an appropriately active exchange rate policy, the staff representative acknowledged. While the possibility of a steep devaluation should not be ruled out, if the effects of the new foreign exchange and trade regimes did indeed reduce the propensity to export, it did not seem wise to use the exchange rate instrument in order to correct other policy mistakes. Instead, one should explore which faults in the system might be corrected to allow exports to be sufficiently dynamic.

There had been close collaboration between Fund and World Bank staff on Yugoslavia, the staff representative stated. Some of the delays in the negotiations for the second structural adjustment loan were related to the new trade regime, particularly the import liberalization measures, as well as the regime's effect on export propensities and the exchange rate, since the allocation was not being done through the market but through administrative decision.

She did not agree that there were no benefits to be derived from quarterly data on numerous national account components, the staff representative said. In the process of generating the quarterly data, the authorities had found that many questions had surfaced about developments in the economy, about their ability to monitor those developments, and about ascertaining whether they were actually on their targeted path, compared with their traditional review on a year-to-year change basis. Therefore, the authorities' new approach to the data had been helpful to both them and the Fund staff.

It was true that the trigger mechanisms specified in the commercial bank agreement with Yugoslavia were very limited and could not be considered a comprehensive early warning system, the staff representative from the European Department commented. The commercial banks and the authorities sought an indicator of the continued ability of Yugoslavia to service its external debt, and therefore the country's reserves and the cash flow on exports had been chosen as indicators. The banks had not wanted an indicator that could be manipulated by the suppression of imports, which would not augur well for the ability to repay; in addition, the banks did not want a trigger that would go off too frequently, as they did not wish to trigger frequent discussions with the authorities. Because the trigger mechanism was so limited, the banks had insisted on the provision of enhanced surveillance by the Fund and had asked that surveillance reports be as complete and frank as possible.

The staff representative from the Exchange and Trade Relations Department said that the difference of views on Yugoslavia's request for enhanced surveillance was not surprising. Enhanced surveillance was meant to restore normal market relations between the debtor country and its creditors, and if the country's track record had been clearly favorable, the commercial banks would probably have entered the multiyear rescheduling arrangement without requesting any involvement by the Fund. Because enhanced surveillance represented a transition to the normal situation in which market decisions completely guided the creditors on lending operations vis-à-vis the country, it was important to remove the Fund's signal function from the relationship. However, the comprehensiveness and frankness of the staff reports would remain the same, to enable the creditors to make their judgments.

It was possible to specify a formula by which one judged whether or not interest rates on a certain segment of deposits were real--namely the rate of inflation, plus 1 percent--the staff representative from the Exchange and Trade Relations Department noted. However, it was expected that the staff and the authorities would sometimes have different estimates, because the formula was not a mechanical application of past inflation rates but was a forward-looking set of expectations about inflation. The authorities were going rather far in advancing their schedule of increasing the rates on selective credit, but there had been a lag in the adjustment to an appropriate loan rate structure. The formula for attaining real positive rates was a transitional one; the proper positive rates were clearly fully arbitraged rates, which should not be judged by a formula but by other factors in the economy, such as what the public was doing vis-à-vis its holdings of dinar assets versus foreign currency assets. It was not reassuring that, whenever interest rates came down, as they had in recent months, there was a resurgence of public interest in foreign currency deposits. That dollarization was a signal that the staff hoped the authorities would use more frequently than any particular formula in the future.

Just as there were different views in the Board about the value of the country comparisons contained in the staff report, the staff also had at least shades of view about them, the staff representative of the Exchange and Trade Relations Department pointed out. The staff avoided comparisons of adjustment results in some of its general papers, because it was extremely difficult to find the proper samples, similar timing of events, and other factors that made comparisons of the results of adjustment valid. Although it was easy to calculate the impact on countries of certain actions--interest increases, oil price changes--it was difficult to look at a few particular parameters and then make judgments about the effects of the validity of policies and adjustments that might have been in force at quite different times in the history of specific countries. Therefore, caution should be exercised in the interpretation of such cross-country comparisons.

Mr. Polak observed that nearly every speaker had recognized the great improvement that Yugoslavia had achieved in the balance of payments for three years in a row--even though 1985 had been a difficult year--and the role that the flexible exchange rate had played in bringing about the current account surplus. Another interesting aspect of the balance of payments situation was the new response of the authorities to the credit that was again available to them on a voluntary basis. The authorities and various entities had been cautious, particularly with respect to the longer maturity foreign loans; their behavior had been induced partly by the market mechanisms and partly by the clear responsibility of the debtor for the results of such transactions. As a result, a cofinancing loan with the World Bank for the agricultural sector had not been taken up, owing primarily to the lack of interest on the domestic side, because there was a great awareness of the risks of acceptance of foreign currency loans. Such caution explained in part the slow disbursement of some project loans of the World Bank. In many respects that was a very healthy development and seemed to indicate that the lessons of the 1970s had been learned.

In an earlier Executive Board meeting (EBM/85/66, 4/29/85), it had been clear that the Yugoslav authorities, the staff, and the Executive Directors were in agreement that strong additional structural efforts would be necessary to complete the domestic aspects of the adjustment process, Mr. Polak recalled. The staff had made welcome suggestions on how to make structural improvements, many of which had indeed been accepted or were in the process of being accepted. For example, interenterprise credit would be channeled into the banking system; shorter maturities were being introduced for enterprise deposits; the interest rates on selective credit of the National Bank of Yugoslavia had been raised sharply, to just below the deposit rate; disincentives to stockbuilding had been introduced; the accounting procedures of enterprises were being radically improved; financial discipline was being strengthened; the tax burden on enterprises would be reduced; and attempts were being made to channel household savings more directly into productive investment. In the broad structural area there was considerable unity of view between the staff and the authorities.

Gratitude was due to all Directors who had been willing to support Yugoslavia's request for enhanced monitoring or surveillance from the Fund, even though some of them had understandable reservations on the subject, Mr. Polak added. He agreed with everything that had been said by the staff about the role of the Fund. There would also be an important role for the banks. The report by the staff mission would, of course, be made available to the commercial banks. Quite apart from the trigger clauses and statistics, which were probably not all that important, there were clauses in the multiyear rescheduling arrangement to allow for a polling of the banks in situations in which there was a negative report by the staff; that was due not only on the external side. The provisions of the arrangement made it clear that where Yugoslavia's economic performance was not compatible with "sustained economic growth and with a viable external payments position consistent with the continuing ability to service external debt, then the banks, after polling can take joint action and make the further implementation of the MYRA conditional on further consultations with the Fund."

He had not failed to notice in the current Board discussion, as in some earlier discussions on Yugoslavia, a certain amount of disappointment with what had been achieved, and indeed, in some cases a certain amount of irritation, Mr. Polak mentioned. Executive Directors probably knew that there were similar feelings on the other side; in Belgrade, feelings of irritation about what was perhaps a too close relationship with the Fund were widespread--in the press, in Parliament, and elsewhere. Therefore, it was desirable, for that reason alone, for the stand-by arrangement between the Fund and Yugoslavia to come to an end and, as far as the banks were concerned, to be replaced by a somewhat looser relationship. There had been some discussion as to what would be the proper relationship between the Fund and the member in connection with a possible rescheduling by official creditors, whether or not in the form of a multiyear rescheduling arrangement; while that matter would have to be discussed by the Paris Club, it would be wise for official creditors as well to realize that, for the time being, such close relations between the Fund and Yugoslavia had come to an end, for the benefit of both, and that it would be useful to move into a slightly more remote, enhanced surveillance, relationship than the one that had prevailed since 1979. Therefore, the acceptance by the Board of enhanced surveillance was extremely welcome.

Mr. Zecchini, pursuing the staff's analysis of some technical points, noted that he had been struck particularly by the trade-off between the interest rate mechanism and stringency in the context of credit rationing. In a situation of credit rationing, the interest rate mechanism became less relevant for monetary policy management, for theoretical reasons that were well explained in the economic literature and perhaps should be pursued further. In what the staff had said about the interest rate performance criteria also had widespread implications. If performance criteria were considered as a benchmark to guide actions and assessments, they should be precise, with the attendant consequences if the country's performance did not meet the criteria. Alternatively, the benchmark of performance might be a loose one, more in the sense of monitoring variables. In either case there was a problem of deciding whether the benchmark should be a specific figure or a range of figures. In Yugoslavia, it seemed that the staff had chosen a specific figure, and since the figure had not been met, he concluded that Yugoslavia's performance had not been in line with what the staff had suggested. However, if the staff requested a waiver, then it should explain why the criterion was no longer a valid benchmark, or why the country should not have to meet the predetermined performance criteria.

The staff representative from the European Department said that credit ceilings lower than the market clearing level, as in Yugoslavia, gave rise to disintermediation outside the banking system. Such disintermediation was undesirable, because it was not a reflection of the deepening of the financial markets, nor a reflection of increased efficiency of the use of financial resources and credit allocation, but was an escape mechanism from the policy instrument.

The authorities did indeed wish to meet the performance criterion for interest rates, the staff representative indicated. However, they had been constrained by other domestic considerations and had thus been prevented from full compliance with that performance criterion. Nevertheless, they had moved considerably in the desired direction, and the staff had therefore supported the waiver request.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/86/43 (3/10/86) and EBM/86/44 (3/12/86).

2. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 85/81 and 85/82 are approved. (EBD/86/60, 3/5/86)

Adopted March 11, 1986

3. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/86/55 (3/7/86) and EBAP/86/56 (3/10/86) is approved.

APPROVED: November 18, 1986

LEO VAN HOUTVEN
Secretary