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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/134

2:30 p.m., August 8, 1986

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
A. Alfidja	Mawakani Samba
	M. K. Bush
	D. C. Templeman, Temporary
	M. Lundsager, Temporary
	P. Péterfalvy, Temporary
	T. Alhaimus
	M. Z. M. Qureshi, Temporary
H. Fujino	M. Sugita
	B. Goos
Huang F.	
	Jaafar A.
	J. Hospedales, Temporary
	M. Foot
H. Lundstrom	
	L. Leonard
	G. D. Hodgson, Temporary
E. I. M. Mtei	
	M. A. Weitz, Temporary
	J. E. Suraisry
	G. Ortiz
H. Ploix	S. de Forges
J. J. Polak	A. Steinberg, Temporary
	A. V. Romuâldez
G. Salehkhou	
	A. S. Jayawardena
	A. Vasudevan, Temporary
S. Zecchini	N. Kyriazidis

L. Van Houtven, Secretary
J. K. Bungay, Assistant
R. S. Franklin, Assistant

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Also Present

IBRD: D. A. Cook, K. T. Yurukoglu, Eastern and Southern Africa Regional Office. African Department: A. D. Ouattara, Director; L. M. Goreux, Deputy Director; A. Basu, M. W. Bell, G. Devaux, M. E. Edo, C. Enweze, E. K. Martey. Asian Department: D. Villanueva. European Department: L. A. Whittome, Counsellor and Director; P. B. de Fontenay, Deputy Director; P. Fontana, D. Gottlieb, N. L. Happe, P. L. Hedfors, H. B. Junz, M. Z. Khan, S. Mitra, A. Mountford, G. Szapary. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; J. T. Boorman, E. H. Brau, A. Chopra, S. Kanesa-Thasan, N. Kirmani, V. P. G. Schoofs, R. L. Sheehy, E. J. Zervoudakis. External Relations Department: H. P. Puentes. Fiscal Affairs Department: G. M. Bartoli, G. Blöndal, A. Ize, W. Perraudin, B. A. Sarr. Legal Department: F. P. Gianviti, Director; P. L. Francotte, R. H. Munzberg, S. A. Silard. Middle Eastern Department: E. J. Bell, E. B. Maciejewski, M. Zavadjil. Secretary's Department: A. P. Bhagwat. Treasurer's Department: T. Leddy, Deputy Treasurer; D. Berthet, D. V. Pritchett, B. B. Zavoico. Western Hemisphere Department: H. M. Flickenschild, G. Yadav. Advisors to Executive Directors: W.-R. Bengs, L. P. Ebrill, K. Murakami, R. Valladares, A. Vasudevan. Assistants to Executive Directors: A. Bertuch-Samuels, O. S.-M. Bethel, B. Bogdanovic, P. Di Mauro, R. Fox, V. Govindarajan, G. K. Hodges, J. M. Jones, S. King, T. Morita, R. Msadek, A. H. Mustafa, J. K. Orleans-Lindsay, W. K. Parmena, C. A. Salinas, G. Schurr, S. Simonsen, B. Tamami, L. Tornetta, H. van der Burg.

1. BURUNDI - 1986 ARTICLE IV CONSULTATION; STAND-BY ARRANGEMENT; AND STRUCTURAL ADJUSTMENT ARRANGEMENT

The Executive Directors continued from the previous meeting (EBM/86/133, 8/8/86) their consideration of the staff report for the 1986 Article IV consultation with Burundi and a request by Burundi for an 18-month stand-by arrangement in an amount equivalent to SDR 21 million (EBS/86/119, 6/3/86; and Cor. 1, 8/7/86), together with a request by Burundi for a three-year structural adjustment arrangement in an amount equivalent to SDR 20.069 million (EBS/86/147, 7/10/86; and Cor. 1, 8/7/86). They also had before them a report on recent economic developments in Burundi (SM/86/177, 7/23/86).

The Deputy Director of the Exchange and Trade Relations Department noted that in dealing with the case of Burundi, the staff had done its best to follow closely the Chairman's summing up of the March meeting on the structural adjustment facility (EBM/86/56, 3/26/86). As in other pending cases, the staff had attempted to use benchmarks sparingly; obviously, not all the policies under a structural adjustment facility arrangement were subject to benchmarks, and there had been a clear effort to minimize the number of benchmarks in structural adjustment facility programs.

Directors had expressed reasonable concerns about cross-conditionality, an issue with which the staff itself was concerned, the Deputy Director continued. In general, the Fund was to monitor those benchmarks that were components of the annual structural adjustment facility programs, and the Bank was to monitor those measures specifically related to its provision of structural adjustment credits. That division of labor still left an area of policies being looked at by both institutions. In examining those policies, the staff for its part would continue to be mindful of the very clear instruction that cross-conditionality must be avoided.

Contrary to what some Directors had implied, there was no question of suspending a structural adjustment arrangement if the data showed that the intrayear benchmarks were off track, the Deputy Director said. The benchmarks were not performance tests; rather, they were designed to ensure discussions between the staff and the authorities aimed at finding solutions to the problems that had led to the deviations. In his summing up at the conclusion of the March 26 meeting on the structural adjustment facility, the Chairman had observed that "deviations from benchmarks will of course be noted" and that an "effort will be made to understand why they have happened. If the reasons are such that they could derail the direction of a program, policy adjustments may well be necessary, and they will be taken up in discussions leading to the arrangement in support of the next annual program." The alternative to such use of benchmarks--to wait until the end of the year of the annual program when it might be difficult and perhaps not possible to return the program to its initial path--was not a palatable one. In that context, he saw nothing peculiar about what had been proposed in the program for Burundi in respect of consultation clauses. All programs relating to first credit tranche purchases had consultation clauses. While one could debate the appropriate level of conditionality of the structural adjustment facility, he believed that it was commonly understood that the conditionality of that facility was akin to the first credit tranch conditionality; hence, to leave consultation clauses out of a structural adjustment facility arrangement would seem odd. In passing, he noted that consultation clauses were simply provisions enabling the Managing Director to call for a consultation with the authorities, a consultation that could include a staff visit to discuss the issues in the field.

In response to Mr. Jayawardena's query about whether the classic precautionary stand-by arrangement of the type negotiated with Burundi indicated a lack of confidence in the economy, the Deputy Director observed that the Fund had a long history of having negotiated precautionary stand-by arrangements; and the record with respect to those arrangements had been generally good. He would not want Directors to feel that a precautionary stand-by arrangement somehow represented a "second-class" form of arrangement. Finally, with regard to Mr. Finaish's concerns about a balance of payments test in the Burundi case, it must be remembered that one of the principal purposes of a stand-by arrangement was to achieve a significant increase in reserves; and it seemed logical, in those circumstances, to include a safety-net approach. Besides, a balance of payments test would help to bring some precision to discussions about exchange rate policy.

The staff representative from the Legal Department, responding to questions by Mr. Alfidja, observed, first, that paragraph 6 of the decision on the structural adjustment facility referred to "consultation," and focused on the possibility of deviation from the indicators that were identified as benchmarks under the program. The Fund had had considerable experience in applying such a provision in other Fund arrangements, and it had seemed only natural to include it in the structural adjustment facility arrangement in order to ensure that if deviations from the benchmarks gave reason to be concerned that the program was not being implemented, discussions would take place aimed at determining the reasons for the deviations and at finding ways of putting the program back on track.

Second, it was indeed possible that the resources available to Burundi under the arrangement might increase, the staff representative said. Finally, he could not go along with Mr. Jayawardena's characterization of the proposal for Burundi as a shadow program supported by a shadow stand-by arrangement. The program was a real one, and real purchases could be made under the stand-by arrangement even though the authorities had indicated that, for the time being, they had no intention of making such purchases. Moreover, the arrangement contained performance criteria and a review clause, and the Fund was backing the arrangement with financial assurance; hence, under the Fund's guidelines on conditionality, the normal safeguards applying to stand-by arrangements were incorporated.

Mr. Alfidja remarked that his concern with the provision was that, according to the language, the consultation could be triggered by deviation from "any" of the indicators, which seemed to suggest that even a minor deviation from a single indicator could lead to a consultation.

The staff representative from the Legal Department replied that the language to which Mr. Alfidja had referred was part of a provision which left the initiative for consultation either to the Government of Burundi or to the Managing Director when it was considered appropriate to consult "because of deviations from any of the indicators." It would not have been helpful to have provided for consultation because of deviations from "all" the indicators, an unlikely development; similarly, it would not have been helpful to provide for possible consultation when deviations occurred from only certain of the indicators. In the circumstances, the word "any" seemed properly descriptive.

Mr. Goos recalled that he had earlier alluded to the increase in the public sector deficit, the decline in fiscal revenues, and the decline or stagnation in domestic savings, all of which were reflected in a substantial increase in the external accounts. He would appreciate clarification from the staff of why greater emphasis had not been put on those developments--which were crucial for the longer-term stability of the country--and why greater financial adjustment had not been envisaged in the program. In particular, noting that the case of Burundi was the first for which a structural adjustment facility program had been designed, he was concerned that it might set the stage for future programs in which too much emphasis was placed on growth and investment at the expense of financial stability.

Mr. Qureshi remarked that Mr. Goos was apparently interpreting as a weakness in the program the increase in the current account and fiscal deficits that he saw projected in the period from 1987 onward. It should perhaps be noted that the forecast deficits for the period after 1987 were significantly lower than those registered in the period prior to 1986. The year 1986 was a special one because the large windfall gain from the increase in the price of coffee had a positive impact on both the fiscal and the current account deficits. To say that unexpectedly good performance in the first year of the program should be the basis for assessing performance in the subsequent period was perhaps unfair; a more equitable approach might be to compare performance in the period 1987 and beyond with a corresponding medium-term period preceding the inception of the program.

Mr. Goos replied that Table 1 on page 3 of the staff paper showed that the "consolidated overall deficit, excluding grants" would increase from -4.1 percent to -6.9 percent in 1989; including grants, it would increase from -0.3 percent to -3.2 percent in the same period. Those figures could not be interpreted to mean that there would be progressive adjustment in the years ahead; rather, they showed a deterioration over a four-year period, irrespective of whether the figures were lower than in some earlier period or base year.

The staff representative from the African Department remarked that it might be helpful for Directors to look at Table 3 in EBS/86/119, where the projection for net reserves equivalent to a number of months of imports showed that, through 1990, a target for reserves equivalent to four months of imports had been set, and that target was consistent with staff projections for capital inflows. He shared some of the concerns that had been expressed by many Directors about the feasibility of mobilizing those inflows, although he had noted that the amount of new capital needed in the form of disbursements as a proportion of new commitments was not particularly high. In fact, if the capital flows materialized, the current account deficits shown would be consistent with a fairly comfortable level of reserves.

It was also important to note that borrowing would be on concessional terms and that, beginning in 1988, a decline in the debt service ratio was expected, the staff representative continued. A medium-term view was certainly important; and in the event that deviations from the medium-term targets were to occur, it would be important to consider adjustments in the policy package. The fiscal scenario, to which Mr. Goos had referred, showed a steady upturn in capital expenditure and net lending, but those aggregates were fully explained by the last two lines of the table on page 13, namely, the "foreign-financed components" and the "locally financed components." A statement had been incorporated in both the stand-by arrangement and in the structural adjustment facility arrangement to the effect that those expenditures would be monitored in such a way that there would be no prefinancing of, or spending on, projects for which sufficient aid support was not available.

Admitting that for 1988 and 1989 the staff had no firm projections for revenues--which would have been helpful--the staff representative observed that if the economy responded, then the FBu 32 billion in revenues being projected for 1988 and 1989 might be considered a fairly reasonable estimate. Of course, the pace of progress of rehabilitation in the public enterprise sector would also be important because, by 1988 and 1989, a fair amount of rehabilitation would have occurred, and some help to that side of the budget could be envisaged in the longer run. In sum, there was some prospect for marginal gains on the revenue side, and greater restraint would be needed on noncapital expenditures, but none of the figures shown in EBS/86/119 indicated recurrent expenditures increasing by an enormous magnitude. In any event, the numbers for 1988-89 would be reviewed, and the staff would bear in mind the overall external objectives established in the scenario and would bear in mind that capital expenditures must be reviewed by the World Bank if financing was available.

Mr. Jayawardena reiterated an earlier question regarding the stand-by arrangement and the authorities' indication that they would not draw on the arrangement. The staff had suggested that the authorities could draw on the arrangement if the resources were needed. However, he had noted that they could draw on the first credit tranche up to SDR 10.675 million, with an additional SDR 4.5 million under the structural adjustment facility. Since Burundi was entitled to no more than SDR 15.835 million under the stand-by arrangement before the June review, he was confused about the need for a stand-by arrangement at all.

The Deputy Director of the Exchange and Trade Relations Department replied that the stand-by arrangement had been requested by the authorities; it had not been imposed upon them by the staff.

Mr. Jayawardena stated that he had not meant to suggest that the stand-by arrangement had been imposed upon the authorities, but he was puzzled why the country was requesting a stand-by arrangement when it could get the same financial benefits without such an arrangement. He presumed the staff would advise a country of what it did or did not need; and there could be some good reason why Burundi was asking for a stand-by arrangement when it had available to it an easier way of dealing with the problem. He would appreciate hearing the authorities' reasoning.

The Deputy Director of the Exchange and Trade Relations Department noted that the stand-by arrangement had been in negotiation since 1984 at the authorities' request. It had taken some time to put all of the elements together, including the work on the exchange system, tariffs, and so on. In the meantime, the structural adjustment facility had become available and, in effect, had taken on the character of an "add on" in Burundi's case. He was not in a position to say whether, if the whole process could be started over, the authorities would still choose the same approach.

Mr. Qureshi recalled that in his earlier intervention, Mr. Finaish had raised a question on the relationship between the design of structural adjustment facility programs and stand-by programs. In responding to that question, the staff had suggested that significant differences existed between the two programs, although the clarification of that answer had been limited to the indication that benchmarks rather than performance criteria were used in the structural adjustment facility programs and that the cost and maturity of financing provided under that facility were different from those relating to stand-by programs. As he saw it, those elements were related to the monitoring of arrangements and to the terms of financing rather than to the design of programs, and he was much more interested in matters like differences in the composition, pace, and sequencing of adjustment policies.

The Deputy Director of the Exchange and Trade Relations Department said that he was not at present in a position to give a detailed answer to Mr. Qureshi's question. Among the fundamental differences between the two programs were the maturities of each and the terms on which money was provided, and those elements tended to help shape the design of the programs. At the moment, the staff was grappling with a wide range of structural adjustment facility programs, nearly all of which were being considered for members that already had stand-by arrangements. And the countries in question were those with which the Fund, and perhaps the Bank as well, already had some experience. Therefore, the question of the fundamental differences between the design of stand-by arrangements and structural adjustment facility arrangements had not been determined at this time. Moreover, as he had noted in his earlier remarks, more light would be shed on these aspects when a case of a structural adjustment arrangement was considered by itself and not in conjunction with a stand-by arrangement.

Mr. Mtei remarking further on an issue raised by Mr. Jayawardena, wondered whether, if Burundi were to request a drawing under the first credit tranche of the stand-by arrangement, it would have to observe the conditionality attached to purchases in the upper credit tranche.

The staff representative from the Legal Department replied that the stand-by arrangement covered both the first credit tranche and the upper credit tranches. The first purchase could be made without observance of any of the conditions in the arrangement, that they related to phasing and performance criteria. Upper credit tranche conditionality would not apply unless Burundi wished to make purchases in the upper credit tranches.

Mr. Suraisry remarked that even if it were possible for the staff to provide the answers to the questions raised by Mr. Qureshi, it might not be appropriate for the staff to do so. The structural adjustment facility for Burundi was the very first of its kind, and there would no doubt arise problems during the implementation of the program that would have to be taken into account in the design of future programs. In that respect, it was important for the staff to leave room for flexibility to design programs that, on the basis of experience, were appropriate to members' needs.

Mr. Jayawardena said that he would not prolong the discussion by delving into any of the fundamental issues arising from the staff's reply to his question. Suffice it to say that fundamental questions had been raised about his understanding or conception of how the facility would evolve, and he hoped that an opportunity would be provided in future to discuss those questions.

Mr. Mtei confirmed that negotiations on a possible stand-by arrangement had begun as early as 1984; and, he had traveled with the staff mission to Burundi on those earlier occasions. An agreement on major aspects of the stand-by program had been reached in March 1986, before any conclusions had been reached in the Board about how to tackle the structural adjustment facility. As the staff had explained, the coffee boom in Burundi, coupled with improvements in the balance of payments, due in part to declines in petroleum import prices, had led the authorities to decide not to draw on the proposed stand-by arrangement; but they had in the meantime become interested in the less costly resources under the structural adjustment facility, and they were looking forward to receiving other resources--from the World Bank and bilateral providers--to finance their adjustment efforts.

Speaking more generally on arrangements under the structural adjustment facility--and not specifically on the way in which they were applied in the case of Burundi--Mr. Mtei noted that a number of Directors had agreed with his suggestion that, in determining benchmarks for monitoring the performance of programs under the structural adjustment facility, the Fund should work toward ranges of figures rather than specific targets. He was also pleased to note that Directors agreed that such benchmarks would be treated as indicators rather than as specific targets to be attained. Such flexibility was crucial in translating the programs of low-income countries into reality.

His concern about lumping together a stand-by arrangement and a program under the structural adjustment facility was related to the danger that the strict and higher conditionality of arrangements in the upper credit tranches might be introduced into programs under the structural adjustment facility, Mr. Mtei continued. In that context, he had noted the indication that, thus far, the Fund had been concentrating only on countries that already had a stand-by arrangement or that were requesting a stand-by arrangement from the Fund in conjunction with requests for use of resources under the structural adjustment facility. It was to be hoped that such a conjunction was coincidental and not based on some notion that countries asking for assistance under the structural adjustment facility must also undertake a stand-by arrangement with the Fund. Of course, in the case of Burundi, the authorities had undertaken to implement the stand-by arrangement and fulfill the performance criteria, which coincidentally were identical to the benchmarks for the first annual installment of the structural adjustment facility program, but they would probably be looking toward flexibility in the observance of those benchmarks.

The Burundi authorities had undertaken to implement a wide range of policy measures under a comprehensive adjustment program, Mr. Mtei commented. Those included exchange rate policy measures, liberalization of import and exchange controls, reform of the structure of import tariffs, liberalization of price controls, reform of the investment code, review of the public investment program, review of producer prices for agricultural products, development of the coffee sector, rehabilitation and privatization of public enterprises, budgetary and credit policy, flexible interest rate policy, and external debt management. There was even a requirement to maintain a certain level of net foreign exchange reserves under the structural adjustment facility. With so many changes and policies being pursued, it was to be hoped that the Fund would not be too rigid in demanding specific results.

He noted from the statement read out by the Acting Chairman at the beginning of EBM/86/133 that the World Bank recognized that the resources being provided under the structural adjustment facility were "minimal" when viewed against Burundi's needs for financing adjustment and growth; indeed, in Burundi's case, they were equivalent to only 47 percent of quota, Mr. Mtei said. During the early discussions of the structural adjustment facility, he had attempted to stress the problems that might arise if resources should turn out to be insufficient to finance the adjustment and growth needs of individual countries. He understood that the World Bank Executive Board felt that the nature of the Bank's own financial flows, because they were slow disbursing, might have to be changed so that the Bank could respond more appropriately to the adjustment and growth objectives of countries. He hoped that the Fund and the World Bank would act as catalysts to generate other resources so that the large financial needs of the low-income countries could be met.

He was pleased to note that a majority of Executive Directors supported his view that all possible should be done to ensure that the growth objectives agreed with the low-income countries were not sacrificed, Mr. Mtei commented. Of course, the Fund should also strive for stability and balance of payments viability; but if the aim was to resolve the debt problem, there was no alternative but to ensure economic growth in the very poor countries.

As others had noted, the Burundi authorities did not intend to request any purchases under the stand-by arrangement, Mr. Mtei said. Their interest was in collaborating with the staff in formulating a sound adjustment program and monitoring developments with a view to attaining a viable fiscal and external position. The authorities felt that, rather than use relatively costly Fund resources to support the program, they would utilize their own resources from windfall coffee receipts and any concessional external assistance that might be forthcoming during the period. On a related matter, despite the indication of the staff representative from the Legal Department that the stand-by arrangement should be treated as "normal," there were areas where a rather different approach might be taken. He would appreciate hearing whether, since the authorities had clearly indicated their intention not to draw under the stand-by arrangement, Directors would consider waiving the normal payment of the commitment fee.

When the structural adjustment facility had been established, it had been decided that the full amount of the reflows from the Trust Fund should be disbursed during the three-year period, Mr. Mtei commented. It had also been acknowledged that the 47 percent of quota that eligible members could draw under the facility representated a conservative estimate based on the assumption that all eligible members would come forward with requests for purchases under the facility at almost the same time. As he understood it, the Board's expectation had been that the amount of available resources was to be determined, inter alia, by the speed and volume of reflows, which could permit higher levels of disbursements. For that reason, it had been agreed that management should review the status of inflows in June 1987 and June 1988 so that the second and third year drawings under the structural adjustment facility could be revised as warranted. It was his own expectation that such higher levels of disbursements in the second and third years would be possible, and he was thus suggesting that his colleagues amend the proposed decision by replacing the words "equivalent to" in the paragraphs containing the relevant amounts to "not less than." Such a change would reflect the intention to review the situation in June 1987 and in June 1988 with the possibility of increasing the disbursements.

The staff representative from the Legal Department noted that under the Articles of Agreement, the Fund had the authority to impose a commitment fee for stand-by arrangements, and the Fund had done so in a general way under Rule I-8. Under the Rule, a charge of 1/4 of 1 percent a year (payable at the beginning of each 12-month period of the stand-by arrangement) was imposed on amounts not purchased. When a member made purchases under an arrangement, there was pro tanto a refund of the fee. The result was that a member that did not make any purchase under an arrangement would not receive a refund of the fee, while a member purchasing the full amount available under the arrangement would have the fee fully refunded. Mr. Mtei had asked for special treatment in the case of Burundi on the grounds that the authorities had announced their intention not to request a purchase under the stand-by arrangement. The difficulty with the proposal was that the Fund was providing financial assurances in the normal way under the stand-by arrangement and must manage its affairs in such a way as to make the resources available if Burundi exercised its legal right to request them. Therefore, as a matter of general policy, it was difficult to see how a declaration of intention at the beginning of an arrangement could serve as a basis for special treatment. It was of course for the Board to consider how to deal with Mr. Mtei's request.

On the proposed modification to the draft decision, the staff representative noted that the language change suggested by Mr. Mtei would in effect assure Burundi that should the resources available in the structural adjustment facility turn out to be less than expected, the amount that could be drawn by Burundi would not be diminished. Such an approach could shortchange other members that might come in later and that had an equal call on the resources during the period of the arrangement before the review. In the circumstances, the assurances provided by substituting the words "not less than" for "equivalent to" in the relevant paragraphs of the decision might not be appropriate.

The Deputy Treasurer said that, while he agreed with his colleague from the Legal Department that it would perhaps not be appropriate to change the language of the decision along the lines recommended by Mr. Mtei, he could confirm that the reviews mentioned by Mr. Mtei would take place; and it remained that the staff's expectation that it would be possible to augment the disbursements in the second and third years. Of course, it was conceivable that the amounts could be less if, for example, members failed to make repayments of Trust Fund loans in substantial amounts or if there should be a significant increase in the number of members eligible for use of the resources. Still, on present expectations, it was likely that the amounts would increase.

The Acting Chairman asked for reactions of members of the Board to Mr. Mtei's proposal to waive the commitment fee.

Mr. Foot said that he could find no grounds for waiving the fee in Burundi's case. The commitment fee was a fundamental part of Fund financing, and waiving it for Burundi could have implications for other members that had paid the fee in the past. Perhaps the matter should be pursued in the context of discussions on the Fund's income position; the present discussion was not the appropriate place.

Mr. Mtei indicated that he would withdraw his proposal.

The Acting Chairman made the following summing up:

Executive Directors generally endorsed the appraisal in the staff report for the 1986 Article IV consultation with Burundi. Directors noted that Burundi's economic and financial situation had weakened noticeably over the past five years, and agreed that the impact of adverse weather conditions on the output of the dominant agricultural sector, combined with fluctuations of world commodity prices for Burundi's major export--coffee--had constrained the rate of economic growth. They underscored, however, that those difficulties had been compounded by inappropriate pricing policies, weak demand management, low domestic savings, and an appreciating exchange rate.

Against that background, Directors welcomed the structural reform program that Burundi was putting in place within the framework of the structural adjustment loan recently approved by the World Bank. The reforms of the structure of import tariff protection, the rehabilitation of the public enterprise sector, the reform of industrial policies, including the investment code and pricing policies, were all appropriate steps in the right direction. Directors welcomed the emphasis in the public investment program on the rehabilitation and development of agriculture, and stressed the overriding need to diversify and expand the production and export base. Directors expressed the hope that the ambitious medium-term growth target of 4 percent could be achieved, and in that context they drew attention to the volatility of coffee prices.

Directors also commended the authorities for their decision to supplement the structural reform measures with a comprehensive adjustment policy package that would help reverse the deterioration in Burundi's financial situation that had taken place in recent years. In that connection, they noted with satisfaction the recent depreciation of the exchange rate for the Burundi franc and the Government's commitment to follow a flexible exchange rate policy. Such steps should enable the authorities to strengthen production incentives in the export sector, liberalize imports, and help achieve a viable balance of payments position over the medium term, without recourse to import and exchange restrictions. Some Directors expressed concern about the forecast widening of the external current account deficit in the medium term that was associated, in part, with the projected investment effort. They urged the authorities to strengthen the domestic savings effort and to stand ready to prune investment if the needed foreign financing did not fully materialize.

With regard to fiscal policies, Directors took note of the authorities' decision to reduce further the overall deficit in government operations by improving tax collection, increasing the elasticity of the tax system that currently relied heavily on foreign trade taxation, and containing government expenditures, in particular, public investment and wage outlays. Directors viewed those steps as essential to achieve an overall improvement in the financial position of the Government, eliminate domestic arrears, reduce bank borrowing, and ensure an adequate flow of credit to the private sector. Directors welcomed the increase in the structure of interest rates that had been implemented to achieve real positive rates. They viewed that decision as an important step to encourage a rational utilization of domestic credit and domestic financial savings, and to reduce the Government's recourse to foreign borrowing and related rising debt service payments. Some Directors indicated that a much stronger domestic savings effort would have been appropriate.

Directors endorsed the far-reaching structural reforms and adjustment measures that Burundi had decided to implement with the support of the Fund under a stand-by arrangement and with resources provided under the structural adjustment facility. They viewed the Government's package of measures as adequate to strengthen Burundi's external position, elicit increased inflows of concessional finance, increase net official reserves, reduce the obstacles to efficient resource allocation, and lay the foundation for sustainable economic growth over the medium term.

It is expected that the next Article IV consultation with Burundi will be held on the standard 12-month cycle.

The Executive Board then took the following decisions:

Decision Concluding Article XIV Consultation

1. The Fund takes this decision relating to Burundi's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1986 Article XIV consultation with Burundi, in the light of the 1986 Article IV consultation with Burundi conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Burundi maintains the restrictive exchange measures described in EBS/86/119 in accordance with Article XIV, Section 2, except the exchange restrictions on foreign remittances of

profits, dividends, and other income pertaining to international transactions which are subject to approval by the Fund under Article VIII, Section 2(a). The Fund grants approval for the retention of these restrictions until the completion of the first review under the stand-by arrangement for Burundi set forth in EBS/86/119, Supplement 2 or December 31, 1986, whichever is earlier.

Decision No. 8359-(86/134), adopted
August 8, 1986

Stand-By Arrangement

1. The Government of Burundi has requested a stand-by arrangement equivalent to SDR 21 million.

2. The Fund approves the stand-by arrangement set forth in EBS/86/119, Supplement 2.

Decision No. 8360-(86/134), adopted
August 8, 1986

The Executive Directors then turned to the proposed decision on the structural adjustment arrangement.

The staff representative from the African Department, recalling that paragraph 4 of the proposed decision listed a series of items by which the Fund would appraise Burundi's progress in implementing the policies and reaching the objectives of the program, suggested that the word "and" be used instead of "or" to link item (a) and items (b), (c), (d), and (e).

Mr. Polak asked the staff to explain what was meant by the suggested change. If he had understood the staff correctely, all five items had to be taken into account, should they occur.

The staff representative from the Legal Department agreed that the original drafting was perhaps not sufficiently clear. Unless Executive Directors objected, the staff would delete both the "and" and the "or's" from the series of items listed under paragraph 4, because all those items did indeed have to be considered.

Mr. Jayawardena, noting that the main feature of paragraph 4 was that the Fund should appraise the progress of Burundi in implementing the policies and reaching the objectives of the program, recommended that items (a), (b), (c), (d), and (e), be deleted.

The staff representative from the Legal Department replied that a technical point was involved in paragraph 4. Those items were included in the decision on the stand-by arrangement with Burundi; however, even if that arrangement were canceled, the structural adjustment facility program might still remain in effect. Moreover, the duration of the two programs was different, in that the stand-by arrangement was for a shorter time; and given that the overlap of the two programs was only partial, there was virtue in retaining the specific items in the text of the arrangement under the structural adjustment facility.

The staff proposed to follow the format of decisions for stand-by arrangements, and had redrafted the proposed decision for approval of arrangements under the structural adjustment facility, the staff representative continued. The proposed decision would thus read:

> 1. The Government of Burundi has requested a three-year structural adjustment arrangement, and the first annual arrangement thereunder, under the structural adjustment facility.
>
> 2. The Fund approves the arrangements set forth in EBS/86/147, Supplement 1.

Mr. Alfidja, commenting on the text of the arrangement itself (pp. 20-22, EBS/86/147) suggested that paragraph 6 be altered so that the phrase, "whenever the Managing Director requests consultation because of deviations from any of the indicators under paragraph 4 above" would read instead, "whenever the Managing Director requests consultation because of major deviations from the indicators under paragraph 4 above."

Mr. Foot, saying that he understood Mr. Alfidja's problem with the original wording in paragraph 6, expressed concern about introducing words such as "major," because they gave rise to problems of interpretation. Perhaps a better revision would read, "whenever the Managing Director requests consultation because he considers that consultation on the program is desirable." In other words, the request for consultation would be left to the Managing Director's consideration, because indicators were one, but not the only, factor involved.

The staff representative from the Legal Department noted that the proposed revisions departed from the standard language used in stand-by arrangements. The staff, in drafting the original wording, had tried to retain time tested words on a feature that was common to both arrangements, namely consultation.

Mr. Alfidja replied that he was not completely convinced by the staff remarks. For the stand-by arrangement language, the Board had had an opportunity to discuss and agree on it. Such was not the case for the structural adjustment facility, and therefore he resisted the idea of taking the standard language from the stand-by arrangement and automatically making that a part of the language for the structural adjustment facility. At some other time, the Board might wish to develop a standard decision for the structural adjustment facility, but that was not currently possible. For the text of the structural adjustment facility arrangement with Burundi, he was happy with the formulation proposed by Mr. Foot.

Mr. Mtei said that he agreed with Mr. Alfidja, because the Board had agreed to be more flexible in the administration of programs under the structural adjustment facility, and therefore, the legal wording of such an arrangement had to be different from that for a stand-by arrangement.

Mr. Goos, Mr. Suraisry, Mr. Vasudevan, and Mr. Huang supported Mr. Foot's suggested revision.

The Executive Board then took the following decision:

Structural Adjustment Arrangement

1. The Government of Burundi has requested a three-year structural adjustment arrangement, and the first annual arrangement thereunder, under the structural adjustment facility.

2. The Fund approves the arrangements set forth in EBS/86/147, Supplement 1.

Decision No. 8361-(86/134), adopted
August 8, 1986

2. SWEDEN - 1986 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1986 Article IV consultation with Sweden (SM/86/178, 7/18/86). They also had before them a report on recent economic developments in Sweden (SM/86/182, 7/25/86).

Mr. Lundstrom made the following statement:

On behalf of my Swedish authorities, I wish to express our appreciation for the very stimulating discussions with the staff mission. The exchanges of view during the mission's visit to Stockholm have been valuable and fruitful for both parties. The ensuing staff report provides a solid description and analysis of the Swedish economy and the problems it is facing. My Swedish authorities are, on the whole, in agreement with its contents.

The staff report gives a fair account of the main components in the economic policy strategy pursued by the present Government since it took office in 1982. Its aim has been to expand production, investment, and employment, while at the same time restoring balance in the current account, reducing the budget deficit, and stabilizing price and cost developments. The devaluation undertaken in 1982 helped Sweden restore its international competitiveness and redirected resources toward exports and investments. This devaluation has been followed up by consistently tight fiscal and monetary policies, determined efforts to reduce the public sector deficit, virtual elimination of subsidies to the corporate sector and a series of supply-side measures to improve the functioning of the economy.

On the achievements of these policies over the past four years, my Swedish authorities believe that the report gives a balanced assessment. By and large, the strategy has proven successful. It has been possible to reduce substantially the financial imbalances in the economy, while production and investment have increased. And it has been possible to curb unemployment and inflation simultaneously.

Some key developments over the past few years deserve mention.

a. Economic growth has been satisfactory over the past three years. Total employment has increased in Sweden and unemployment rates are low by international standards.

b. Profits in the manufacturing sector have approximately doubled since 1982. Swedish business has proved dynamic and capable of utilizing the improved competitiveness. Industrial production increased by 18 percent from 1982 to 1985.

c. Investment has expanded strongly and industrial investment has increased by as much as 37 percent in the period 1982-85.

d. The rate of inflation has been relatively high but was reduced substantially in the course of 1985. The downward trend has been further accentuated this year, bringing the inflation rate to a level corresponding to the European average.

e. The deficit on current account, which reached 3.6 percent of GDP in 1982, was eliminated after two years. Last year a deficit reappeared, but this year a surplus on current account is foreseen.

f. The Central Government budget deficit has been reduced from more than 13 percent of GDP in 1982 to slightly above 4 percent forecast for the current fiscal year. For the consolidated public sector--which is the measure most commonly used for international comparisons--the deficit was 6.3 percent in 1982, clearly above the OECD average of 4.0 percent. In 1986, forecasts point to a deficit of about 1 percent of GDP, as compared with the OECD average of about 3.3 percent.

g. Since 1982, several credit market regulations have been relaxed or eliminated. Examples of regulations that have been abolished are liquidity requirements for banks, regulation of bank lending rates and credit ceilings for banks, finance companies and, mortgage institutions. Regulations that have been relaxed are the issue control on the bond market and investment requirements for insurance companies.

These rather favorable developments confirm what was already apparent a year ago, namely, that the deteriorating trend in Sweden's economic performance since the mid-1970s has been fundamentally reversed, although certain problems remain.

The Swedish authorities are convinced that in order to consolidate the achievements reached so far and to proceed even further, economic policy will have to remain firm and consistent. As also pointed out by the staff, this will require additional efforts to reduce the budget deficit as well as success in constraining price and wage increases.

As a result of strong domestic demand and a number of occasional factors, the current account weakened in 1985, showing a deficit of SKr 9 billion. During the current year, a marked improvement is foreseen, due mainly to developments in oil prices and the dollar rate. In fact, figures for the first two quarters of this year indicate an improvement over the first two quarters of 1985 by SKr 15 billion, bringing the current account during the first six months of 1986 to a surplus of SKr 6 billion. The forecast in the Revised Finance Bill of a SKr 3.4 billion current account surplus for the year as a whole may, if anything, be somewhat conservative. The trade balance during the first six months of 1986 showed a surplus of SKr 19 billion, whereas the surplus during the corresponding period last year was only SKr 6 billion. The current account surplus together with a private capital inflow of SKr 8 billion resulted in a currency inflow to Sweden of approximately SKr 14 billion during the first half of 1986.

As from the beginning of 1985, the aim of the Swedish authorities has been to avoid, over a longer period, net government borrowing abroad. The favorable market situation in early 1985 was used for sizable borrowing operations (SKr 22 billion in net figures). They have been followed by net repayments in the second half of 1985 (SKr 11 billion) and the first half of 1986 (SKr 11 billion).

Inflation continues to slow quite markedly. During the period January to June of this year, prices increased by a mere 1.6 percent, and present estimates point to price increases not exceeding 3 percent in the course of the year. This would correspond to an average inflation of some 4 percent for 1986 and would mean that the inflation rate has been halved since last year. As the staff notes, the improved inflation performance is undoubtedly in large part due to the fall in energy prices. There are, however, also encouraging signs that Sweden is coming to grips with the problem of excessive wage cost increases, which has plagued the economy for a number of years. The two-year wage agreements, which were concluded in the private labor market in late spring, are welcome and imply a significant moderation of wage costs, especially for 1987. The general awareness of the problems posed by continued inflation and the importance of wage restraint has increased and partly explains the very limited use in this year's wage agreements of formal clauses linking the rate of pay to the cost of living or to wage developments in other sectors. The situation in the public sector is still unclear, and agreements will not be concluded until, at best, early fall, but the authorities remain confident that acceptable settlements will be reached.

As regards private consumption, it may be noted that the authorities and the staff differ in their estimates (2.7 percent and 3.3 percent, respectively) for 1986. There is a risk that private consumption could rise faster than foreseen. To date, however, there are no clear indications that this will be the case. Tax on oil has already been raised to partly offset the effects of falling international oil prices. However, should oil prices fall further and remain very low for some time, the Swedish Government would be prepared to consider raising taxes further on gas and oil. Such a decision would not only have a dampening effect on private consumption, but would also help prevent alternative energy sources from becoming too unattractive.

Interest rates, which have been reduced gradually since May 1985, have more or less remained unchanged during the last few months. In view of the large increase in lending from banks, finance companies and mortgage institutions, the Riksbank has counteracted attempts from the market to lower the interest rate level. The annual growth in bank lending was 18.9 percent in June, compared with 1.7 percent one year earlier. A large part of this expansion could, however, be explained by reintermediation.

As to the unemployment situation, it may be worth mentioning that, according to the latest available information, unemployment has been further reduced to a level of 2.4 percent of the labor force in June this year.

Finally, as regards government finances, preliminary calculations indicate that the presently forecast budget deficit for the current fiscal year (July 1, 1986-June 30, 1987) of SKr 45 billion will be revised downward slightly to some SKr 43 billion.

It is the firm intention of the Swedish Government to continue economic policy along the lines pursued so far. The staff and the authorities agree on the need for continuing a restrictive fiscal and monetary policy, combined with various measures to improve the performance of the economy, to make labor and capital markets function better. Such measures are necessary if sufficiently high growth is to be maintained in the years to come. The necessary structural adjustments can be achieved more rapidly and effectively in an environment of economic expansion and rising employment.

Budget policy will have to remain very restrictive in order to reduce the remaining budget deficit. All expenditures will continue to be strictly scrutinized and any increase will have to be financed by compensating cuts in other items. Existing expenditure programs will be continuously reassessed. The Swedish Government has also committed itself to keeping the overall tax pressure by and large unchanged, which implies that an improved budget balance must be achieved primarily by expenditure reductions.

Among the supply-side measures that the Swedish Government is presently preparing, perhaps the most important is, first, the continued reform of the tax system. The main objectives of income tax policy in the years ahead will be to simplify the tax system and to make changes which will facilitate wage agreements at a low nominal level and encourage work and savings through lower marginal tax rates. To this end, decisions have already been taken to change the tax scales for 1987 and 1988.

Second, the Government intends to present proposals to Parliament this fall in line with suggestions by the Committee on Capital Gains Taxation aiming at simplifying and stimulating trade in stock.

Third, the Government has appointed a committee to look at corporate taxation with a view to simplifying the system, stimulating capital mobility, and eliminating distortions. The overriding objective of this exercise is to design a system conducive to economic growth.

Furthermore, in this year's Revised Budget Bill, measures to improve the functioning of the labor market were presented as well as suggestions to stimulate the felling of timber. Further measures in the labor market, as well as those concerning research exceeding 3 percent in the course of the year. This would correspond to an average inflation of some 4 percent for 1986 and would mean that the inflation rate has been halved since last year. As the staff notes, the improved inflation performance is undoubtedly in large part due to the fall in energy prices. There are, however, also encouraging signs that Sweden is coming to grips with the problem of excessive wage cost increases, which has plagued the economy for a number of years. The two-year wage agreements, which were concluded in the private labor market in late spring, are welcome and imply a significant moderation of wage costs, especially for 1987. The general awareness of the problems posed by continued inflation and the importance of wage restraint has increased and partly explains the very limited use in this year's wage agreements of formal clauses linking the rate of pay to the cost of living or to wage developments in other sectors. The situation in the public sector is still unclear, and agreements will not be concluded until, at best, early fall, but the authorities remain confident that acceptable settlements will be reached.

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Furthermore, in this year's Revised Budget Bill, measures to improve the functioning of the labor market were presented as well as suggestions to stimulate the felling of timber. Further measures in the labor market, as well as those concerning research and development will be put forward. Measures aiming at simplifications for the business sector in general (including transportation) have been proposed and will be followed by additional efforts.

As noted by the staff, the process of deregulation and liberalization in financial markets is well underway. The changes have resulted partly from increased pressure to keep pace with an accelerating international trend toward capital liberalization and increased integration of financial markets. However, developments in the domestic economy have played an important role as well.

The Swedish capital and credit markets have experienced a rapid evolution during the past few years. New instruments have been introduced and the actors in the markets have responded positively and with considerable inventiveness. During 1986, we have also seen the establishment of 12 foreign-owned banks in Sweden, following last year's decision to open up this opportunity.

The abolishment of lending ceilings will for some time--up to two years--lead to a substantial credit expansion. Part of the lending which took place earlier outside the credit institutions can be expected to move back primarily to the banks. The methods generally applied for measuring lending and liquidity may therefore give the wrong impression that credit policy has become more expansionary. A substantial reshuffling of loans will occur without implying any change in the firmness of monetary policy.

Following the deregulation of the domestic market, the focus of interest is now turning toward a liberalization of foreign exchange control. During the past few years some admittedly cautious steps have been taken in this direction. In the spring of 1986, the Government and the Sveriges Riksbank presented an outline for a more ambitious liberalization program, made possible by the improvement in the current account after 1982 and the reduction of the Central Government deficit. The first important step was taken in June 1986, when the requirement that direct investments from Sweden should be financed abroad was abolished. Further steps involve the purchase by Swedish residents of foreign shares and real estate abroad.

The Deputy Director of the European Department noted that the latest statistics presented in Mr. Lundstrom's opening statement had obviated the need for a supplement to the staff report. The developments outlined by Mr. Lundstrom were very much in line with what had been projected in the staff report, although it was noteworthy that the latest figures on credit and money indicated a strong expansion of the aggregates. Bank credit was currently running at about 19 percent, and broad money for the first six months was at an annual rate in excess of 10 percent against a rate of less than 1 percent in 1985.

Mr. Alfidja made the following statement:

I am pleased to note from the staff report and Mr. Lundstrom's helpful statement that, on the whole, the Swedish economy continued to perform satisfactorily. Though economic growth slackened somewhat, the central government budget deficit was further reduced, inflation continued to abate, and the unemployment rate fell. Moreover, on the basis of available data for the first four months of 1986, it appears that the country has set the stage for a consolidation and a broadening of the progress achieved over the past few years. Indeed, developments in the external sector and cost and price behavior that gave cause for concern to the Board during its discussion of the 1985 Article IV consultation with Sweden, are turning favorable. Thus, the external current account position, which recorded a deficit in 1985, is expected to move back to a slight surplus in 1986. Inflation is projected to fall to 2.3 percent, and the framework agreement reached in the private sector for wage settlements could augur favorable wage cost developments this year. Beyond these figures, the most encouraging features of the Swedish economic performance are the phasing out of ailing industries and the ensuing strengthening of the structure of the economy as well as the development through an adequate research and development program of new and more promising sectors. The Swedish authorities deserve commendation for these achievements.

Having made these general observations, let me now comment briefly on Sweden's cost and price performance and the fiscal sector, two areas among others where decisive policy actions are needed to enhance the chances of a successful implementation of the third phase of the Government's program.

First, I share the authorities' view that an improvement in Sweden's relative cost and price performance is crucial for the attainment of the objectives of the program, because losses in competitiveness would, according to the authorities' own illustrative scenario, translate into slower growth and poor fiscal performance. I would therefore encourage the authorities to pursue their efforts aimed at moderating wage increases so as to avoid any further erosion of competitiveness. As the largest employer, the Government should set the example in wage settlements. Although, understandably, some difficult negotiations lie ahead because of the propitious environment for increases in wage claims, I urge the authorities to stick to their announced policy of not granting additional wage awards in 1986 beyond the average increase of 6 percent provided for under the 1985 agreement. Action to further reduce inflation and dampen inflationary expectations in the economy would facilitate the Government's task. In this respect, I welcome the decision to pass on to enterprises and consumers the benefits of lower energy prices.

Second, notwithstanding the important progress achieved in reducing the financial imbalances in the economy, more remains to be done on the fiscal front. With the central government budget deficit at nearly 6 percent of GDP in 1985/86, there is clearly a need to speed up the pace of the reduction of the budget deficit if the Government is to achieve its objective of fiscal balance by FY 1990/91. The Swedish authorities could take advantage of the generally favorable economic environment to adopt a more aggressive stance than the one implied in their illustrative simulations of the central government budget. I concur with the staff that the savings stemming from the fall in energy prices in the form of external current account surplus could be utilized to retire foreign debt so as to reduce interest payments abroad. Local authorities that seem not to have been fully participating in the Central Government's budget reduction efforts, as testified by the trend in their spending, should become more involved. The steps taken by the Central Government to sterilize part of liquid assets are appropriate but need to be strengthened in order effectively to rein in expenditures.

To conclude, I would like to say a few words on Sweden's impressive official development assistance (ODA) record. Despite its fiscal consolidation efforts, the Government has managed to maintain ODA at the relatively high level of 0.9 percent of GDP in 1985/86. And the decision adopted by Parliament in April 1986 to raise the appropriations for ODA to reach the level of 1 percent of GDP for FY 1986/87 is indeed commendable and praiseworthy. Moreover, Sweden's strong support for international organizations, particularly their development activities, is exemplary.

Mr. Steinberg made the following statement:

Recent economic developments in Sweden have been on the bright side with improvements in the external and fiscal positions and in the inflation rate. The staff attributes such developments partly to exogenous factors, like the reduction in oil prices and in interest rates, and partly to domestic policies, including the tight monetary policy, the further decline in the budget deficit and the phasing out of ailing industries. These achievements are even more conspicuous considering the exceptionally low unemployment rate in Sweden.

Indeed, one could be pleased with the present situation if it were not so tenuous. The low unemployment rate, the high capacity utilization, past experience with excessive nominal wage increases, and the projection for a high increase in wages in 1986 justify, in my opinion, the cautious staff approach and the call for more ambitious targets for the balance of payments, for the fiscal position, and for economic growth. And Mr. Lundstrom himself tells us that the authorities agree that certain problems still remain, without naming them, and that additional efforts to reduce the budget deficit and to constrain price and wage increases are required.

The fiscal position, although improved, is still a cause for concern. Public consumption is projected to continue growing in 1986 in real terms, albeit at slightly lower rates, and public investments are projected to increase at a faster rate than in 1985. Total expenditures are at a high level of 64 percent of GDP and more than half the total are transfers and interest on the debt. Figures given in SM/86/182 show that the rise of transfers to households in 1985 was more rapid than wage increases in that year, a development expected to continue in 1986. I agree with the staff that larger than planned cuts in the deficit are warranted, mainly on the expenditure side. I thus welcome Mr. Lundstrom's indication that the Swedish authorities are convinced that they ought to further reduce the budget deficit to consolidate the achievement so far and to proceed even further. It would be interesting to know whether the authorities would also consider setting budget targets for the medium term.

The achievement of the sociopolitical goals of a very low unemployment rate and a high level of welfare payments are not costless and might negatively affect Sweden's competitiveness by increasing production costs; it might also reduce the incentive to work--even if so far that result is not detectable--and it can inflate the public sector and make it engage in activities that in other industrial countries are left to the private sector to handle. It would be surprising if, contrary to the experience in other countries, the public sector in Sweden will prove to function more efficiently than the private sector.

Reducing the public sector deficit will increase the national savings, which could finance investments without resorting to the accumulation of external debt. However, it may also be desirable to increase the private savings rate, particularly that of households, which since the beginning of the 1980s has decreased considerably.

Wage cost hikes could be detrimental to Sweden's competitive position, particularly as another devaluation has rightly been ruled out. The relatively low increase in labor costs that accompanied and followed the devaluation of 1982 contributed to its success, to the generation of manufacturing profits, and to investment growth. With a tight labor market, wage increases might jeopardize the achievements so far. Mr. Lundstrom has told us that there are encouraging signs that Sweden is coming to grips with this problem. We certainly hope so, and we encourage the authorities to bear the problem in mind when the public sector wage agreement is negotiated this autumn. It is encouraging to find that the tax system is under scrutiny and that the aim is to simplify it, to make it less distortive, and to increase incentives to save, invest, and acquire skills.

The authorities should be commended for the deregulation of monetary policy and the use of new monetary instruments, particularly open-market operations, thus making the policy more market oriented. I tend to agree with the staff that a monetary expansion caused by capital inflows should be checked primarily by tighter fiscal policies to curb demands and by further easing of the exchange exchange controls. However, I am more concerned than the staff with the fast growing bank lending to the private sector (Table 21 of SM/86/182) and with the rate of growth of financial assets and their liquidity level (Table 22 of SM/86/182 and the table on page 95). While I can sympathize to a certain degree with the authorities' argument that part of the credit expansion does not finance excessive demands but rather represents a reshuffling of existing loans into the banking system, I would caution the authorities to be very careful with such developments. The experience gathered in my own country with respect to a similar phenomenon is that data are generally not so definite on the size of such reintermediation flows, and there might be a temptation to interpret these data in an asymmetrical way. Finally, we should commend the authorities for their support of free trade and easing exchange controls and for their decision to raise ODA in the current fiscal year to the equivalent of 1 percent of GDP.

Mr. Goos made the following statement:

There is no doubt that the Swedish authorities have made impressive progress in stabilizing their economy over the past years--an achievement that is highly commendable. As the staff rightly put it, Sweden finds itself in a quite enviable position in several regards, including most notably the low rate of unemployment.

However, several signs of an underlying weakening in important economic indicators have emerged. Most conspicuous in this regard was the re-emergence of a current account deficit in 1985, a deficit accompanied by, and certainly related to, a continued erosion of international competitiveness due to domestic price and cost pressures, and--what has found surprisingly little attention in the staff report--a continuation of the rather dramatic fall in the personal savings ratio to below zero last year.

While the immediate repercussions of these tendencies on economic developments will be largely neutralized in 1986 and perhaps also in 1987 by the declines in oil prices, interest rates and the U.S. dollar, they nevertheless require immediate attention in order to prevent these tendencies from becoming entrenched in the economy. Moreover, as the staff rightly stresses, the present rather favorable external environment offers the opportunity to consolidate and even accelerate the progress made in recent years at relatively low overall costs. Such costs could certainly become much higher if corrective action were to be unduly delayed.

Another aspect that lends additional emphasis to the need for timely and decisive action is that some of the projections for developments in 1986 may be on the optimistic side--such as the estimates for growth, expected by some observers to reach only 1-1 1/2 percent instead of the 2 percent mentioned in the paper--or the projections for wages, which according to business sources could even increase by 8.5 percent. If such an increase in wages should materialize, the expectations with regard to domestic prices and exports would certainly have to be revised as well.

Against this background, I found it reassuring to note that the Swedish authorities agree with the staff on the need for continued restrictive financial policies, including a very restrictive budget policy, supplemented by various structural measures. While this general orientation of the strategy pursued by the authorities is highly commendable, the staff apparently would prefer to see somewhat faster progress than that envisaged by the authorities in the reduction of both the external current account deficit and the fiscal deficit. In this regard, for the reasons mentioned in the paper, and in view of the uncertainties to which I have just referred, we are inclined to side with the staff. Without repeating all the arguments put forward in the paper, I would like to endorse particularly the staff's recommendation to use the opportunity provided by the decline in oil prices to the extent possible for generating additional savings and for retirement of foreign debt. While appreciating the authorities' concern about the inflationary effect of additional energy taxation, I fear that the pass-through of the lower energy prices to consumers might have even more adverse effects on domestic prices in view of the already strong expansion of domestic demand.

Another recommendation that seems crucial to both domestic and external adjustment, including the containment of cost and price pressures, concerns the need to encourage private savings. I have already referred to the dramatic decline in the personal savings ratio, which is illustrated in Chart 5 and which I found rather puzzling. I would welcome staff comment on the reasons underlying the decline in this ratio and what specific measures the staff would recommend in order to stimulate private savings.

Labor market policies apparently continue to pose one of the most difficult challenges to economic management in Sweden. As already indicated, we believe that an appropriate degree of overall financial constraint combined with appropriate incentives for private savings are the most important conditions for moderating wage demands. In this context, I join the staff and previous speakers in welcoming the clear indication of the Government to unions and employers that they will remain firm in their financial policies and not accommodate excessive wage increases by a devaluation of the krona. By contrast, I am less convinced, as I was in the previous consultation discussion, about the usefulness and eventual effectiveness of tax rebates or other government concessions aimed at influencing wage demands, the more so since they tend to render the task of fiscal consolidation more difficult. The authorities could, however, play a more effective role in directly influencing wage settlements in the private sector by setting a good example in their own wage negotiations.

The authorities are to be commended for the progress that is being made in the area of structural reform, although I share the staff's concern that faster progress in reducing the tax burden would be desirable. Finally, I should reiterate our appreciation of Sweden's active commitment to free trade and its outstanding record on development assistance.

Mrs. Ploix made the following statement:

Since 1982 the Swedish authorities have implemented an economic policy strategy aimed at expanding production, investment and employment, while restoring balance in the current account, reducing the budget deficit, and stabilizing price and cost developments. Even if favorable external developments--in particular, the reduction in oil prices and the decrease in interest rates--have played a role in helping the authorities achieve their objectives, the economic policies implemented have also been instrumental. I particularly welcome the substantial progress made in the areas of inflation and the current account and budget deficits. With regard to unemployment, the current rate of 2.4 percent puts Sweden in an enviable position vis-à-vis the European countries.

As stressed by the staff and by Mr. Lundstrom, the main challenge for economic policy in Sweden is to ensure sustainable progress toward better internal and external balance. The staff recommendations address the main issues, and I am pleased to see that the Swedish authorities go along with them. In my view, at this stage the management of the economy is more a question of persistence with current policies than of further adjustment. I presume that is the staff's judgment as well, as evidenced by the statement: "The current economic results, though impressive, remain fragile." Two indicators of this fragility are inflation and the current account. In the recent past, Sweden's relative inflation performance has not compared favorably with that of its main trading partners. The inflation differential remained adverse in 1985, at over 3 percent, and the staff's forecasts for inflation in 1986 and 1987 are somewhat higher than those of the authorities. This may be explained by the full capacity utilization of the economy and the low rate of unemployment, which tend to boost labor costs and prices. And wages are at the core of the issue here.

As regards the current account, the projections for 1986 are dominated by the oil balance improvements equal to 1 3/4 percent of GDP as shown in Table 3 on page 7 of the staff report. But the non-oil goods balance is expected to worsen, and the current account will barely balance according to the staff's projections. Therefore, further progress depends on the implementation of firm macroeconomic policies, the preservation of international competitiveness, and the pursuit of structural reforms.

On the first point--implementation of firm macroeconomic policies--I would like to make a comment on the staff's advocacy of an accelerated reduction in the fiscal deficit; and I might here slightly differ from Mr. Goos. As I stated earlier, the general orientation must be kept; nevertheless, given the favorable trend expected in the current account balance for 1986 and 1987, and given the interactions between Sweden and its neighbor countries, one may wonder if it is necessary at this point to increase the pace of fiscal adjustment, except perhaps adjustment by the local authorities.

On the preservation of international competitiveness, the staff notes that "losses in competitiveness are quickly reflected in slower growth, which in turn affects the budget deficit." It is thus important to restore the recently lost progress achieved in international market shares since 1982. To do so, competitiveness must be restored, and growth in domestic demand must not outpace that in partner countries, as demonstrated by the 1985 experience and expressed strikingly in Table 2 on page 6 of the staff report. The government plan to bind employers and trade unions to a long-term pact holding down wage increases is thus welcome, since wage moderation is of paramount importance. In that connection, I would be interested in hearing Mr. Lundstrom's comments on the implementation of the 1986 wage agreement.

On the pursuit of structural reforms, the staff has given a full description of the measures contemplated or already taken, especially with regard to the supply side. Results already achieved, manifested by the halt in the relative decline of the manufacturing sector, show the potential improvements from such measures. The deregulation of business activities and the painful but necessary discontinuation of subsidies to ailing industries have been of great help and, as stressed by Mr. Lundstrom, the reform of the tax system currently in preparation and the liberalization of exchange controls will be welcome additions. Also, like others, I commend the authorities for the level of ODA.

In conclusion, the Swedish authorities deserve commendation for the successful pursuit of structural reforms, due in large part to a remarkable social consensus. I hope Sweden will remain as it is, not only for its own well-being but for that of the international community as well.

Mr. Zecchini made the following statement:

In 1985 the Swedish economy continued its significant progress toward the objective of correcting the main macroeconomic imbalances in line with the adjustment program started in 1982. Unemployment was down to 2.3 percent, the inflation rate was reduced to 5.8 percent and is expected to fall to 2.3 percent in 1986, and the current account reached almost equilibrium. In spite of such an enviable position, we agree with the staff that "current economic results, though impressive, remain fragile." The major elements of weakness, in our opinion, can be identified in the external account, in labor market rigidities and in growth constraints. Last year, the trade surplus decreased following a continued reduction in the growth rate of export volume and faster growth of import volume. In 1986, growth in import volume is projected to continue to outpace that of exports and, in spite of a sharp improvement in the terms of trade, the trade balance will deteriorate slightly according to the staff report.

The labor market shows increasing signs of excessive rigidities. Shortages of skilled workers and technicians have stabilized in 1985 but remain at relatively high levels, as shown in Chart 3 of SM/86/182. Indicators of mobility calculated by the OECD, such as measures of employment, turnover rates, and migration, show a declining trend. Finally, capacity utilization in the manufacturing sector is at present higher than that of the previous cyclical peak and largely exceeds the OECD average, while some branches of industry--e.g., the automobile sector--have begun to experience bottlenecks. All these factors tend to undermine the durability of the successful adjustment achieved so far, and their correction is essential in order to make possible balanced noninflationary growth.

Fiscal policy has succeeded in cutting the government deficit by more than half in the past three years, and a further deficit reduction is projected for the 1986/87 fiscal year. However, we tend to share the concern that, given the present small margins of unused production capacity, the contribution of fiscal policy to keeping effective domestic demand in line with supply is not adequate at a time when the substantial gains in the terms of trade provide strong stimuli to domestic expenditure. For the same reasons, we would have preferred that the authorities had not let lower energy prices be passed through entirely to consumers. Partial taxation of such gains would have boosted government revenues and helped reduce the fiscal deficit. Moreover, additional revenue could have allowed the introduction of new measures aimed at promoting fixed investment in order to increase production capacity rather than consumption in the short term.

As the staff points out, fiscal adjustment has been concentrated on the expenditure side. Since 1982, while the expenditure/ GDP ratio has been cut by 3 1/2 percentage points, the fiscal revenue in relation to GDP has risen by 1 1/2 percentage points. The burden of taxation has thus edged up and, as a ratio to GDP, is now 20 percentage points above the industrial countries' average, in spite of the reform of income taxation in 1983-85. In this respect, we tend to share the staff's contention that such levels of taxation may act as a disincentive to savings and investments. Gross fixed capital formation as a percentage of GDP has been constantly declining since 1980, and this may ultimately represent a constraint to growth. Therefore, while we commend the Swedish authorities for their intention to prevent a further increase in the tax burden, we would urge them to consider the possibility of actually reducing it.

Monetary policy in 1985 was aimed primarily at reaching external equilibrium. Higher interest rates in the first part of the year succeeded in reversing a significant capital outflow. The capital inflows that have occurred since then have contributed to the reconstitution of official reserves. However, in view of the effects of such inflows on domestic liquidity expansion, and given the high interest rate differential--in nominal and real terms--compared to interest levels abroad, the authorities should consider some reduction in interest rates. This action should take priority over further easing of exchange controls if the latter were to give rise to undesirable capital outflows that could be checked mainly through increases in interest rates. Such increases should be avoided in view of the need to support fixed capital formation for the purpose of overcoming supply constraints. Finally, the authorities should be commended for the progress made in dismantling direct controls on bank credit and interest rates.

Labor market policies and developments will play a crucial role in the evolution of the economy in the coming years. In view of strong pressure on wages brought about by low unemployment, favorable profitability and satisfactory liquidity in the business sector, and given the commendable commitment of the authorities to avoid exchange rate depreciations for adjustment purposes, a major effort is needed to maintain labor cost developments in line with the objective of improving external competitiveness, thereby consolidating the external adjustment. Given the commitment to exchange rate stability, relative unit labor costs will be the determining factor in influencing external competitiveness of Swedish manufacturers. External competitiveness seems to have had a strong and rapid impact on Sweden's export market shares, especially in the past few years, as can be seen in Chart 9 of SM/86/182. Therefore, it is crucial that the authorities keep up their efforts to moderate wage increases. In this respect, we welcome the implementation of a number of measures pertaining to income distribution and social transfers in exchange for cooperation by the unions in wage negotiations. Although such measures fall short of the adoption of a formal incomes policy, they are a substitute for the use of other demand management policies, which entail a higher cost in terms of employment. We would appreciate hearing whether the Swedish authorities plan to utilize that type of measure more extensively. The authorities clearly recognize the important impact that public sector wage settlements have on wage negotiations in the private sector. Accordingly, we support the authorities' decision not to propose any additional increase in workers' remuneration for 1986 in addition to the large carryover rise, which stems from the 1985 agreement and which is equivalent to about 6 percent.

Finally, we commend the authorities' efforts to take "further action on the supply side of the labor market to improve training and enhance mobility." Nevertheless, in our opinion, such measures, although useful per se, are not a good substitute for a less rigid wage determination system and for a lower burden of taxation. Both elements appear more important to enhance overall labor market flexibility and to correct potentially inflationary bottlenecks in production.

Mr. Leonard made the following statement:

A higher growth rate to be achieved through an expansion of exports and investment, maintenance of competitiveness through better price and cost performance, reduction of the public sector deficit, an active employment policy and incomes redistribution based on social equity comprise a highly desirable but formidable set of demands. In the circumstances, the progress made by Sweden in moving toward those objectives--progress which has resulted partly from fortuitous external circumstances but also from the well-founded policy measures taken by the authorities--is remarkable. The slight regression that took place in 1985 has been overcome, and it now seems likely that a favorable outcome for fiscal year 1986/87 is reasonably assured. This view is borne out by the information in the staff reports and in Mr. Lundstrom's statement.

The staff and the authorities quite rightly look to the containment of wage pressures and fiscal restraint as two crucial factors for the continuation of Sweden's favorable economic performance in the medium term. In the wage area, a high degree of social consensus is clearly necessary to keep a brake on the rise of nominal pay incomes, but this in turn makes heavy demands on the Government in regard to social expenditures and shaping the taxation system to conform with national perceptions of equity. In seeking to meet these demands, there is a double danger: that the Government's room for maneuver in reducing fiscal imbalances is restricted; and that the system of pay settlements through central bargaining tends to become unduly rigid.

It is not surprising that wage drift, as noted in the staff papers, is becoming a larger component of pay increases. In circumstances of central pay bargaining, drift does tend to become the channel through which market forces assert themselves and, as such, it is not to be discouraged. It seems to me that the goal should be to minimize, over time, the element of general increase provided by central bargaining and to let the market forces, as represented by drift, have greater sway. The particular way in which this should be done, while at the same time maintaining social consensus, is, I am afraid, beyond my competence to outline and must be a matter for the Swedish authorities.

On the fiscal position, I agree with the staff that a tighter grip on expenditure would be appropriate. In particular, transfers to the local authorities and social welfare programs merit close scrutiny. Expenditure cuts by the local authorities and the assumption on their part of more of the financing of their expenditure would decrease the amount of transfers and grants necessary from the Central Government. It is also conceivable that with the increase in efficiency of private services in social welfare areas traditionally performed by the public sector, the authorities could encourage further privatization of these services and further relieve the burden on the public purse.

Looking to the medium term, I can agree with the staff that in face of the present favorable circumstances, the authorities might raise their ambitions in regard to growth, the performance of the external account and the reduction of external debt. There is a touch of novelty about the staff's advice here that is worth remarking upon. The more rigorous action that the staff is recommending is not for the sake of better balance accompanied by growth; that that is achievable with the present thrust of policy is borne out by the medium-term projections. What the staff is urging is better balance at an even higher level of growth. It is not often that we meet with a proposal of that kind in the Board, and I regard it as altogether welcome. The opportunities exist and the staff is right to draw attention to them. Star performers should always be encouraged to recognize their full potential. Besides, in the present rather unexciting, even drab, prospects for the world economy, economic managers in other countries do need examples that may spur their own ambitions.

On monetary policy, this chair commends the authorities on the removal of credit regulations and deregulation in the financial markets, as described in Appendix IV of SM/86/182. Following liberalization, however, caution in the exercise of policy is advisable, as the interpretation of movements in the monetary aggregates will become more difficult. We support the authorities' pegging of the exchange rate to a basket of currencies, as that helps loosen the constraint on the effectiveness of monetary policy imposed by the previous arrangements.

On a related matter, I am uncertain of the net effects of the liberalization of exchange controls as discussed on pages 12 and 13 of the staff report. In the last full paragraph on page 12, it is suggested that liberalization could be expected to boost capital outflows, whereas in the next paragraph the official view is given that liberalization would boost current receipts in foreign exchange and benefit the economy. I realize, of course, that the two ideas are not necessarily incompatible, but I am not sure what the interaction between them is, and I would like the staff to comment on that point.

While Swedish trade policy is commendably liberal, I note that import restrictions continue to exist on agricultural and textile products. The staff explains the degree of importance of agricultural products in trade and explains why some protection is seen by the authorities as called for; but the staff does not give quite the same background to the need for textile constraints. It does seem strange that particular protection is needed in this area, and I would be glad to be informed of the reasons for it.

Finally, it is encouraging to observe that Sweden's social concern finds expression not only domestically but also abroad through overseas development aid. The extent of Sweden's efforts here are outstanding, and I can only congratulate the authorities on them.

Mr. Ortiz made the following statement:

The management of the Swedish economy has indeed been successful over the last three years, and the list of accomplishments outlined by Mr. Lundstrom is quite impressive. The imaginative combination of "orthodox" policy instruments--a tight monetary policy and a fiscal policy stance aimed at reducing the fiscal deficit-together with other policies directed toward improving the efficiency of factor markets through institutional changes, as well as the increased social awareness of the need to maintain international competitiveness, have placed the Swedish economy in an enviable position, as the staff describes in the appraisal. It would appear that this so-called "third way" economic strategy that the Swedish authorities have been pursuing merits additional reflection by the Fund and all its members.

External competitiveness has been restored following the devaluations of 1981 and 1982, increasing business profitability, stimulating private investment, and outpacing the comeback observed in nearly all other major industrial countries. This restoration of competitiveness resulted in an expansion of exports in 1983/84 and in the maintenance of an adequate level of GDP growth throughout the period. Furthermore, inflation has been reduced to a level comparable to the European average, and unemployment--the black spot in most European economies--has been reduced to an enviable 2.4 percent, a figure that could be considered as full employment, given the corresponding level of youth unemployment. We also should keep in mind the fact that Sweden has applied a less stringent policy on foreign workers in comparison with other advanced European countries; in this context, one could say that Swedish labor policies have been especially successful.

Although favorable developments in the external environment--such as the decline in energy prices and the recovery in the industrial world--have facilitated Sweden's favorable performance, the policies adopted by the authorities have undoubtedly been decisive in the restoration of competitiveness and the overall increase in economic efficiency. This has resulted in an overall improvement in the economic situation which compares favorably against that of other European economies.

In looking to the future, the staff has emphasized that Sweden's achievements, although remarkable, remain somewhat fragile, a thought shared by other Directors who spoke before me. Two main areas of concern have been pointed out. One is that developments on the wage front, heightened by the effects of wage drift, may endanger the inflation gains made thus far as well as the maintenance of the competitive position of the country. A second area to which attention is drawn is the balance of payments, since the improvement experienced this year is largely attributed to the decline in oil prices, while it is noted that in present circumstances it may be advisable to reduce the overall level of external debt. I think that is an important policy recommendation by the staff.

The available information on the progress of negotiations between Swedish entrepreneurs and the trade unions appears to be encouraging, but perhaps the staff or Mr. Lundstrom could comment further on the matter. A labor pact spanning a lengthy time horizon would significantly help to dispel uncertainties regarding the maintenance of international competitiveness, further encouraging business investment. In this sense, the authorities' emphasis on supply-side measures, as pointed out by the staff and by Mr. Lundstrom, appears to be both appropriate and necessary.

While it should be recognized that a cautious approach to external developments is in order, and the maintenance of international competitiveness ought to remain a priority, it seems to me that the fiscal stance maintained by the authorities at present is broadly appropriate and that efforts should be concentrated on containing labor compensation in line with productivity gains. On the external debt, apart from the fact that its overall size--on the order of 20-22 percent of GDP--is quite manageable and implies judgments on intergenerational transfers and so on, the question of its eventual reduction cannot be examined independently of the utilization of debt flows. The staff mentions that the interest rate burden represents a drain on national resources; but this is only true if the return of investment or the uses to which this debt is put are not sufficiently productive to cover its servicing. The staff's implicit proposition that Sweden ought to achieve balance of payments surplus over the next few years is not convincing, at least from the arguments contained in the report. This is not to say, of course, that efforts should not be made to stimulate private savings. As Mr. Goos pointed out a few moments ago, the fall of private savings over the past several years could be a cause for concern.

To conclude, I commend the Swedish Government for its continued concern for the difficulties of developing countries, especially those at the lower end of the income spectrum. My authorities hope that other industrial countries do as much as Sweden is doing in this respect. I would also like to mention that my authorities welcome the Swedish authorities' stance on trade and protectionism and wish them success in their effort to promote a reduction in worldwide protectionism as well as in the implementation of their overall economic strategy.

Mr. Sugita made the following statement:

Since 1982, considerable progress has been made in many key areas of the Swedish economy. Total output grew by 8 percent in 1982-85. The unemployment rate remained at the very low level of around 3 percent. The public deficit was reduced and the current account balance showed considerable improvement, although that trend was reversed in 1985 because of a sharp rise in domestic demand. It is also noteworthy that there has been a favorable change in industrial structure, as evidenced by the phasing out of ailing industries and the growth of high technology industries.

However, continuous wage pressures remain the most intractable problem of the economy and seem to present the authorities with some dilemmas in the conduct of macroeconomic policies. First, the economy is operating at a relatively high capacity utilization rate, and some shortage of technical employees has emerged. A fall in oil prices is expected to add further to the demand growth. So far, however, the burden of demand restraint has been borne mainly by credit restraint. Fiscal policy has not been sufficiently restrictive, and a tax increase has been ruled out, given its likely effect on prices and the implications for wage negotiations.

Second, the fixed exchange rate system--which has been chosen presumably because domestic price stability is a preferable way of containing wage increases--limits the maneuverability of monetary policy. Credit restraint has been somewhat self-defeating, as the capital inflow induced by higher interest rates has resulted in the expansion of domestic liquidity.

These dilemmas of macroeconomic policy clearly point to the need for tackling effectively the strong wage pressures that emerge from time to time. Mr. Lundstrom has mentioned several measures, including tax reform, that will improve the functioning of the labor market, and I hope that they will lead to a reduction in the recurrent wage pressures that have been observed in recent years. It is also essential that macroeconomic policies be conducted as flexibly as possible to reduce excess demands in the goods and labor markets.

With respect to fiscal policy, the central government budget deficit declined from 13 percent of GDP in 1982/83 to 8.3 percent of GDP in 1984/85, and a further reduction is expected. I welcome this development and urge the authorities to continue their efforts. In view of the high level of taxation in Sweden, I share the staff's view that a reduction in the public deficit should be achieved mainly through expenditure restraint. In this respect, I also join the staff in urging greater efforts by the local authorities. As for monetary policy, I welcome the liberalization of credit markets.

On external policy, the liberalization of exchange controls is a step in the right direction, and a lifting of restrictions on capital outflows is expected to reduce, to some extent, the dilemma faced by the monetary authorities that I mentioned earlier. The recent favorable economic environment, arising from the decline in energy prices, provides a good opportunity to reduce the external debt, which, at 21.9 percent of GDP in 1985, is rather high. Finally, I commend the Swedish authorities for their active commitment to the principles of free trade and their outstanding record on official development assistance.

Mr. Huang made the following statement:

Sweden has made some remarkable achievements in several important areas during the past three years. To save time, I will not specify these in detail; suffice it to say that I agree with Mr. Lundstrom's assessment that the deteriorating trend in Sweden's economic performance since the mid-1970s has been fundamentally reversed. This reversal should be attributed to the authorities' economic policy strategy, and to their efforts in its implementation as well.

In spite of this commendable progress, some problems still deserve mention. It is appropriate that the authorities continue to pursue a tight budget policy as an important component of the economic strategy. The best way to reduce the budget deficit is to restrain the expenditures of both the central and local governments. It seems that the recent reductions in oil prices have provided the authorities with a good opportunity to make greater strides in reducing the budget deficit for the current fiscal year. It should be pointed out, however, that domestic price performance in Sweden is dependent to a considerable extent on the price behavior in the world market. Its domestic price performance is vulnerable to external price shock. If the authorities are able to achieve a greater reduction in the budget deficit under the present favorable external environment, they will be able to moderate any inflationary pressures from the world market that may arise in the near future.

The authorities' efforts to improve the external balance should not be slackened. As indicated in the staff paper, in spite of a small trade surplus recorded in 1984, a weak export performance--due partly to some erosion in competitiveness--brought the current account back into deficit in 1985. In order to expand exports, Sweden must greatly improve its competitiveness by sustained efforts to accelerate productivity growth rather than by a sharp depreciation of the krona, as in 1982. In addition, protectionism stemming from abroad has jeopardized Sweden's efforts and, consequently, damaged its balance of payments. In this context, the improvement in Sweden's external balance depends crucially on the support of the international community. Finally, the decision of Sweden's Parliament on its appropriation for official development assistance should be commended.

Mr. Jaafar made the following statement:

Since 1982, the Swedish authorities have been successful in making considerable progress toward a steady rate of growth in their economy. The external position, too, has been in balance; and, more important, these developments occurred with a reasonable degree of price stability. In 1985, a satisfactory rate of GNP growth was recorded, although the rate was somewhat more subdued than in 1984. The unemployment rate declined further to less than 3 percent, among the lowest rates achieved in the industrial world. While the external position has deteriorated slightly, it is still at a comfortable level. If there is any cause for concern, it is the relatively high rate of inflation for the year. It should be noted that despite steady deceleration in the inflation rate in the past four years, the price differentials, when compared with Sweden's major trading partners, remain considerable.

Remarking on certain aspects of policy in the staff report, I note, first, that Sweden's record in respect of fiscal consolidation and expenditure rationalization has been impressive, particularly for the four-year period between FY 1982/83 and FY 1985/86. Therefore, the continuation of a similar fiscal stance for FY 1986/87, which envisages a deficit of close to 4 3/4 percent of GDP, or approximately 1 1/4 percentage points lower than the level observed in FY 1985/86, is particularly welcome. I am, however, not convinced that a more ambitious target for fiscal consolidation is needed, as it seems to me that most of the assumptions underlying the authorities' projections for the current account, especially those for oil prices and export values, are on the conservative side. Furthermore, an improvement in the current account position in the first quarter of 1986 over the same quarter of last year has indicated the likely trend for the remainder of this year.

For the medium term, I agree with the authorities that the attainment of growth, employment, and external objectives will depend critically on an improvement in Sweden's relative cost and price performance and a steady reduction of the fiscal deficit to the equivalent of 1 percent of GDP by the end of the current decade. This scenario, in my opinion, is more logical and more practical in present circumstances than the more ambitious one suggested by the staff.

On money and credit policy, I am encouraged to note that substantial progress has been made toward the abolishment of direct controls on bank credit and interest rates. With this important step taken toward liberalization, I believe that it will not be long before the remaining control on commercial banks' investment in housing bonds is removed, thus paving the way for a wholly market-oriented approach to the conduct of monetary policy. As for the short-term monetary stance, the resolution of the dilemma between a desire both to achieve a balanced "currency flow" and to maintain an appropriate level of domestic liquidity under the fixed-exchange rate regime has become a real issue of increasing importance. The problem lies with the limited scope which the authorities have for sterilizing capital inflows and the effectiveness of their foreign exchange interventions. With the aim of improving efficiency, I share the authorities' views on the need to encourage a further liberalization of exchange controls. I also see merits in the suggestion that the stance of monetary policy and interest rates should remain cautious if price differentials are to be narrowed further. The staff suggested in an introductory statement that, subsequent to the consultation, there was a very strong expansion in money and credit. If that is true, I would tend to look at such a development with some concern because it is not consistent with the aim of preserving stability in prices which I mentioned earlier. I believe it would also not be in line with the aim of a durable domestic and external balance.

Finally, on the wage front, it is indeed not an easy task for the authorities to achieve wage moderation under present circumstances, when capacity is almost fully utilized and the unemployment rate is at an extremely low level. As the Government is the largest employer, its active participation in wage negotiations is an important element that should help to prevent excessive wage settlement, at least in the public sector. But, it is difficult to see whether that restraint would be followed in the private sector. Tax measures in terms of rebates and bracket adjustment should help to an extent; however, market forces will eventually reassert themselves in a tight supply situation, as is now becoming more apparent in Sweden. From a longer-term perspective, I think the solution to this problem is through an improvement on the supply side of the labor market. In view of the steady progress being made toward structural adjustment, which has resulted in a bias toward high technology industries, it is becoming more important to gain additional training and to establish the appropriate policy to address directly the problem of labor mobility. In the short term, I should like to underscore the desirability of not resorting to any accommodation of excessive wage claims through either a relaxation of financial policies or a devaluation of the krona. The Government's reaffirmation of its commitment to the present exchange rate of the Swedish krona is, therefore, reassuring.

In conclusion, I can share the staff's view that Sweden, though a comparatively small country, is committed to free trade and has been pursuing this policy earnestly, as is clearly indicated on page 59 of SM/86/182. I would like, however, to echo the concern of Mr. Leonard regarding protection against agricultural products and textiles. I would also like to express my appreciation for Sweden's timely decision to raise official development assistance in the current fiscal year to 1 percent of GDP.

Mr. Suraisry made the following statement:

In the past few years, the Swedish authorities have made commendable progress on many economic fronts; not only were inflation, the budget, and the current account deficits reduced, but successful efforts were made in restructuring the economy. It is encouraging to note that these efforts have been made without compromising one of the main macroeconomic objectives, namely, employment. Indeed, the rate of unemployment was only 2.3 percent in 1985, a rate that is low by any standard. This testifies to the authorities' sound economic policies.

To sustain the progress made toward a more balanced economy, it is important, as the authorities are aware, that the adjustment efforts be continued. In fact, since there are some uncertainties which, if not dealt with successfully, could undermine the gains achieved so far, these efforts need to be strengthened.

Maintaining a competitive position is always important for any country, but for a small, open economy like Sweden's, such a competitive position becomes even more important. Movements in domestic costs must be in line with those in the main trading partners if improvement in the balance of payments is to be preserved, or deterioration in the external balance is to be avoided. For this purpose, further progress in the inflation field is called for so as to avoid a devaluation cycle. This requires continued efforts on several fronts. I welcome the information provided in Mr. Lundstrom's statement that further progress in inflation is expected after 1986.

In examining fiscal policy, one has to remember that the pickup in output that took place recently has not been achieved through expansionary fiscal, or, for that matter, monetary policies. On the contrary, firm demand management policies have been an important element of the authorities' strategy to achieve a more balanced economy, both internally and externally. Government expenditure has been reduced in some areas, and subsidies to ailing industries have been discontinued. As a result, the budget deficit was reduced, and, as the OECD Economic Survey indicates, the uninterrupted increase in the ratio of general government spending to GDP since World War II was stabilized in 1983 and reduced to 65 percent in 1984. This is a commendable achievement. However, the ratio of government spending to GDP is still one of the highest among industrial countries. Hence, there is room for further reductions in the budget deficit. The high level of government spending, together with very high levels of taxation, argue for government expenditure to take the brunt of adjustment, so as to free scarce domestic resources for the private sector.

On monetary policy, I welcome the cautious approach which the authorities are following. Such caution is important for inflation to be checked and, consequently, for competitiveness to be restored. Recently, however, the authorities have had to face a difficult challenge that stems from deregulations and inflows of capital. This challenge, without doubt, complicates the task of continued firm monetary policy, since the economy needs time to adjust to deregulation, and capital inflows encourage credit expansion. To meet this challenge, a combination of fiscal retrenchment and a further liberalization of exchange controls should be pursued.

Due to several factors, upward pressures on wages are increasing. Resisting such pressures is essential if the cost structure in Sweden is to be in line with the cost structure of its main trading partners. For this purpose, every effort should be made to ensure that the forthcoming wage negotiations do not produce agreements that pose problems in the future. Strong leadership by the Government, for that matter, is required. I should add that the Government is making commendable efforts in this area as Mr. Lundstrom's statement makes clear. On a related matter, Sweden's very low rate of unemployment, at a time when its support for ailing industries is being discontinued, provides a good example to countries in similar situations. It proves that discontinued support to ailing industries does not necessarily lead to high unemployment.

In pursuing their adjustment strategy, the authorities complemented their firm demand management policies with structural policies designed to remove bottlenecks and reduce rigidities in the economy; deregulation, liberalizing exchange controls, emphasizing the supply side of the labor market, and the taxation reform introduced in 1983-85 are noteworthy accomplishments. Continued efforts in these areas, especially in the tax and labor market areas, are of paramount importance for expanding the economy's capacity utilization, which is running at a high rate, and are essential for sustained, noninflationary growth.

On the taxation issue, I note that the tax burden is above the industrial countries' average by 20 percent in relation to GDP. In addition, marginal tax rates are very high. Therefore, it is clear that further progress in the tax system is needed, so as not to create work disincentives. As a minimum, it is important not to add to the already heavy tax burden. In this context, I welcome the ongoing efforts to reform the tax system. I also commend the authorities for allowing the lower energy prices to pass through to the private sector. In addition to its favorable impact on the private sector and growth, such a move has profound implications for inflation, the forthcoming wage negotiations, and, consequently, competitiveness. High energy taxation is likely to lead to higher costs, and therefore to a loss in competitiveness, something the authorities are trying to avoid. Therefore, before recommending a higher energy tax, we have to be very careful. It is important, in assessing the short-term difficulties, not to overlook the medium-term prospects. We should refrain from any temptation to recommend something that could compromise such a prospect.

Finally, I commend the authorities for their dedication to free trade, and I sympathize with their complaint against protectionism, which benefits no one. I also commend them for their recent action to increase their contribution to official development assistance to 1 percent of GDP. Sweden's awareness of the problems of the least developing countries and its efforts to help alleviate these problems deserves recognition and praise.

Mr. Alhaimus made the following statement:

I am in broad agreement with the staff's analysis and conclusions on the Swedish economy. In particular, I endorse the conclusion in the staff appraisal that, by comparison with most other countries, Sweden enjoys an enviable position: the current account of the balance of payments is expected to show a surplus this year; inflation and unemployment are at a very low level; and further success in lowering the central government fiscal deficit has also been achieved in the past year. Prospects are expected to be positively affected by the brighter profit situation, which is likely to help capacity expansion; and, at the structural level, the economy will benefit from the phasing out of ailing industries and the development of more promising sectors.

Policy action in the fiscal, monetary, and external areas certainly contributed to the present improved situation. To a considerable extent, however, the fall in oil prices has been an important factor in the improvement. Gains in the terms of trade are in fact estimated by the staff to amount to the equivalent of nearly 2 percent of GDP. In the external sector, the oil balance improvement is expected to be about 1.75 percent of GDP in 1986, while the non-oil balance will worsen. In light of this, I share the staff's view that the current economic situation remains fragile and that the authorities should aim at more ambitious targets, especially toward keeping domestic costs at lower levels and increasing the national savings rate by further fiscal restraint. As Mr. Lundstrom has indicated, the authorities are aware of the need for additional efforts. One policy measure which has been embarked upon, however--the tax on oil--is bound to limit the positive impact of full pass through of energy prices.

Finally, like other speakers, I commend Sweden's commitment to free trade and to a high level of financial assistance to developing countries. Particularly commendable is the decision of the Swedish Parliament to raise official development assistance in the current fiscal year to the equivalent of 1 percent of GDP, a very high level compared with the performance of industrial countries.

Mr. Mtei made the following statement:

I agree with the staff that the Swedish economy is, in many ways, in an enviable position. First, price inflation, which had peaked at well over 13 percent in 1980, was reduced significantly by 1985 and is expected to fall to about 4 percent in 1986, which is almost half the level attained last year. This rapid deceleration in the rate of inflation in 1986 has in effect brought it to a level comparable with European partner countries and has been facilitated to a large extent by a favorable external environment. The fall in energy prices has been particularly significant in that regard. Nevertheless, it is also pertinent to note, as Mr. Lundstrom has reminded us, that there is an increasing general awareness of the problem of excessive wage costs and that the authorities are coming to grips with it. This is evidenced by the moderation of wage costs in private sector wage settlements that have been reasonable although higher than the Government had originally anticipated. Although the Government has played an active, albeit indirect, role in influencing these private sector wage settlements, unions appear to have acted rather responsibly by not only agreeing to lower wage settlements but also by accepting two-year agreements.

Second, the rate of unemployment remains one of the lowest among partner countries in Europe and other industrial countries. With extensive employment schemes initiated during the period of high unemployment, this result is not surprising. The firmness of economic activity in the past few years and the recent strong industrial production performance has undoubtedly helped to absorb the labor force. The economy is, in the event, operating at almost full capacity, which in turn had led the staff to offer some precautionary advice about potential problems that such a situation could pose, both in terms of the labor market as well as the possibility of resurgence of inflationary pressures. I am, however, confident that since the authorities agree with the staff on the policy package for the medium term, the authorities should be able to achieve sufficiently high growth under stable price conditions.

In the areas of fiscal and monetary policy, the authorities have been successful in maintaining a restrictive stance. The central government deficit, which had peaked at more than 13 percent relative to GDP in 1982, had been projected to fall to about 4 percent in the current fiscal year. Also, the consolidated public sector deficit is expected to be reduced to about 1 percent of GDP in 1986 and, at this level, it will be significantly lower than the average for the OECD countries, estimated at 3.3 percent.

The monetary and fiscal policy stance, together with the gain in competitiveness achieved by the devaluations of the krona in 1982, have also benefited the external sector. Following a setback in 1985, when the deficit on the current account reappeared, the outturn in the first six months of 1986 indicates that a surplus could be registered. I should like to endorse the stance taken by the authorities on the question of exchange rate policy, which provides a clear signal to the economy that "excessive wage increases will not be accommodated through a relaxation of financial policies and/or a devaluation of the krona."

Finally, I endorse the stance taken by the authorities in the area of international trade and external aid. Their efforts in pressing for further liberalization of trade under the auspices of GATT is to be welcomed and, indeed, encouraged. The dismantling of trade barriers and the opening up of markets in the industrial countries to products from the less developed countries is a sure way of relieving them of the debt burden that is presently crippling their economies. As regards external assistance, *with official development assistance at 1 percent of GDP*, Sweden remains a good example of a country that is genuinely interested in achieving a transfer of real resources to the less privileged countries for purposes of development. My authorities commend the Swedish authorities for these efforts and urge those countries in positions similar to that of Sweden to emulate the Swedish example.

Ms. Bush made the following statement:

We are in general agreement with the direction of economic policy followed in recent years by the Swedish authorities. Their policy direction has had some positive effects on the economy, and the additional efforts that are being made should bode well for continued improvements. With the "third phase" focus on tackling structural elements of the economy in order to stimulate growth in a noninflationary manner, the Swedish authorities should be able to realize more substantial success.

We are pleased to see some reductions in the fiscal imbalances, both in the Central Government and the overall public sector. Some reduction in the public sector expenditure ratio from 67.5 percent in 1982 to 65 percent last year, and the further anticipated fall this year, are most welcome, particularly since Sweden's expenditure to GDP ratio is one of the highest in the industrial world. We also think that the authorities' budget policy generally is appropriate, but two elements in particular are important. First, specific increases in expenditures must be financed by cuts in other areas, an approach that will lend an element of discipline for expenditure restraint that should be most helpful. Second, budget improvement must come from expenditure reductions, rather than tax increases. Such an approach is rational since both expenditures and tax rates in Sweden are very high. I must add, immediately, that we do welcome the tax reform that the authorities have been undertaking. This reform is extremely important to the supply-side and growth objectives. Lower marginal tax rates and simplification of the system for individuals is very important, and we encourage the authorities in their planned simplification of corporate taxation as well. This, along with the proposals to stimulate trade in stock, should be helpful in encouraging capital mobility.

The nature of the enacted and planned tax reform is, I think, particularly important at present for a number of reasons. First, Sweden is already utilizing its productive capacity at a very high level. As the staff notes, "productive capacity is nearly fully stretched." On a related matter, although investment has improved substantially in the past couple of years, it is falling again in 1986. Capacity expansion and a more sustained revival of investment, we think, could be helped by tax reform, most specifically, tax reductions and simplification; and all should help with the supply-side and growth objectives of the Swedish authorities.

Second, Sweden has a high rate of employment, although some of the employment schemes imply something less than the most efficient use of the labor force. I understand that some of them are aimed at enhancement of the skilled labor force and, presumably, the technical labor force. However, a potentially growing economy could create demand for labor that would allow more effective and efficient utilization of members of the labor force currently being trained, and of those who are presently in relief work and other employment schemes. And the tax reform effort is important in this regard as well, since the other tax rates on individuals should encourage them to devote additional time to work, thereby generating additional saving and investment. In addition, a lower tax burden on individuals might help to avoid strong wage pressures. That being said, I must also note that the tax burden is still very high, and we hope that the authorities will continue with further tax reductions and reform, particularly in view of their growth objectives.

I would like to pose one question on taxes. I note in the staff paper that the authorities apparently do not intend to further reduce the tax burden beyond the marginal rate cut that is planned for 1987/88. I wonder whether any consideration is being given to some further adjustment of tax brackets for inflation, which could also be very important for the authorities' goals.

Other important and positive structural efforts in the Swedish economy include deregulations of some business activities--particularly in the transport sector--the discontinuance of subsidies to ailing industries, the efforts toward wage restraint, and the deregulation and liberalization of the financial markets, including introduction of some new financial instruments and savings schemes. I would appreciate hearing whether any further deregulation of business activities is contemplated, what the outlook is for wage settlements over the next year or so and what is the expected effect of the deregulation of financial markets on the potential for savings and investment trends, which we noted that the authorities have projected to be not so promising in the immediate future. Further, we welcome the granting of licenses to 12 foreign banks and subsidiaries last year, the changes that have brought about a more market-oriented monetary policy, and the liberalization steps taken with regard to foreign direct investment and exchange controls. Finally, I welcome Swedish support for including agriculture and services in the new GATT trade round.

Mr. Salehkhou made the following statement:

The Swedish economy benefited during the past year from a combination of a favorable external environment and successful monetary and fiscal policy. The result has been much progress in containing inflation and in substantially reducing financial imbalances.

The strategy followed by the present Government since 1982, and which is based on the stimulation of investment and exports to achieve a high growth rate, has successfully reversed the downward trend since the late 1970s. In this respect, Mr. Lundstrom's statement, as well as the staff's well-balanced reports, paint a clear picture of the evolution and achievements of the Swedish economy between 1982 and 1986.

However, the growth rate in 1985 reached only 2.3 percent, as against 3.4 percent in 1984, on account of constraints on productive capacity and slight erosion in competitiveness, which opened the door to rising imports. Strong domestic demand has been behind this early trend in 1985. But the application of a tight monetary policy has dampened the buoyancy of internal demand. This is also reflected in the pattern of growth in 1985, which seems to have been achieved by strong internal demand as compared with 1984 or even earlier when growth was export led after the devaluation of the krona in 1982.

The Government's guideline on wage increases was exceeded in 1985, but the authorities have renewed their efforts in 1986 to maintain wages within sustainable limits. Both the two-year wage settlement made in the private sector, and the envisaged public sector settlement, provide for average earnings increases of no more than 6 percent and 4 percent in 1986 and 1987, respectively.

The objective of wage restraint is to combat inflation, which has been on the authorities' priority list. The result of the Government's action in 1985 was more than satisfactory, as inflation abated to 5.8 percent, compared with 8.1 percent in 1984, partly helped by the price freeze adopted in March of 1985.

The prospects for 1987, based on further moderation of wages and a decline in international commodity prices, seem to favor a further reduction in the inflation rate in Sweden by another 1/2 of a percentage point.

On the fiscal front, while several measures have been taken to rationalize the budget, automatic linkages and indexation have been eliminated. Fiscal policy has been concentrated on expenditure control wherever possible, with an average of 2 percent reduction per year in government consumption and investment in real terms. No new expenditures could be undertaken without compensation elsewhere. The central government deficit, which in 1985 was 5.6 percent of GDP, is projected to decrease to 4.8 percent of GDP in 1986. Revenue measures will bring an increase of only 1 percent of GDP, which is less than the wage bill. On the expenditure side, the Government has applied a reduction of

5 percent on all purchases of goods and services. Reductions in budgetary transfers have also been made, and limits have been set on transfers to households.

The Government's fiscal program works hand in hand with monetary policy, which eliminates the need for the heavy use of monetary instruments to stem the rise in liquidity. Monetary policy, however, remains the cornerstone of Sweden's adjustment program and it has been quite successful. It is increasingly based on the normal play of market forces, which represents a change from quantitative controls and regulatory systems. Monetary policy acquired greater flexibility along with the introduction of innovative instruments such as the treasury discount notes for institutional investors and the channeling of household savings through the National Debt Office.

Pressure exerted by the authorities on the expansion of credit has helped decelerate the rate of growth of the monetary aggregates. A significant factor in this deceleration is the compulsory scheme applied in 1985 of the purchase of securities by enterprises through deposits at the Riksbank. Money stock also decelerated sharply in 1985 and in 1986, on account particularly of the issuance of longer maturity discount notes.

The use of monetary instruments to control the current flow of capital for balance of payments purposes has been a consistent feature of Swedish monetary policy. The outflow of capital registered in early 1985 resulted in a sharp worsening of the overall external account and led the authorities to raise interest rates and lower bank lending. As a consequence, the outflow was reversed in the second half of the year.

Nevertheless, the year ended with a small deficit on the current account, compared with a surplus in 1984. The trade balance deteriorated as a result of high demand for imports and a slowdown in exports. In 1986, however, the current account is projected to return to a surplus position on account of the strict demand control measures applied and the improvement in the terms of trade. In addition, net interest payments are projected to register a decline due to lower international interest rates and favorable exchange rate developments. Already in the first quarter of 1986, imports have decreased by 8 percent and exports have increased by 3 percent. Projections for external trade, therefore, may be slightly different for the remainder of the year, as imports are now projected to increase by 6 percent and exports by 5 percent.

Sweden's net external debt as a percentage of GDP declined from a peak of 23.3 percent in 1984 to 21.9 percent in 1985. More than half of the debt is in medium-term and long-term maturities, essentially an old government debt contracted in the 1970s when the market was favorable. Since 1984, borrowing has been more to refinance loans at more favorable terms and/or to maintain a strong reserve position.

Debt service payments have increased in recent years on account of rising total debt and interest rates. The debt service ratio--which, in 1980, was 11.1 percent--accelerated significantly to 19.4 percent in 1985. In 1986, however, because of lower interest rates and lower dollar value, the debt service ratio is expected to decline to about 17.8 percent. This may not be considered excessive, however, and Sweden's total debt does not presently appear to be a major concern.

Sweden's policy on international trade is liberal, in particular with respect to developing countries under the non-discriminatory GSP program. Sweden also supports an extension of the multifiber arrangement which would favor poorer countries. Sweden's position against the proliferation of protectionism is well-known and highly valued.

As far as official development assistance is concerned, it can be said that Sweden sets the standard for other industrial countries. The recent decision of the Swedish Parliament to raise the level of ODA to the UN target of 1 percent of GNP for 1986/87 represents an increase of 10 percent. A large part of this aid is channeled through multilateral agencies; the rest is provided on a bilateral basis for development activities in needy countries. The Swedish authorities are to be commended for their sensitivity to the plight of the developing nations and for their efforts in effectively discharging their responsibilities toward these countries.

Mr. Hospedales made the following statement:

I am in broad agreement with the staff's well-balanced and technical appraisal outlining the considerable progress which has been made by Sweden in achieving its objectives for growth and employment as well as for correcting internal and external imbalances. This latter objective was the subject of Board concern on the occasion of the 1985 Article IV consultation discussion, and the Swedish Government's commitment to tackle these economic imbalances and their success in doing so are to be commended. Mr. Lundstrom has underlined in his statement a particular economic strategy, which aims at enhancing growth rates through the expansion of exports and investment. This chair finds the approach to be appropriate and well-founded, like the commitment to restrain financial policies and to contain prices and costs so as to maintain international competitiveness, given a fixed exchange rate objective. In this connection, the active employment strategy, which has had a positive impact on labor market rigidities, has served to limit the unemployment rate to 2.3 percent, an excellent record by any standard.

While this chair agrees with the staff that there remain several points of vulnerability in key areas which must be addressed, we are confident that given the impressive track record so far, Sweden will certainly take advantage of the current international environment, while remaining alert to the need to take appropriate measures if that environment--especially oil prices and interest rates--should change in a direction unfavorable to Sweden.

Finally, we wish to associate ourselves with the remarks of the staff and other Directors who have complimented the authorities for their generous record of official development assistance. We welcome Sweden's decision to raise the ODA/GDP ratio to 1 percent in the next fiscal year, which implies an effective increase of 10 perent. This increase represents an exemplary approach to international economic cooperation and is all the more commendable in the light of Sweden's current adjustment measures.

Mr. Vasudavan made the following statement:

We are in general agreement with the staff appraisal, and we join other Executive Directors in commending the Swedish authorities for their very high level of official development assistance. One observation I have to make concerns the mention made by the staff earlier in the meeting of the large rise in broad money in a recent period. I wonder whether this development has anything to do with the ongoing financial deregulation?

The Deputy Director of the European Department said that the staff was quite concerned about the rapid expansion of liquidity in Sweden. The reasons for the growth in credit and money in the first six months of 1986 were difficult to determine. As Mr. Vasudevan had hinted, financial deregulation might have been at the root of the increase; but it was also possible--as Mr. Lundstrom had suggested--that it had been due to reintermediation in the banking system or even that it represented a genuine acceleration of credit. After all, the removal of credit ceilings in other countries had often been followed by a sharp expansion in bank credit. Whatever the cause, he was troubled by Mr. Zecchini's suggestion that the authorities should perhaps give priority to reducing interest rates rather than liberalizing exchange controls. As he saw it, the authorities must remain cautious about reducing interest rates in the present situation, at least until they could be certain that the acceleration of credit had been due to reintermediation. It should perhaps be mentioned in that context that the overall balance of payments in Sweden had turned negative in June, another danger signal to be heeded by the authorities.

In response to Mr. Goos's request for an explanation of the reduction in the savings ratio, the Deputy Director noted that only the household ratio had fallen; the overall private savings rate was positive, since the corporate sector was a net saver. The fall in the household savings ratio was partially a statistical matter and due to the fact that all numbers relating to pensions were recorded in the public sector or in the financial sector. Also important, however, was the fact that in the past few years households had not been investing as much in housing as previously, owing in part to high interest rates, the increase in the price of new homes, and some saturation in the housing market. In passing, he noted that the financial savings ratio had increased, indicating that there had been a shift in the way in which households saved. The authorities had taken a number of steps to reverse the trend. For example, they had developed some savings schemes which benefited from tax advantages; another measure aimed at increasing the savings ratio was the current limit--to 50 percent of interest payments--on the deductibility interest payments, and the authorities were considering a further limitation on the amount that could be deducted.

A number of Directors had queried the staff suggestion that stronger fiscal adjustment in Sweden was needed, the Deputy Director recalled. In the short term, with nearly full capacity utilization and strong demand pressures on labor, a case could be made for a stronger fiscal effort, which would have the advantage of reducing the burden of adjustment on monetary policy and might even allow for a reduction in interest rates. For the medium term, the considerations were rather different. If Sweden wanted to grow faster, it must invest more, given that it was already at full capacity; and in order to invest more, it must generate savings, mainly through a reduction in the dissaving of the public sector.

On incomes policy, Mr. Zecchini had wondered whether the authorities had not institutionalized the informal incomes policy toward which they had moved, the Deputy Director continued. The authorities were reluctant to move toward a formal incomes policy although, in practice, they went a long way toward discussing with the unions and the employers the room available for wage agreements, taking into account the fiscal framework. There was no doubt that in 1985 and 1986, a number of tax measures had been closely linked to wage negotiations. Tax rebates and certain adjustments in the tax brackets had clearly been intended to reduce wage demands by the unions. Staff discussions with the union leaders suggested that, in Sweden, wages were negotiated on an after-tax basis to the extent that the negotiators explicitly took into account decisions by the Government on taxes and on transfers to households.

In response to a question by Mr. Leonard, the Deputy Director observed that the staff's statement that "relaxation of exchange controls could contribute to capital outflows" was not inconsistent with the authorities' view that a relaxation of exchange controls could result in greater receipts of foreign exchange. Greater private investment, for example, at first represented an outflow; over time, however, it could be expected to lead to a reflow on the current account of the balance of payments in the form of higher exports and/or payments of dividends. The same could be said for purchases of foreign shares by Swedish residents: following an initial outflow, a reflow of dividends would occur that would be recorded as receipts in the current account of the balance of payments.

Restrictions on textiles--mentioned by a number of speakers--had been discussed in the staff report for the 1985 Article IV consultation, the Deputy Director commented. Import penetration of textiles in Sweden was perhaps greater than in any other industrial country, and the shrinkage of the textile industry in Sweden had been considerable. Although there remained some restrictions on textiles, they did not in practice keep out a large volume of imports.

An interesting question had been raised by Mr. Ortiz, who had wondered whether Sweden would not be better off using its domestic resources for investment than for repaying its debt, the Deputy Director recalled. As with many industrial countries with mature economies, the rate of return on investment was normally greater abroad--at least at the margin--than it was at home. In that respect, it made economic sense for Sweden to repay its debt. In addition, the conditions at present favored a reduction of the debt incurred at a time when the conditions internationally had been less favorable than they were at present. The Swedish authorities saw the present circumstances as providing an opportunity to repay their debt, an opportunity that might not be available in the future.

On the prospects for wages under the current agreements, the Deputy Director said that there was little that he could add to what had been outlined in the staff report. He was rather troubled by the suggestion by private forecasters that wages might rise as high as 8-8.5 percent; evidence available to the staff suggested that its forecast of a 7 percent increase continued to be appropriate for the private sector. In the public sector, a great deal of unrest and some strikes had occurred during the time of discussions, but the authorities and the unions had agreed to put negotiations on hold until the autumn; whatever increase might eventually come out of those negotiations, it had at least been postponed for the time being.

In response to those that had questioned the reforms in the tax system, the Deputy Director observed that considerable adjustments in the tax brackets would be effected. The income tax brackets would be adjusted by more than 15 percent in 1987 and by more than 11 percent in 1988, or much more than the rate of inflation. The result would be a reduction in the income tax burden for a number of taxpayers. Finally, on two specific questions raised by Ms. Bush, he observed that there were only two areas--transportation and labor legislation--in which clear deregulatory efforts were under way. Deregulation in the financial markets had been fairly recent, and it had been difficult to know what the impact of that deregulation would be on savings and investment.

Mr. Zecchini recalled that he had raised a point during his intervention concerning interest rate policy and the liberalization of capital movements that had not been answered by the staff to his satisfaction. As he saw it, there was little doubt that caution was necessary in monetary management, particularly at a time when structural changes in banking intermediation and in liquidity preferences were taking place. However, he had been concerned specifically with the tradeoffs between interest rate movements and the liberalization of capital movements and had wondered whether the liberalization should lead to outflows of capital. Put in another way, he wondered whether it was appropriate to ask Sweden to go ahead with liberalization measures that would prompt a rise in interest rates. His own view was that it was not wise at present, when there was a real need to enhance fixed capital formation, to allow for a rise in interest rates simply in order to allow a quick implementation of liberalization measures.

The Deputy Director of the European Department replied that his earlier answer to Mr. Zecchini's questions had been set against the background of the problem faced by the Swedish authorities of fairly sizable capital inflows that were adding to liquidity in addition to the expansion of commercial bank credit. The dilemma was a typical one facing many countries, and the resolution of the problem was not an easy matter. The authorities could lower interest rates or they could attempt to push capital out by liberalizing exchange controls. The staff tended to favor the latter approach because, for the reasons he had indicated earlier, commercial bank credit was expanding at rates that were worrisome. Capital inflows had ceased in June, but there were indications that they had resumed in July; so the problem was not yet settled, and it continued to seem to the staff a reasonable policy to limit the expansion of liquidity from the outside by easing exchange controls rather than by reducing interest rates in the present circumstances.

Mr. Lundstrom agreed with the staff that the new expansion of credit and money was alarming. As the expansion had been more vigorous than had been experienced for several years, the authorities had been questioning its causes, and it was clear that the reintermediation to which he had referred in his opening statement was certainly responsible for a considerable part of the expansion. However, there were other reasons. Since the base year used for the calculation had been a year with very low credit expansion, the recent increase appeared magnified. More important, however, was the composition of the increase, particularly in bank credit, a considerable part of which stemmed from transactions in the corporate sector where money had been borrowed in the banks to finance purchases of so-called premium bonds or lottery bonds of the sort that had tax advantages. Corporations that had been liquid and corporations expecting export incomes in the next few months had borrowed money in order to purchase those types of securities. On the whole, it seemed clear that households were not principally responsible for the increase in credit, which was not particularly indicative of the expansion of private consumption, although there had been some increase in retail sales. In any event, the authorities were monitoring the situation closely.

As noted by Mrs. Ploix, the key to success in Sweden was likely to be greater persistence in implementing policy rather than the adoption of further adjustment measures, Mr. Lundstrom continued. Such persistence was particularly important to restrain inflation and wage increases. There remained an inflation and wage cost differential between Sweden and its main competitors, but that was mainly because one of those competitors--Germany--was experiencing no inflation whatsoever. However, if Sweden were compared to Europe as a whole, its performance would appear to be more encouraging. In the 12 months ended June 1986, consumer prices had increased by 3.4 percent, compared with a 4 percent increase in Europe generally; and the gap that still existed between Sweden and certain European countries had been decreasing for some time. The hope was that the inflation rate from January 1986 to January 1987 would be held to about 3 percent.

It was difficult to know what the outcome of the public sector wage agreements was likely to be, Mr. Lundstrom continued. He could only repeat the indication of his authorities that they firmly intended to keep public sector increases at the same level as those granted in the private sector, i.e., 6.7 percent.

It was interesting to note that Mr. Zecchini had taken a rather different view from that of Mr. Suraisry and Mr. Alhaimus with respect to the effects of the oil price decline, Mr. Lundstrom commented. He was happy to note, however, that the Swedish authorities were attempting to satisfy both views: thus far, gains from the oil price decline had been passed on to consumers; at the same time, the authorities were intending to implement an increased tax on heating oil from January 1987 and were considering other forms of energy taxation increases.

The reference in some international newspapers to a possible wage pact between the Swedish Government and the trade unions had apparently been based on a misunderstanding, Mr. Lundstrom said. As far as he knew, there had been strong contacts between the Government and the unions, but the Government was anxious not to interfere in wage negotiations. What was more important was that the authorities had explained in different contexts the negative effects of high nominal wage increases; and that educational campaign had apparently begun to bear fruit. For example, in the July budget bill for 1986/87, it had been made clear that the consequences for high wage increases would be a marked check on economic growth and an decrease in industrial investment, a curbing of the necessary expansion of the export sector, and a possible increase in unemployment rates. It was with such remarks that the Government was attempting to increase the public awareness of the negative effects of high wage settlements.

Agreeing with Ms. Bush and others that investment in Sweden must be sustained, Mr. Lundstrom observed that the Swedish productive sector--particularly the manufacturing sector--was too small, and one of the clearly declared aims of the authorities was to increase that sector. One reason why investment had apparently not performed as well as might have been wished was that there had been a gradual redirection from capital-intensive sectors to other sectors where investment tended to be less expensive, such as toward investment in marketing and research and development, areas where Sweden's record was rather good. Indeed, he noted from the most recent issue of Business Week that Sweden was second only to the United States in spending on research and development in relation to industrial output.

Finally, on the discussion between Mr. Zecchini and the staff about the appropriateness of the exchange control liberalization effort at present, Mr. Lundstrom remarked that the measures in question had been under study for a long time and had been viewed from a longer-term perspective. They represented a considerable change in Sweden's regulatory system, which had been introduced during World War II. The changes were meant to produce positive effects in the longer term.

Mr. Zecchini observed that the staff should perhaps explore in the next Article IV consultation the impact of relative interest rates and exchange controls on capital movements. If with the current relative level of interest rates Sweden was experiencing a net inflow of capital, an effort should be made to find the reasons behind that inflow.

The Acting Chairman made the following summing up:

> Directors noted the marked improvement in Sweden's economic performance since the previous consultation, especially in the areas of inflation and the balance of payments. While falling interest rates and oil prices had made a contribution to this improvement, the policies followed by the Swedish authorities had played an important role. A deterioration in the external accounts and unduly rapid domestic demand growth in early 1985 had been arrested by a sharp tightening of monetary policy, and the fiscal deficit had also been reduced. The rate of inflation had fallen from more than 8 percent to 3.5 percent over the past 12 months. Meanwhile, Sweden's exceptionally low rate of unemployment had been safeguarded; profitability in the enterprise sector continued to be healthy; and the virtual elimination of industrial subsidies together with an impressive research and development effort, had helped to restructure industry.

Directors questioned, however, the sustainability of the current economic performance, observing that Sweden continued to encounter difficulties in controlling costs that threatened to erode the competitive position. In addition, Directors noted that the rate of capacity utilization in manufacturing was well above the OECD average, that some bottlenecks had appeared--including shortages in certain skills--and that new investment had been weak. It was to be hoped that the wage accord reached in the private sector would hold in the face of the buoyant economic climate. Directors supported the authorities' effort to seek pay moderation in the public sector, noting that the carryover from the public sector settlement in 1985 left no room for further salary increases under the 1986 official pay guideline. It was further observed that the effects of the rise in absorption in the economy had partly offset the effect of the terms of trade gains in 1986, and that the current account was projected to be barely in balance in 1986, in spite of the large reduction in the oil import bill. Thus, concern was expressed that Sweden might have lost some of the edge in international competitiveness that had been gained in the recent past.

The pace of fiscal consolidation had slowed of late, and most Directors believed that for the purpose of strengthening domestic savings and, also, in order to dampen wage pressures, fiscal policy should be tightened. They judged that the local authorities should make a larger contribution to fiscal discipline and that restraint needed to center on expenditures--especially public sector pay and social subsidies and transfers--rather than on revenue, since the tax burden was already high and above the average of other industrial countries.

Several Directors considered that a cautious approach to interest rate reduction remained appropriate in order to control domestic liquidity and to balance the overall external account. More rapid fiscal adjustment would serve to relieve the pressure on interest rates. Directors commended the far-reaching liberalization in monetary control arrangements undertaken in 1985-86, with a greater role being accorded to market forces in interest rate determination and the allocation of financial flows. Directors supported the determination of the authorities to maintain the effective exchange rate of the krona and to foster external adjustment through wage restraint and a greater savings effort, and they welcomed the statement that cost pressures would not be accommodated by means of devaluation or fiscal relaxation.

With respect to the medium term, a number of Directors suggested the adoption of a more ambitious external current account target, noting that such a goal could also be combined with a higher rate of growth. The fall in energy prices, they said, offered the opportunity not only for greater domestic absorption but also for a higher external surplus and repayment of foreign debt, given Sweden's still sizable net foreign debt burden and debt-servicing requirements. To take advantage of that opportunity would require a tighter fiscal stance than envisaged. A stronger fiscal consolidation and an improvement in the very low personal savings rate were also required if Sweden was to finance a rise in the share of investment in the economy--necessary for raising the potential rate of growth--without renewed recourse to foreign debt.

Directors also considered that, over the medium term, supply enhancing measures were of crucial importance. Policies promoting deregulation, flexibility in wage arrangements and in the functioning of labor markets--including the elimination of employmentcreating schemes--and incentives for labor supply, labor mobility, and capital formation needed to be strengthened. In that context, Directors welcomed the authorities' recently announced measures to simplify the tax system and reduce the personal income tax burden. They also welcomed the recent partial relaxation of exchange controls and encouraged the authorities to make further progress in that direction.

Directors commended Sweden's record on official development assistance and its firm commitment to a free trading system. They welcomed Sweden's promotion of international efforts to dismantle trade barriers, and some Directors expressed the hope that the Swedish authorities would reduce the protection that was particularly affecting the agricultural sector.

It is expected that the next Article IV consultation with Sweden will be held on the standard 12-month cycle.

3. YUGOSLAVIA - ENHANCED SURVEILLANCE - MIDYEAR CONSULTATION

The Executive Directors considered the staff report for the 1986 midyear consultation under enhanced surveillance with Yugoslavia (SM/86/176, 7/17/86; Cor. 1, 8/5/86; and Sup. 1, 8/7/86).

Mr. Polak made the following statement:

The recent discussions of the Fund mission with the Yugoslav authorities constituted in two respects a break with the long string of such discussions over the past few years: they were the first discussions held under enhanced surveillance, rather than under a stand-by arrangement; and they were also the first discussions for the new Yugoslav authorities (including the Prime Minister, the Minister of Finance, and the Governor of the Bank of Yugoslavia) who had taken office on May 15 of this year. The report clearly reflects these two new elements.

The arrangements for enhanced surveillance have only recently been concluded with the creditors concerned and approved by the Fund. Enhanced surveillance as far as the commercial banks are concerned was approved by the Board on March 12, 1986; that for the benefit of official creditors was approved on May 12. It may be recalled that the terms of surveillance for official creditors had been the subject of difficult negotiations. The creditor governments were anxious to establish a system of monitoring that would give them the assurance that Yugoslavia would continue policies that would provide not only a strong enough balance of payments to service its debt but also the internal equilibrium that would serve as the economic underpinning for external performance. Accordingly, they insisted on the monitoring of a wide range of variables and of five specific policy undertakings. Yugoslavia, on the other hand, was anxious to establish the fact that its relationship with the Fund was sharply different from that under the stand-by arrangements of the past; that for that reason the target figures set for certain variables should not be considered as "triggers" or "performance criteria"; and that the scope of these variables should not be excessively wide-ranging. On this latter point, the Managing Director in his summing up of EBM/86/80 (5/12/86), recalled the views of Directors "that the Fund should not be limited in the monitoring process to any specific set of variables or targets, but should cover all those that are relevant" (SUR/86/40).

It is a pleasure to report that, in spite of the potential for conflict on the scope of the monitoring exercise, the discussions in Belgrade in June proceeded smoothly over all relevant areas of the Yugoslav economy brought up by the mission and that the scope of the exercise proved in practice not to be a contentious issue.

The new Yugoslav team indicated that it was approaching the problems of the country's economy with the idea that their solution would have to be found not through additional administrative measures but, on the contrary, through greater reliance on market criteria. The objectives of the authorities were to resume growth, to increase the foreign currency earnings from the exports of goods and services, and to reverse the pernicious inflationary trend. To deal with these problems, the authorities envisaged introducing three successive policy packages over a short period of time. The first of these was introduced shortly after the mission left, although the gist of it was discussed with the mission and reflected in part the mission's observations; the second was announced a few days ago; and the third is left for later this year.

It is seen as essential to provide major incentives to exports so as to enable a higher sustainable level of imports and in this manner increase production as the single way to a higher level of supply that would in turn effect a downward pressure on prices. This could of course be implemented only in an environment of stronger financial discipline.

To increase production and exports, the first set of measures includes the devaluation of the exchange rate, customs measures, and preferential interest rates for exports and agriculture. The difficult financial position of enterprises will be helped with the new accounting law that should eliminate the exorbitant cost burden of interest rates, exchange rate differentials and stock revalorization. Concurrently, the position of the banking system is being strengthened through greater autonomy of the banks vis-à-vis the enterprises that have founded them. Also, the need that the authorities felt to deal as soon as possible with a worsening inflationary situation underlies their decision both to tighten price control and to introduce a somewhat different approach to the calculation of interest rates (described on page 20 of the staff paper), the effect of which was to lower them to substantially negative figures in real terms. From indications given by the authorities at the time when the mission was in Yugoslavia, as well as from other indications since that time, this new approach is to be considered as an interim attempt to ease the pressures on costs of production, and it will be open for reconsideration before the end of the year. On the basis of the rate of inflation in the recent past, the authorities expect that their measures to moderate price increases will lead to positive real interest rates by October. The Board's views will be an important input in the review of these matters by the Yugoslav authorities.

In accordance with the April 13, 1986 understanding on Enhanced Monitoring (EBS/86/96, Annex A-II) "the quantified prospective economic outturns and the policy variables that are to promote achievement of these outturns" were thoroughly discussed between the staff and the authorities. However, it is evident from the paper that not all gaps in perception or assessment between the two parties could be resolved. In the circumstances, the staff's view on a certain number of unresolved issues is clearly expressed in the report, which is fully in accordance with the April 13 understanding.

The second set of measures have just been announced. A more efficient use will be made of short-term foreign borrowing. Payments due to foreign partners in joint-venture agreements are given the highest priority. Imports will be increased (including those from the nonconvertible area) so as to augment domestic supply where price increases considerably exceeded the 1986 targets. Proceeds from increases in the gasoline tax will be used as an additional incentive to exports. Priority credits will be available for production for exports and for agricultural production and fertilizer stocks. Agricultural production will also be subsidized through regional funds.

Some indications are also available on the measures still to come, later this year, which will be looking toward the medium term. The next round of staff discussions should be able to appraise them. An important component of this third package is expected to be a reform of the tax system, which would include a general income tax. This should reduce the anomaly that incomes in the private sector, which have been rising sharply, are taxed at lower scales, while wages in the socialized sector, which have continuously shrunk in real terms, are heavily taxed. It is intended that the new tax measures will help curtail consumption and alleviate the tax burden on enterprises.

Although the economy has performed well on the external front in the past several years, as documented in the staff paper (there has in fact been a net repayment of external debt of $550 million since the beginning of the year without an emergence of arrears, with an external reserves level of $2.3 billion and with increased imports), the internal, structural weaknesses in the economy are now increasingly coming to the surface. The unbalanced regional development hinders the application of uniform measures. The consequences of past unprofitable investments are extremely difficult to overcome. Inadequate fiscal reform, an increasingly unequal income distribution, the large role played by foreign currency holdings, and market interventions have reduced the effectiveness of credit policy in lowering inflation and promoting production and export growth. Restrictive policies of the past few years have caused a lag in technological and scientific development. Against this background, it was seen that the export sector required urgent attention and this has been addressed in the recent measures.

In the forthcoming period, the authorities' priorities will be geared to the unification of the market. Structurally, attention will be given to the development of tourism, agriculture, and small-scale industry, areas where employment can be fostered and where rates of return can be realized in the shorter run. Administrative procedures for the development of small-scale industry will be simplified and unified across the country. As a first step to the more direct utilization of household savings, housing projects have been initiated. There will also be joint export programs that will cut across regional boundaries. The complexity of the economic structure necessitates a gradual step-by-step approach in the current period if the influence of market forces is to be successful in the more medium term.

The staff appraisal, like the rest of the staff's report, is of high analytical quality, and I would not differ from the staff's description of the risks that would be involved if the policies of positive real interest rates and price liberalization were abandoned. I also share the staff's view that the authorities must urgently attack the fragmentation of the markets for capital, labor, goods, and foreign exchange. As I have already indicated, this view is shared by the Yugoslav authorities. The staff goes too far, however, when it concludes in its final substantive paragraph on page 27 that "the recent measures constitute a clear move away from the use of market signals and discipline," and that this "raises doubts about the Government's commitment to the strengthening of market forces." With respect to the market most relevant to the ability of Yugoslavia to continue its current account surplus, one of the early measures taken was a step devaluation of the dinar to a lower real effective value which is to be maintained from here on, as well as other financial measures to stimulate exports. Short of adopting a fully floating rate, the Yugoslav system will inevitably continue to involve some rationing of foreign exchange. The Yugoslav authorities agree that there are problems in the implementation of the new foreign exchange law. Some of these problems are due to the external environment, and some are due also to the fact that the new law was put into effect without a sufficiently long preparation period. The authorities intend to take further measures that will strengthen the market forces in the functioning of the new foreign exchange system, thus making it more efficient.

In conclusion, having studied the staff report with great interest, my authorities want to stress their firm determination to allow a strengthening of market forces, and they expect that the further measures to be taken later this year, starting in September, will bear out their position.

Mr. Jayawardena made the following statement:

Mr. Polak's useful statement clarifies succinctly recent developments in Yugoslavia and the intentions of the new authorities to meet the challenges posed by those developments. Clearly, there are a number of areas of policy which need immediate attention and which have been described in the staff report as well as in Mr. Polak's statement, both of which also bring out quite clearly the underlying differences between the staff and the authorities in the approach to the problem. However, the basic objectives of the authorities and the staff are the same--namely, resumed growth, increased export earnings, and moderation of the inflation trends. Therefore, the differences outlined in the staff report appear to be differences only of degree and priorities, rather than of a very fundamental nature.

We have always welcomed explicit statements by the staff of its views, irrespective of whether those views are substantially different from those of the authorities. However, if staff must express doubts about the commitment of a government, that should perhaps be done only after substantial discussion and only with a clearly defined purpose. Noting that the new Government took office only in May 1986, we tend to agree with Mr. Polak's observation that the statement on page 27 of the staff report casting some doubt on the commitment of the Government may be going "too far." Besides, we must remember that the procedures under enhanced monitoring are different from those under stand-by arrangements in that the targets are not to be "triggers" or "performance criteria."

Turning to specific areas of policy, let me first take up interest rate policy. The staff has voiced its misgivings about the recent reduction of nominal interest rates by the authorities, which the staff feels made most interest rates markedly more negative in real terms. The staff has urged the classical arguments of promotion of savings, better allocation of resources, discouraging flight of capital and promotion of effectiveness of monetary policy; and it has suggested that, in a high inflation environment, it is necessary to retain adequate real interest rates. The authorities, on the other hand, seem to feel quite strongly that, in the special circumstances of Yugoslavia, very high interest rates are a source of cost-push inflation and a major impediment to investment and growth, and that was the reason behind the moderation of the interest rates effected from July 1, 1986. The authorities have also stated that a modified formula that takes into account the record of inflation over the past three months and a targeted rate for the next four months would be used in determining the real rate of interest. This novel approach, they feel, is an interim attempt to dampen inflationary trends, and we welcome the intention to reconsider it before the end of this year.

As we have stated in the past, while it may be necessary in some cases to maintain a real positive interest rate to give sufficient incentives for saving and to ensure proper allocation of resources, it is not clear whether, in the particular circumstances of Yugoslavia, savings are that highly interest-elastic, and whether the interest rate can have a major impact on allocation of resources in a system still subject to widespread regulation. We also have some sympathy with the current approach of Yugoslavia in deriving the interest rate formula, since we believe that it would be harmful to index interest rates to short-term rates of inflation. Such a step in itself could fuel further inflation, and in the case of many countries, this Board has strongly urged against indexation. In any event, since the authorities have an open mind on the subject and have kept the matter under close review. We would like to support their stance in this regard and would, at this stage, hesitate to recommend, a priori, a reversal of their recent decision to reduce interest rates. However, they should carefully watch the savings-inflation behavior and should be ready to take corrective steps if necessary.

We agree generally with the staff that a surge in real personal income, in excess of productivity, needs to be avoided; in that context, the measures contemplated by the authorities for wage moderation in the second half of this year are welcome.

In the area of price liberalization, the authorities have taken a number of measures in the recent past which have resulted in the decontrol of the prices of a significant number of goods. They have also modified the system of determining the prices for public utilities like railways, electicity, and post and telegraph services, so as to make them reflect costs more closely. These are all positive steps. When viewed against that background, the recent price regulations are of comparatively lesser significance and seem to have been undertaken more to break the psychology of inflation. Therefore, we should not rush to a judgment that there is a permanent or sharp reversal of pricing policy. And one can expect the authorities to review this aspect, once a more stable environment in terms of prices is achieved. In the external sector, the economy has clearly performed well in the past few years, with reserves reaching about $2.3 billion. The new exchange and trade system, which has been in force since January 1, 1986 reflects the fact that Yugoslavia, in the present circumstances, needs to have some system of foreign exchange rationing. However, even in this area, the authorities are apparently willing to make modifications so as to strengthen the use of market forces, while at the same time ensuring that the new system serves the intended purpose of transferring sufficient foreign exchange reserves from surplus to deficit regions and banks.

In sum, the situation in Yugoslavia is clearly a difficult one, and the authorities have been doing their best to grapple with the complex issues which appear to be somewhat unique to Yugoslavia. The complexity of the economic structure of Yugoslavia would seem to require a gradual and planned approach to the freeing of markets if the adjustment is to be successful in the medium term. The steps taken by the authorities in recent months are in some cases nontraditional, but they have certainly been taken with a view of achieving the broad objectives of growth, a reduction of inflation, and an increase in exports that will lead to external stability and market efficiency. In that effort, the authorities deserve the full understanding and support of this Board. Clearly, there are certain unique features in the

Yugoslav economy that must be reckoned with in considering the relevance of standard remedies which would apply to many other countries. We need to improve our understanding of the complex economic, political, and social relationships in Yugoslavia that will ultimately dictate the relevance of traditional economic remedies. Yugoslavia has progressed quite far in its recent collaboration with the Fund, and there is a great need to maintain this relationship and spirit of understanding. The second set of economic reforms just announced and the medium-term measures contemplated, as described in Mr. Polak's statement, give us hope that Yugoslavia has the capacity to make further substantive progress. Given the complex regional power-sharing arrangements in Yugoslavia, this progress may be perceived by many to be inadequate or too slow. We, too, would like more rapid progress in economic reforms; but it is the authorities who know best regarding the pace of adjustment.

Mr. Templeman made the following statement:

In supporting Yugoslavia's enhanced surveillance arrangement at the Board discussion in May, we emphasized the virtually unprecedented agreement of the official creditors to reschedule without insistance on a stand-by or extended arrangement. We had hoped that the staff would be able successfully to engage the Yugoslav authorities in a consultative process, with the optimum outcome being joint quantified projections. In the absence of that outcome, we urged the staff to comment on both the consistency and achievability of the policy program and, if necessary, to put up its own alternative projections. As nearly as I can tell, this is what has happened, but I would welcome comment by the staff on its experience so far with this procedure.

It is clearly evident that significant differences remain between the staff and the Yugoslav authorities following their consultations. I list in particular, in this regard, interest rate policy, credit policy, and the foreign exchange rate and exchange system. There also appear to be some differences of view about the status of price controls, wage policy, financial discipline and public spending, all of which are also important matters.

On interest rate policy, the monitoring arrangement called for interest rates to be 1 percentage point in real terms, based on the discount rate as the guide rate. I think that it is fair to say that this commitment has not been complied with, either statistically--as evidenced by the chart on page 12b of the staff report--or conceptually--as evidenced by a major change in the guide rate and in the formula for calculating the rate. Frankly, we are most disappointed by this development; we concur in the staff's assessment of the seriously negative impact which this is likely to have on savings and investment, inflation, the balance of payments and monetary conditions in Yugoslavia. We are only slightly reassured by Mr. Polak's reference to the change in interest rate policy as an interim measure. We also share the staff's concern about the rapid rate of growth of the money and credit aggregates through May, which are accommodating a surge in wages.

The authorities indicated last April that they intended to maintain the degree of price control liberalization which they had achieved at that time. Whether or not this understanding has been respected is doubtful. We acknowledge that the number of items on the free list was increased early this year, expanding the list from about 28.5 percent of all items to about 42.5 percent of all items, a positive step. However, the extension of the advance notice period for that group of prices from 30 days to 120 days goes in the opposite direction, as has the rollback of some prices. We are quite uneasy about this turn of events, particularly because the underlying inflationary pressure due to excessive wage rate and credit increases may tempt the authorities to resort, once again, to suppression of inflation through even more comprehensive controls.

We are a little more confident about exchange rate policy, which was to be exercised in such a way as to equalize inflation differentials. The supplement to the staff report seems to say that in the period end-April through end-July, there has been a real effective depreciation of the dinar of about 5 percent. However, we would welcome a confirmation of this interpretation. Concerning the exchange rate system that went into effect at the beginning of 1986, we would only repeat our belief that the basic approach of using administrative controls, which is embodied in the Yugoslav system, is a step backward in terms of creating a true national market that would encourage efficiency, export growth and export diversification. The lack of such a market for goods, capital, and foreign exchange remains a fundamental structural weakness.

Another of the specific targets under the enhanced monitoring arrangement was a surplus this year in the current account balance on convertible currency transactions of at least $500 million. Based on data through June, the official forecast of a surplus of $930 million, even taking into account a gain from the world oil price decline of $300-400 million, seems increasingly unlikely to be achieved. I would welcome an updated staff comment on what the current account balance this year might eventually prove to be. We acknowledge the need to encourage faster export growth, but we question the advisability of preferential interest rates, which is a reversal of a policy objective achieved under the stand-by arrangement, and I wonder how the proceeds of the gasoline tax will be used to provide a further incentive to exports.

Another understanding in the surveillance arrangement concerns financial discipline, with measures anticipated to strengthen the effectiveness of monetary policy and to curtail the access of loss-making enterprises to real and financial resources. We welcome the passage of the law prohibiting nonbank guarantees of promissory notes, the fact that the losses of loss-making enterprises have been financed to a greater extent by credits (rather than grants), the increased number of liquidations and mergers, and the encouragement being given to the private sector and to joint ventures. But, we would appreciate staff comment on the new accounting law, which Mr. Polak says would eliminate the exorbitant cost burden of interest rates, exchange rate differentials and stock revalorization. Also, we note the continued failure to provide enterprises with an attractive short-term instrument for investment of surplus funds. And, it appears that there have been very large increases in enterprise losses, as shown in the table on page 45 of the report. We would appreciate some further staff explanation of what is happening in this area.

A number of quantitative limits were established in the monitoring arrangement, as contained on page 8 of Annex A-II of EBS/86/96 of last April. These concerned net domestic assets, M2, domestic credit, federal budget expenditures, external reserve changes, and ceilings on net short-term and gross medium- and long-term external debt. Unfortunately, comparable data are not clearly presented in the staff report. However, with staff assistance, it has been possible to compare actual performance at the end of March against the enhanced monitoring limits. Except for the M2 target, all other end-March limits were respected. Since some of them were also formal ceilings under the old stand-by arrangement, there may have been added incentives for compliance. Unfortunately, the lack of actual data for June 30 makes it impossible to assess performance against the specific monetary and fiscal limits for the period after the stand-by arrangement ended. It does appear that the external commitments were all respected at end-June. However, revised monetary forecasts for net domestic assets, M2, and domestic credit indicate that each of these limits is now expected to be exceeded as of the end of June, September, and December. At the time of the midterm review, we would appreciate from the staff a clear and separate presentation in the staff report of a comparison of actual data and agreed limits under the official creditors' monitoring arrangement.

Finally, I would like to comment briefly on some measures of economic performance and prospects for Yugoslavia, in connection with the outlook for meeting its future debt obligations. For 1986, real growth seems likely to fall short of the authorities' 3 percent goal, although 2 percent growth would be some improvement over last year. An inflation rate from December to December of 100 percent would clearly be disappointing and unsatisfactory. The current account surplus may still be met, although the importance of the beneficial effect of lower oil prices may raise questions about whether there is a solid underlying basis for believing that future external goals will also be met. Finally, the staff's new medium-term debt scenarios do not look very different from the ones presented in February, with a debt GSP ratio in 1990 of 25-30 percent and a debt service ratio of 28-33 percent. The debt service ratio looks to be the more troubling one.

In conclusion, I am rather concerned about recent developments in the Yugoslav economy. The staff has been quite helpful in setting out differences of view with the authorities in some areas. Unfortunately, some of these are key areas of the economy which have, in the past, also been a source of concern. The official creditors in proceeding with a virtually unprecedented rescheduling without a stand-by arrangement agreement have counted on Yugoslavia's continued pursuit of strong macroeconomic adjustment and structural reform policies. I must say that we have been rather disappointed so far. Fortunately, we will have another occasion to review the situation before official creditors must make a decision about the second year of debt rescheduling. In the meantime, I would strongly urge the new Government to monitor closely the results of its latest actions, and I hope the authorities move quickly to correct some of these policies if they are shown to be ineffective in dealing with Yugoslavia's problems.

Mr. Goos made the following statement:

The excellent staff report leaves little doubt that the Yugoslav authorities--notwithstanding the achievements of their past adjustment efforts--still have a long way to go before a satisfactory and sustainable overall economic position is reached. Against this background, recent developments in Yugoslavia appear less than satisfactory, inasmuch as they point in the wrong direction, notably toward slower growth, a further acceleration of inflation, and renewed pressures on the external accounts. Even more worrisome is the impression one gets from the paper that those negative trends tend to be reinforced by the present stance of economic policies.

The most unfortunate development of the recent past in my mind is the apparent inclination of the authorities to roll back previous reform measures, most notably in the areas of interest rate and price policy. While the concomitant greater reliance on administrative measures can be expected at best to bring only temporary relief, experience clearly shows that in the longer run it is bound to aggravate the still widespread structural problems. Accordingly, if the authorities' stated commitment to economic adjustment is to be taken seriously, it would appear that they will have to correct their present policy stance sooner or later under the pressure of market forces. Otherwise, they will end up back on the past detrimental course of on/off policies. I have nothing to add to what the staff says in this context about the potential impact of such an outcome on the credibility of the authorities' policies both at home and abroad. However, my authorities consider the present policy stance less than helpful with regard to the implementation of the rescheduling agreement with official creditors in May of this year.

As Directors know, the Paris Club will have to discuss to what extent Yugoslavia is actually fulfilling the undertakings under the first stage of the rescheduling agreement. Put another way, it must determine the extent to which the authorities are implementing the economic and financial program which they have presented to the Paris Club for this year. The present policy stance, if maintained, could at least cause considerable difficulties when the question of entering the second stage of the agreement, beginning in May next year, is discussed. I therefore urge the authorities to reconsider their policies in order to bring their program back on track and to build upon the considerable progress that has already been made. It would certainly be most unfortunate if continued policy slippages in the end undermined the basis of the enhanced surveillance agreement with the Fund.

With regard to specific policy issues, I will be rather brief, since I fully agree with the staff's analysis and recommendations, including the favorable assessment of some recent initiatives in the structural area, in particular the measures intended to further strengthen financial discipline in the enterprise sector as well as the intention to encourage the small-scale economy in the private sector and foreign investment in joint ventures. I would therefore like to offer only a few supplementary comments.

First, on interest rate policy, while agreeing on the need to secure sufficiently positive real interest rates and with the view that indexation of monetary instruments could facilitate the necessary political support in that regard, I would strongly advise against indexation. Indexation in all likelihood could not be limited to monetary instruments but would spread sooner or later throughout the economy, affecting all sorts of contractual agreements, especially agreements on wages and salaries. Everybody is certainly aware of the painful experience with indexation in many high-inflation countries, where it seriously impaired the effectiveness of economic management; and I recall the enormous political effort and courage it required in some recent cases to de-link the economy from the price index after the damage had become unbearable. In view of this experience, I strongly feel that a more critical response by the staff to the idea of indexation would have been more appropriate.

Second, on incomes policy, the concerns expressed by staff about recent increases in real wages are well taken. In addition to the undesirable effects of such increases on inflation, import demand, and consumption of exportables, they probably could also be expected to further weaken investment activity. Such an outcome would be particularly unfortunate considering the very strong decline in gross fixed investment over the past years. Hence, a continuation of this trend would undoubtedly be inconsistent with the urgent need for additional investment in order to strengthen Yugoslavia's international competitiveness and facilitate structural adjustment. We therefore welcome the authorities' intention to contain the scope for further wage increases. In this regard, I agree with the staff that rules and regulations for wage moderation would probably be ineffective unless supplemented by sufficiently tight financial policies. At the same time, I believe that such regulations can play a useful role in the context of the Yugoslav economy, provided, however, that they are implemented with sufficient flexibility in order to prevent the emergence of additional distortions. By the same token, it appears necessary to secure nationwide adherence by reaching a consensus between the Central Government and the authorities of the republics and provinces. Finally, we believe that incomes policy should give greater emphasis to an appropriate degree of wage differentiation in order to strengthen incentives to work and improve productivity.

Mr. Foot made the following statement:

The Yugoslav authorities continue to display what appears to be a confused approach to economic policymaking, which raised serious doubts about the plausibility of their objectives, as specified in the quantified economic program, especially for the current account and the rate of inflation. The period since the end of the stand-by arrangement has seen a few steps forward, notably the accelerated depreciation of the dinar, some further price liberalization and some efforts to curb interenterprise credits, thereby strengthening the financial discipline on enterprises. The measures to encourage the development of small businesses and joint ventures are also welcome. However, the steps in the opposite direction have been equally numerous and rather more serious, especially the reduction in interest rates to substantially negative levels and tightening of foreign exchange allocation. As illustration of these steps backward, I note certain developments with respect to two of the three measures used to justify the previous drawing under the stand-by arrangement against the background at that time of a failure to raise interest rates sufficiently. The increase in National Bank selective lending rates has been reversed and, for all short-term deposits at remunerative interest rates, have never been effective. Those developments--or lack of them--represent an inauspicious beginning for enhanced monitoring, and I find the critical tone of the staff appraisal entirely appropriate. Indeed, my authorities regard recent developments in Yugoslavia as unacceptable and consider that the course of policy has fallen well short of the undertakings recorded in Table 1 of the enhanced monitoring agreement as discussed in May. This table did not encapsulate every aspect of policy relevant to Yugoslavia, but clear updating, preferably in tabular form, of the authorities' efforts to meet their objectives could be helpful in future discussions.

The measures announced since the staff report was written have not in any way changed the conclusions of the staff paper and I continue to fully endorse the main message--namely, that the present stance of policy makes the achievement of the authorities' objectives highly unlikely. Growth continues to be sluggish, with investment and exports weak. The trend of the current account also gives cause for concern. As the staff supplement notes, the current account deficit was $320 million worse than planned for the first quarter of 1986 and $390 million worse than the revised plan for the second quarter. The intended current account surplus for the year of $930 million now looks unattainable, unless the authorities respond by cutting imports. If they do, domestic growth will be further reduced and inflationary pressures increased. But where the authorities' economic program is most obviously off track--and where many of the worst effects have yet to show through because that deviation is fairly recent--is in the monetary areas where the recent reduction in interest rates has been justified by an inflation assumption which seems little more than wishful thinking. The previous formula for achieving positive real interest rates was, as Chart 6 of the staff paper shows, inadequate at a time of accelerating inflation. However, the authorities' new formula, which puts even greater weight on inevitably uncertain and, in practice, fanciful forecasts of inflation, is clearly a device to bring down the nominal interest rate while allowing the authorities to pay lip service to the objective of positive real rates. I note Mr. Polak's statement that "the Board's views will be an important input in the review of this matter by the Yugoslav authorities." And I would strongly urge the authorities to reverse their decision before any further harm is done. In this regard, I note the proposal to index debt principal, which may be a more acceptable way of achieving positive real interest rates. There is some intellectual merit in this argument, but it is a poor substitute for more conventional means, unless and until the authorities have and follow a credible and firm counter-inflationary policy. Otherwise, like Mr. Goos, I fear the introduction of indexation may institutionalize inflation and accelerate it.

I would also urge the authorities not to return to price controls, a move they appear to be contemplating. Such controls would provide only cosmetic and possibly short lived reduction in measured inflation; moreover, they will introduce serious distortions in already imperfect markets. The authorities seem to understand a need to break the inflation psychology but they do not seem to appreciate that continued reversals of policy merely destroy any credibility that the adjustment efforts may have, and do nothing to bring about the necessary change of attitudes in the economy.

The staff paper contains a number of examples of inconsistencies and contradictions in economic policy. Thus, while the authorities have continued to pursue an active exchange rate policy rather successfully, they have introduced a new foreign exchange law which discriminates between different sectors and regions by inefficient administrative means. And this law has introduced further inconsistencies such that net importers, who have had their access to foreign exchange reduced, are to be allocated the proceeds of official borrowing from multilateral sources. At the same time, however, their access to foreign exchange from banks is discouraged, as the banks are being prevented from passing on the costs of exchange and interest rate changes to the borrower.

I note Mr. Polak's argument for a gradual approach in increasing the influences of market forces, but my own view is that progress has been far too gradual and halting. What is needed instead is a sustained attack on the structural inefficiencies and rigidities in the Yugoslav economy that reduce its growth potential.

On fiscal policy, the proposed tax reform seems to be a move in the right direction, and the extension of the income tax to the private sector will help curb consumer demand, which has recently been the main source of inflationary pressure. However, I would be interested in any comments the staff or Mr. Polak might have on how tax reform will affect the overall fiscal position, given the process of revenue "earmarking," which makes expenditure control reliant on revenue control. I note in this regard that measures to prevent the regional authorities from spending their excess revenues toward the end of last year were not at all successful, which does not bode well for future attempts to control expenditures in this way.

Export performance has been rather weak so far this year, and it may be that the new foreign exchange law is having an effect here. The 8 percent effective depreciation in June is welcome, as is the focus of the most recent package of measures on exports; but I would like to hear staff views as to whether these will be sufficient to achieve the sort of export growth that the authortiies' program relies upon. In this respect, I note from the staff supplement that the effect of the exchange rate deprecation has recently been partially reversed, a phenomenon which I hope is only temporary. On another matter, I would welcome any information the staff might provide on how negotiations are going on the structural adjustment loan with the World Bank and what measures the program is intended to include.

In sum, my authorities judge that the assessment of this Board must be negative on policies followed to date and that the Yugoslav authorities must be made fully aware of our anxieties. There is still time for more promising and coherent policies, but that time is running out if a satisfactory second stage of the Paris Club rescheduling is to be reached.

Mr. Weitz made the following statement:

Yugoslavia has achieved a very good record of external adjustment in the past three years. The authorities have pursued an active exchange rate policy and a liberalization of prices and they have implemented measures to improve the financial situation. We are grateful to Mr. Polak for his informative statement, and we are pleased to note that the discussions in June proceeded smoothly with respect to all relevant areas of the Yugoslav economy. It is reassuring to know that the new Yugoslav team is approaching the situation with a view to ensuring a greater reliance on market criteria.

Performance of the Yugoslav economy during 1986 has been mixed. On the positive side, we welcome, first, the accelerated depreciation of the dinar implemented in late June 1986, because this measure will have a beneficial effect on both production and exports, and will improve external competitiveness. Second, some progress has beem made in dealing with structural policies. In particular, we welcome the recent measures aimed at encouraging foreign investment in joint ventures. We also note with satisfaction that the development of the small-scale economy in the private sector is being supported by the authorities.

Regarding the tax package that will be implemented soon and that has been described by Mr. Polak in his statement, we believe that tax reform that includes a general income tax will improve income distribution. We would welcome staff assessment of the impact of the possible implementation of the new tax measures on the performance of enterprises. We also take note of the high payments toward eliminating foreign debt made in the first half of the year; the efforts of the authorities in this regard must be recognized.

Remarking on the concerns we have in certain areas of the economy, I note that the authorities have introduced a different approach to the calculation of interest rates, which is described on page 20 of the staff paper. The effect of this approach is to lower the rates to negative levels in real terms, and I agree with the staff that negative interest rates in the economy might aggravate misallocation of resources, indebtedness of enterprises, and inflationary pressures. However, we are confident that this new approach is only an interim attempt to ease the pressures on costs of production and that it will be open for reconsideration this year.

We share the staff's view that the authorities must attack the fragmentation of the markets for capital, labor, goods, and foreign exchange as a matter of priority. On the subject of price liberalization, I note difficulties in assessing the direction of progress already made, due to measures announced recently, and I hope that the authorities see the use of price controls as only temporary. The authorities have pursued responsible fiscal policies in recent years; in particular, great efforts were made to reduce public expenditures. However, it may not be realistic to expect further efforts in this area, and I would like to stress that progress in taxation will be essential to improve fiscal policies. For the reasons mentioned by Mr. Polak, we cannot agree with the staff that "the recent measures constitute a clear move away from the use of market signals and discipline, and this raises doubts about the Government's commitment to the strengthening of market forces." We generally support the growth-oriented approach of the economy that the Yugoslav authorities aim to implement.

Finally, our views on the enhanced surveillance procedures are well-known. We feel strongly that Fund analysis and policy advice under enhanced surveillance arrangements need to be clearly differentiated from the procedures under adjustment programs supported by the use of Fund resources.

Mr. Hodgson made the following statement:

When the Fund agreed to provide enhanced surveillance for Yugoslavia, that decision was designed to allow Yugoslavia to complete multiyear rescheduling agreements with its official and bank creditors while simultaneously maintaining continuity in economic policy, even if no stand-by arrangement was in place. In some respects, the general thrust of policy has been maintained. The authorities continue to utilize a flexible approach to exchange rate management, as demonstrated by a real depreciation of the dinar by some 8 percent in late June to maintain external competitiveness. Fiscal policy has unfolded more or less as planned, although more rapid movement on tax reform seems to be required, and steps should be taken to speed its implementation.

In other important areas, however, policy has deviated sharply from its previous course, raising serious doubts about the continuity of policy in Yugoslavia. The most striking deviation is with respect to interest rates, which were sharply reduced on July 1, making them highly negative in real terms. As the staff has emphasized, a shift to negative real interest rates makes control of the monetary aggregates very difficult, even if the authorities attempt to maintain a relatively restrictive monetary stance. Coupled with the increase in real wages since mid-1985 and a high propensity to consume, the reduction in interest rates and corresponding increase in the growth rate of many aggregates have added fuel to the already strong inflationary pressures within the Yugoslav economy. This is a very worrying development, particularly since the Yugoslav authorities have had to resort to price controls once again in response to the acceleration in inflation.

The shift to negative real interest rates also has serious implications for domestic resource allocation and for the capital account of the balance of payments, and could lead to a shift away from domestic currency in favor of other assets. Similar concerns can be raised with respect to the foreign exchange and domestic credit allocation systems. All of these factors are likely to have a detrimental impact upon Yugoslav economic performance, both in terms of the price level and in terms of real output.

Based on these considerations, it is easy to understand how the staff has reached the conclusion that the recent measures signal a move away from the use of market forces, raising doubts about the Government's commitment to market principles. We appreciate the staff's frank views. As in the past, the authorities have resorted to short-term dirigiste measures in an attempt to limit the disequilibria. In response, Mr. Polak has carefully crafted an argument in his statement that the new Yugoslav authorities intend to place greater reliance upon market criteria in setting economic policy. In that regard, I can accept the point raised by Mr. Polak that the recent devaluation of the dinar does demonstrate a strengthening of market forces in the functioning of the foreign exchange system, although his remarks must be counterbalanced by the restrictive foreign exchange measures which have been in effect since January 1.

Of course, the ultimate proof of the pudding is in the eating. If the Yugoslav authorities are indeed committed to greater reliance on market forces, then tangible evidence of that reliance will have to be shown in the coming months. We would be looking for evidence in the following areas, which are by no means exhaustive: (1) real wages, which most closely reflect output and productivity increases and the labor market situation; (2) interest rates, which provide positive real incentives to domestic savings, support efficient resource allocation and discourage the shift of assets into foreign currencies; (3) a monetary policy that does not accommodate existing inflationary expectations and thus can contribute to a meaningful reduction in inflation; (4) development and implementation of a foreign exchange system which relies less on administrative controls to allocate foreign exchange, such as under the law passed on January 1, and more on market considerations; and (5) an end to price controls.

In conclusion, the authorities would be well-advised to heed the staff's advice to tackle the fundamental weaknesses in the capital, labor, goods and foreign exchange markets. The present favorable external environment provides the authorities with a window of opportunity to demonstrate their commitment to a market approach. That opportunity should not be missed.

Mr. Zecchini made the following statement:

Because we discussed Yugoslavia's difficult economic situation less than three months ago, and since I support the staff's analysis and recommendations, I can limit my remarks to a few critical issues. As this is the first "enhanced surveillance report" for Yugoslavia, I would like to express my first impressions on economic performance so far under this procedure and then turn to some more specific aspects regarding monetary policy and external policies.

We must note with regret that there has been no substantial progress in many key areas of economic performance. The situation instead appears to have worsened in many respects, and the objectives of the 1986 program will probably not be reached.

Inflation has continued to increase and could reach a level of 100 percent by the end of the year. Furthermore, some policy actions are clearly inconsistent with the stated objectives of the program and with the Fund's recommendations. Interest rates have been sharply reduced as of July 1, despite the stated intention of maintaining positive real interest rates; price controls have been intensified in spite of the objective of increasing the role of market mechanisms; and real wages have grown strongly and in excess of the guidelines which were intended to link them to productivity gains.

Increases in real wages, together with the decrease in interest rates, are likely to strengthen domestic demand considerably. As it is doubtful that domestic supply can respond to this increase in a comparable way, inflationary pressures might intensify. Furthermore, the sharp increase in domestic demand will have negative effects on the trade balance. Specifically, on page 18 of the staff report, a possible decrease in availability of export goods is mentioned as a result of greater domestic absorption.

Under these circumstances, we are not sure about the exact role which is being played by the Fund in influencing Yugoslavia's economic policies through this enhanced surveillance procedure. We would like to have the staff's reactions on this as well as some elaboration on the usefulness of this procedure for Yugoslavia and for the Fund. We must add that we appreciate the candor of the staff report, and we attach great importance to the maintenance of this feature in future staff documents.

Monetary policy's lack of coherence with the objectives of the 1986 program remains a source for concern. As can be seen in Table 3, the quantitative monetary and credit ceilings of the program are being systematically overrun by substantial amounts. Furthermore, due to the recent reduction, interest rates on deposits and on loans have become even more sharply negative in real terms. While inflation is running at about 100 percent in 1986, interest rates on deposits are within a range of 42-56 percent, and those on loans are within a band of 53-59 percent.

We also noted that the formula used to determine deposit rates has been changed. However, the relatively modest expected inflation which was incorporated in the determination of the one-year deposit rate is not consistent with the evolution of the economic fundamentals and, as pointed out by the staff, is even below the authorities' optimistic inflation target of 65 percent for 1986. Of course, recent price controls can distort this picture. Sharply negative interest rates, in addition to having an impact on domestic demand, on inflation and on the trade balance, which is undesirable now, also tend to favor a shift to foreign currency-denominated deposits whose share in M2 has risen to 44 percent in 1985. The new importance of this component of M2 may make monetary control even more difficult as total liquidity, denominated in dinars, becomes to some extent a function of the exchange rate. In situations such as the one which occurred in June, when a real depreciation of the exchange rate was necessary, monetary stringency and exchange rate adjustment may become to some extent incompatible as a depreciation may pave the way for an increase in M2.

One of the problems faced by Yugoslavia in monitoring the growth of credit aggregates is related to the importance of interenterprise credit. This type of credit is common to most market economies, but the peculiarities of Yugoslavia's economic system may favor a larger diffusion than elsewhere. However, the possibility for some nonfinancial enterprises to extend credit in substantial amounts is related to the abundant supply of bank credit which they enjoy and to their comfortable liquidity position. A greater stringency of monetary policy and a greater control over credit which is intermediated by the banking system would undoubtedly limit the amount of interenterprise credit which could be made available.

Finally, with respect to external policies, the sluggish export performance of the past months denotes a weakening in Yugoslavia's competitiveness. This weakening, as the staff points out well, stems from the new exchange rate system, which reduces incentives to export, and from the exchange rate policy, which has allowed the dinar to appreciate vis-à-vis the currencies of some of the country's major competitors. In this latter respect, the authorities took appropriate corrective action in June by depreciating the dinar in real terms by about 8 percent, but we regret that the real depreciation was partially reversed in July. A durable strengthening of the external position will require a more consistent set of macroeconomic and structural policies to support the depreciation.

Mrs. Ploix made the following statement:

Today's exercise is a difficult one: we must appraise, in a qualitative way, recent developments in and prospects for the Yugoslav economy. The framework of today's debate does not aim at providing specific analyses or alternative scenarios, but the thrust of our comments must give a comprehensive appraisal to creditors who attach great importance to the Fund's opinion.

As was the case during the last two reviews of the Yugoslav economy, our appraisal of the economic developments remains divided. First, the results, themselves, were uneven. Some results were evidently favorable, such as the performance of the Federal Budget and, more broadly, of fiscal policy. These include the moderate growth in employment, which has been insufficient to lead to a decrease in unemployment, and also developments in the balance of payments, although this aspect remains fuzzy due to the volume of errors and omissions which confuse the analysis and on which we would appreciate comments from Mr. Polak. In any case, the Yugoslav authorities must be congratulated for having respected the proposed guidelines in these areas. The large repayment in the first months of 1986 of Yugoslavia's medium- and long-term debt in convertible currencies demonstrates that the authorities will seize any opportunity open to them.

Other results are less auspicious, and here one should note the rate of economic growth, which, although relatively high at 4 percent in early 1986, has been due to a factor other than the expected one: instead of the net foreign balance contributing to growth, the new impetus came from private consumption.

Finally, certain developments are frankly disquieting. An increase in real personal income, after an admittedly strong growth in 1985, is responsible for the weakening of competitiveness. Because of this weakening of competitiveness and the high level of domestic demand, imports were higher and exports lower in volume than projected in the quantified program. These developments cause us to be concerned about the prospects for growth. And, above all, inflation and the development of monetary aggregates are profoundly disturbing.

On the short- and medium-term outlook, one cannot help but feel that certain decisions taken by the Yugoslav authorities are not sufficient to redress these alarming developments. Foremost among these decisions are those on interest rates. Without dwelling on this issue, let me repeat that we share the staff's view on this long-standing debate. One can only hope that, faced with the unhappy effect on resource allocations produced by largely negative real interest rates, the Yugoslav authorities will be able to tackle the consequences of their decisions with an open mind.

Developments in other areas are equally sources of concern. First, the measures recently taken that strengthen price controls impinge on the progress of the accepted liberalization policy. Like the staff, we hope that temptations to rely on price control measures will be resisted for the reasons which originally led to the liberalization process. Second, the implementation of the new foreign exchange law does not appear to be leading to the expected benefits. It is our hope that the authorities will carefully appraise the situation, taking into account the rigidities clearly induced by the new system. Third, despite the reaffirmed commitment of the authorities toward tax reform, progress has been very slow. I would like to hear from Mr. Polak on the latest developments in this area.

In our opinion, all these recent decisions are not likely to reduce the major structural rigidities which the Yugoslav economy suffers from but, rather, may lead to further fragmentation of the markets for capital, labor, goods, and foreign exchange. Like the staff, we consider that these potentially injurious developments endanger the effectiveness of resource allocations and, thereby, the adjustment process necessary for reasonable and sustainable growth.

In May, when Yugoslavia's public creditors agreed to relax the conditions of their support, it was because they had taken into account the good record of adjustment shown by Yugoslavia during successive Fund programs, and because they were hoping to help Yugoslavia achieve a comeback on the financial markets. Consequently, recent developments are deeply disappointing. It is disturbing that earlier efforts have been relaxed so quickly--within a matter of weeks--and to such an extent. It is, in our view, necessary that such major slippages be promptly corrected so that Yugoslavia is able to maintain the good relations that it had established with its public creditors. More generally, it is crucial that Yugoslavia not jeopardize this special procedure of "enhanced surveillance" which it has requested.

Finally, while the economic situation and prospects for Yugoslavia appear difficult, the authorities are to be warmly commended for their flexible exchange rate, which is a necessity for obtaining the needed growth in exports. Were the policies implemented in other areas as market oriented as their policy on exchange rates, most of our concerns would be sharply diminished.

Mr. Fujino made the following statement:

Yugoslavia has pursued adjustment policies over the past several years and has made achievements in the balance of payments, and exchange rate policy and has strengthened financial discipline in the enterprise sector. Despite these achievements, however, Yugoslavia continues to face a serious adjustment problem. On the external side, the debt service ratio remains at an unsustainably high level. On the domestic side, the structural rigidities in the labor, capital and goods markets have been particularly manifested by the high rate of inflation, which further accelerated recently. The slow growth of the economy in recent years also reflects, at least in part, these structural weaknesses.

In this context, my authorities welcome the commitment by Yugoslavia to adjustment policies, and they support the continuation of a close relationship between Yugoslavia and the Fund under the monitoring scheme associated with the refinancing agreement with official creditors.

For the 1986 program, I would like to support the Government's objectives of continuing the process of external adjustment while aiming at reviving growth and bringing inflation under control. As clearly and frankly spelled out by the staff, however, I am concerned about some of the measures announced or adopted recently which seem to be inconsistent with these objectives.

The most worrisome measure was, as stressed in the staff paper and by many previous speakers, the considerable reduction in interest rates effected on July 1, 1986. While recalling that the authorities' efforts to strengthen financial discipline have been frustrated in the past by negative interest rates in real terms, I endorse the staff's view that any viable anti-inflation plan must include the introduction of positive real interest rates. Here, I particularly note, together with other Directors, the indication by Mr. Polak that this is an interim attempt and open for reconsideration before the end of the year. I expect that this reconsideration will be a positive one. Tight credit policy would also play an important role in curbing real wages.

In view of the high and rising rate of inflation, the authorities have recently taken measures to strengthen control over prices. Given the monetary policy described above, it is indeed doubtful how effective these price control measures will be over the medium term.

During the first four months of 1986, the current account deficit in convertible currencies was higher than expected. While this partly reflected a higher growth of imports than projected, a weak performance of exports was also evident. Under these circumstances, the appropriateness of the new foreign exchange controls introduced in early 1986 has proved to be questionable. Although the accelerated depreciation of the exchange rate in late June 1986 was welcome, the exchange rate policy should continue to be pursued actively, given the inflation differentials between Yugoslavia and its trading partners as well as its competitors.

In concluding, I note that Yugoslavia is responsible for presenting to the international financial community the credibility of its economic policies over the medium term. I express the hope in this regard that the Yugoslav authorities will take carefully into account the points raised in today's discussion in their future formulation of policy.

Mr. Huang made the following statement:

The staff report on Yugoslavia gives a clear description of current economic developments and an informative and helpful analysis on the implications of recent policy actions. I am grateful to Mr. Polak for his instructive statement, which gives us a convincing explanation of measures taken or intended to be taken by the Yugoslav authorities. In the first part of his statement, Mr. Polak referred to the difference of views between Yugoslavia and creditor governments over enhanced surveillance. It reminds me of our statement on Yugoslavia on November 27, 1985 in which we noted that perhaps we ought to take a fresh look at our general approach for countries under enhanced surveillance and that we should concentrate our attention on broad policy performance, thus ensuring that the economy remains on a satisfactory track. By reiterating this, I hope that the role of the Fund in the process of enhanced surveillance and the implications of this procedure for debtor countries may be discussed in this Board in the not too distant future, although we only have very limited experience.

On the midyear consultation report, I am in general agreement with the staff's appraisal, except that some of the criticism seems to be a little too severe, as when the staff concludes that the situation "raises doubts about the Government's commitment to the strengthening of market forces." I notice that the Yugoslav authorities have made considerable progress in their external adjustment efforts in the past three years and, through improvement in the balance of payments position, Yugoslavia is now one of the few debtor countries that has made some net repayment of external debt in convertible currencies. I believe it is also noteworthy that import restrictions have eased, market operations have strengthened, price controls have been relaxed, and the exchange rate policy has become more flexible and realistic.

I am pleased that the main objectives of the new Government, which took office in the middle of 1986, give priority to a revival of economic growth, control of inflation, and a reduction in the external debt service burden. In this context, I believe that the main measures taken by the new Government so far are a step in the right direction, and I hope the authorities will achieve further success in their external adjustment efforts. This hope is strengthened by the three policy packages introduced, or which are going to be introduced, by the new Government, as mentioned in Mr. Polak's statement. I am also pleased to hear that after three or four months, the success of the policies will be assessed and any necessary corrections will be made and additional measures, if warranted, will be taken. It must be kept in mind, of course, that the success of the adjustment efforts of Yugoslavia rest to a certain extent on the economic growth of European countries, which have been the traditional market for Yugoslav goods. Unfortunately, for some time now, prospects have not been very bright because of the slow economic growth of the trading partners.

So far, the achievements of the external adjustment have not been without sacrifice in terms of economic growth and the standard of living; and, on occasion, these sacrifices have involved sensitive social issues. For a new Government comprised of different people, new policies may have been implemented to take into consideration policies which perhaps reflect fresh priorities. Although we may have different views and ideas, yet we also have to recognize that there is no straightforward or simple way to move through a prolonged adjustment process and that sometimes it is necessary to move in a zigzag manner or in a roundabout way. Therefore, since the overall performance of the Yugoslav economy appears to be on track, I prefer to take a more relaxed approach with respect to the secondary aspects of the economic policy of Yugoslavia.

Mr. Péterfalvy made the following statement:

I can broadly agree with the staff appraisal and I welcome Mr. Polak's statement that the new Yugoslav Government seems to have more room for maneuver to accelerate the domestic structural reform process.

We have already elaborated our view on the different aspects of the Yugoslav economic situation during the Article IV consultation discussion in March 1986. I should like to come back to one remark we made at that time, namely, that the "balance of payments adjustment has been excessive, given that structural reform was clearly insufficient." I think that the validity of our remark is being confirmed by the papers before us now.

With great regret, I see from these very informative papers that during the recent period the momentum of the economic reform has weakened and the structural rigidities are increasing again. At the same time, the ambitious external adjustment program seems to be falling behind its objectives. Some rather heretical questions may be asked. Is it not the case that the Yugoslav authorities are discouraged by the very high expectations of external adjustment to go ahead wholeheartedly with their domestic reform program? Is it not the case that, because of this, the external adjusment itself becomes endangered? If the answers are affirmative, the international banking community and the Fund must share some of the responsibilities for the apparent derailment of the Yugoslav program.

Something may have been wrong with the program's design: perhaps the existing conditions--political, social, economic, and even geographic--do not permit so soon as large an external adjustment as expected. We could perhaps have been more cautious by recognizing that the preconditions of a sustainable external adjustment are basically systemic in nature. Such preconditions are the dismantling of structural rigidities, greater reliance on market forces, closer integration of the national economy, and acceleration of the implementation of a comprehensive domestic reform program. I think that absolute priority should be given to the implementation of the reform program. This is where, as Mr. Foot put it, an attack is needed; and as far as the external adjustment expectations are concerned, they must be brought into harmony with the needed attack.

Mr. Romuáldez made the following statement:

We are grateful to the staff for having provided us with a candid and comprehensive assessment of the policies and performance of the Yugoslav economy under the authorities' Quantified Economic Program for 1986. We find ourselves very much in agreement with the staff's comments in the paper. We do so with some measure of disappointment and concern because much of what the staff has to say provides little encouragement about the immediate prospects for the Yugoslav eonomy under the authorities' existing policy stance. While the authorities' objectives with regard to growth and the reduction in inflation and the debt service burden deserve support, we are disappointed that little progress has been made in that regard over the past twelve months and that recent policy measures, rather than addressing the fundamental problems still facing the economy, could well jeopardize the gains made in recent years. In this context, we endorse the staff's comments on page 16 of the paper that some recent policy measures "are likely to exacerbate the country's economic difficulties, casting most serious doubts on the achievability of the authorities' targets."

The summing up at the conclusion of the 1985 Article IV consultation with Yugoslavia in March 1986 noted Directors' concern about "the continued high rate of inflation and the need for constancy and improved cohesiveness of financial policies." It also indicated that "there was a consensus that the authorities should use interest rate policies more actively, both as an anti-inflation tool and as a means to facilitate a more efficient allocation of resources. An active interest rate policy, together with tight credit and fiscal policies were seen to be critical for Yugoslavia."

> Against this background, we were disappointed to read in the staff's appraisal that the underlying policies adopted by the authorities are likely to increase rather than reduce inflationary pressures and that the authorities are turning back on the policy orientations adopted over the past three years, thus undermining the consistency and cohesiveness of those policies. As regards inflation, the staff notes on pages 24 and 25 of its report that "the most unfortunate measure (among those recently undertaken) is the considerable reduction in nominal interest rates...which has made most interest rates markedly more negative in real terms." We agree that "any viable anti-inflation plan must include the introduction of significant positive real interest rates." We also share the staff's concerns about the possible inflationary effects of the thrust of monetary policy and the authorities' proposals for wage moderation and price controls. These fears are highlighted by second quarter cost of living data, which show a further acceleration in prices over that forecast in the revised quantitative targets of the economic program.
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> In conclusion, the authorities have much to do, especially in regaining the economy's momentum toward adjustment. The favorable economic conditions offered by the improvement in the terms of trade provide a good opportunity to enhance their adjustment effort, and we urge the authorities to do so without further delay.

The staff representative from the European Department observed that during discussions with the staff in Belgrade, the authorities had provided all the data that the staff had requested and had even provided updated information by telex, which had allowed the staff to issue a supplementary paper; in that respect, the discussions had been positive. Of course, as Mr. Zecchini had done, one could question the usefulness of the midyear consultation, especially given the rather disappointing performance of the economy. But the Yugoslav authorities themselves had taken a positive attitude toward the consultation, expressing the hope that they could hold discussions with the staff at a time when the new measures were being formulated by the new Government. Even if as yet there was no consensus within the Government on all the measures, he remained sufficiently optimistic that continued discussion would yield positive results.

Some Directors had recalled that two tables had been presented in the Paris Club document, but that only one of those--Table 2--had been updated in the staff report, the staff representative noted. The intention had been to improve upon the presentation of data, since the two tables in the Paris Club document overlapped to a great extent, with only one or two definitional differences. In the end, the two sets of data in the tables had been combined into one.

Remarking on new economic developments and Yugoslavia's prospects for the future, the staff representative observed that at the time of the discussions with the authorities, the data for the first four months of 1986 had appeared to be reasonably consistent with the authorities' projections of a $900 million current account surplus. Of course, the official projection reflected the financing constraint to some extent, in particular, authorities' borrowing program and large repayment of debt--significantly larger in 1986 than 1985. Given the weakening of export performance, the implication was considerable import tightness. However, on the basis of more recent data, current account performance during the first six months of 1986 was considerably below expectations. Nevertheless, a current account surplus on the order of $500 million would still be achievable. As the staff saw it, the particularly unfavorable outcome in the first half of 1986 was due to a number of special factors that adversely affected the current account balance, including the bunching of interest payments, relatively high oil import payments due to still high oil prices before renegotiation of contracts as well as an increase in the volume of non-oil imports reflecting larger orders at the end of 1985 in anticipation of the introduction of the new foreign exchange system. The counterpart could be seen in the capital account, with larger short-term borrowing and errors and omissions, which the authorities attributed to the acceleration of the cashing in of export bills as a result of the new foreign exchange law. Although the staff remained uncertain about the reasons for the emergence of a large errors and omissions item, one could give some credence to the explanation of the authorities since the bulk of the errors and omissions item had emerged in the first quarter of 1986 and had not increased very rapidly since that time. However, that item would have to be watched carefully.

As noted by Mr. Templeman, a real depreciation of 5 percent in the exchange rate had occurred between April and July 1986, the staff representative remarked. However, that change was the product of an 8 percent depreciation followed by a 3 percent appreciation. It was to be hoped that the deviation was a temporary one.

In response to those who had asked how the increase in gasoline taxes would be used to subsidize exports, the staff representative observed that the increase in gasoline prices had taken place after the staff mission had left Yugoslavia, but the authorities had indicated that the receipts would be used to give larger cost term drawbacks for exports. Of course, the staff had pointed out that export subsidies were no substitute for more appropriate policies to improve competitiveness.

Enterprise losses had increased substantially in 1985, and questions had been raised about how those losses would be financed, the staff representative recalled. Nearly one third of the enterprise losses had been attributed by authorities to more realistic accounting rules. If that was true, then losses were at about the same level as in 1984 in relation to net enterprise income. Of course, the explanation provided little consolation because the losses were quite large and, as Directors had mentioned, they were being financed essentially by bank credit expansion.

On interest rates and indexation, the staff representative indicated that the preference of the staff was for a straightforward increase in nominal interest rates so as to ensure positive real rates. However, as has been seen in recent years, such an outcome was difficult to achieve. The authorities felt that by indexing the principal, they could secure political support for their approach, which they felt would be more acceptable than an outright increase in interest rates. The staff had been careful to indicate to the authorities that it would support the approach if it applied to indexation of loans and deposits and not throughout the economy. The authorities themselves were concerned about limiting the approach, and, indeed, they had avoided the use of the word "indexation," and had referred only to a "revaluation of principal" in order to avoid any inference that they were thinking of indexing other than contractual debt obligations.

In response to those who had questioned how the new tax reform would affect enterprises, the staff representative noted that, in the past, an excessively large share of the tax burden had been carried by the enterprises rather than the households. The idea of the reform was to shift the burden away from enterprises to households in order to provide greater incentives for enterprises to invest, thus improving the allocation of resources. The question had been raised whether, since revenue was being earmarked and spent, the tax reform would not lead to higher spending. As he understood it, the authorities wanted to maintain or even diminish the expenditure/GDP ratio; hence, the tax reform was intended to effect a shift in the composition of the sources of taxes rather than an increase in the tax burden on the economy as a whole.

A number of Directors had agreed with Mr. Polak that the staff had been harsh in stating that some of the measures adopted represented a clear move away from market forces, the staff representative recalled. He fully recognized that there had been a move toward reliance on market forces over the past three years and that the Government had been indicating that such reliance would increase. However, in three important areas the measures that had been adopted were a clear move away from reliance on market signals and discipline. The first was the foreign exchange and allocation system, which had increased administrative controls. While the previous system had not been ideal, there had been some market elements in it. Also, price controls had been increased, and interest rates had been reduced, moves which appeared to be away from reliance on market forces. He agreed with Mr. Zecchini that the gradual shift toward foreign currency deposits undermined the effectiveness of monetary policy and the management of the exchange rate, which was why the staff had been urging the authorities to raise interest rates on domestic deposits to arbitrage levels so that the incentives would be to hold dinar deposits rather than foreign currency deposits.

An interesting question had been raised by Mr. Péterfalvy, who had wondered whether the Fund and/or the international community had imposed an excessive burden of external adjustment on the Yugoslav economy that might have retarded desirable structural reforms, the staff representative noted. The staff supported the authorities' objective of arriving in the medium term at a situation in which they would be able to carry out a normal relationship with financial institutions. However, the pace of adjustment chosen by the authorities was their own; it had not been imposed by either the banking community or the Fund. In fact, the Fund staff was often critical of the ambitious debt reduction targets set by the authorities because the staff saw precisely the dangers to which Mr. Péterfalvy and others had referred.

When the staff mission had visited Yugoslavia, the new accounting law had not been brought to the staff's attention, and it was thus difficult to determine whether the new law would alleviate the cost burden of interest rates, the staff representative said. Prima facie, however, it seemed that the new law went in the wrong direction. During the December 1985 mission, the authorities had mentioned to the staff a number of similar schemes, which the staff had opposed and had then heard no more about. He hoped that the new law was not like those schemes, which, if implemented, would be tantamount to a reduction in interest rates. Finally, with respect to Yugoslavia's relations with the World Bank, he understood negotiations were under way, although they had been protracted because of a lack of agreement on certain important measures, particularly interest rates. The next round of discussions would probably take place in September 1986 and would focus, inter alia, on policy in the area of prices, foreign exchange allocation, and interest rates.

The staff representative from the Exchange and Trade Relations Department, recalling a question by Mr. Zecchini on the Fund's influence on the policy of the Yugoslav authorities, noted that what influence there was operated through two related channels: the intellectual persuasiveness of the Fund--exercised through staff missions or through Board discussions--and the reaction of creditors to the Fund's assessment. The first test of the Fund's influence would occur over the next few months when the authorities began to reconsider their recent policy measures. The reaction of the official creditors would no doubt be clarified once they had digested the information in the staff papers, and the potential response of the banks had been established in the provisions of the agreements between the banks and Yugoslavia, where the banks' assessment would be based in part on the Fund's assessment of the sustainability of policies.

Mr. Polak remarked that with the introduction of new accounting practices, more realistic financial positions of the enterprises had emerged. However, the complexities of the inflationary environment had entailed certain double counting in the cost positions of those enterprises; and that double counting was being offset by new measures so that the inflation-induced effects of interest and exchange rates and the evaluation of stocks were being eliminated.

On other matters, Mr. Polak noted that, from one point of view, the staff mission might have arrived too early, i.e., before the new Government had been prepared to deal with the daunting problems it had inherited. As he saw it, however, the mission had been timely, because it had enabled the staff and the Executive Board to convey their views to the new authorities at an early stage. It was clear from the staff report and the discussion that the staff had not been as persuasive as might have been desirable on some major policy questions; however, it was probably just as well that the early staff mission and discussion in the Board had taken place well before the new round of decisions on debt relief that the creditor governments would have to take in early 1987. In the circumstances, some time was available for the authorities to see how their recently adopted measures would work out and to make changes as necessary. As the staff had noted, the authorities were aware that the next few months might show the need for certain important changes; and it was clear from the Board discussion that many Directors would like to see changes, particularly with respect to interest rate policy, price controls, and the foreign exchange law. In that respect, he had found some willingness among the authorities in Belgrade to look closely at the need for change.

The staff and some Directors had questioned the willingness of the authorities to rely on market forces, Mr. Polak recalled. In the final paragraph of his opening statement, he had conveyed the authorities' reaffirmation of their commitment toward relying more on market forces; and while some might feel that the promises were easily made, he had found that the commitments extended to the highest levels. Indeed, the Prime Minister himself had indicated an interest in the stabilization plans recently applied in other countries, including Argentina, Israel, and Brazil. The Prime Minister had said that he had been following those policy changes closely to see how the experiments turned out and that he would be looking for the right time for Yugoslavia to take a similarly comprehensive approach to the problem. While remarking that such a time had not yet arrived--a view he himself supported--the Prime Minister was certain that the solution to inflation was not to be found in freezing wages and prices; indeed, his response was rather one of "animosity" toward price and wage controls. In light of the views expressed in Belgrade, his conclusion was to advise Board members and the authorities to show some patience, at least through the next consultation.

The Acting Chairman made the following summing up:

Directors noted that the midyear consultation was the first under enhanced surveillance with Yugoslavia following the completion of the stand-by arrangement in mid-May 1986. As called for under the Board's general guidelines for enhanced surveillance, the staff had reviewed recent developments and prospects in the Yugoslav economy against the authorities' quantitative targets and policy objectives. The coverage of the staff's discussions with the Yugoslav authorities had been broad based, and Directors welcomed the staff's candid assessment of the economic situation and, for the most part, they supported the staff appraisal.

Directors noted that Yugoslavia had achieved significant external adjustment over the past three years, and the authorities were commended for their recent record of foreign debt servicing. However, most Directors expressed deep concern that recent policy developments would reverse the progress made to date in improving domestic economic performance and the external financial position. A number of Directors stressed that some of the policies adopted recently with regard to interest rates, prices, and monetary expansion, together with a weakening of financial discipline, appeared to run counter to the authorities' policy thrust and objectives which had formed the basis for approval of enhanced monitoring.

Directors indicated serious concern about the continuing high rate of inflation and noted that the surge in real wages since mid-1985 had led to a sharp increase in consumer demand, weakened the competitive position, and contributed significantly to the acceleration of inflation in recent months. They welcomed the authorities' intention to bring real wage increases back in line with productivity gains but stressed that the achievement of such a goal would require a resolute strengthening of financial discipline and a credit policy that was appropriately tight so as to prevent enterprises from granting excessive wage awards.

Most Directors expressed deep regret about the large reduction in nominal interest rates effected on July 1, 1986 which had made interest rates markedly more negative in real terms. This measure was viewed as a reversal of the authorities' earlier undertaking in this respect. The sharply negative real interest rates would further encourage the misallocation of resources and would work to reinforce the flight of domestic money and the preference for real assets and foreign currency deposits. Directors strongly urged the authorities to reverse their decision; without such action, there was little hope for reducing inflationary pressures. In fact, with the sharp decline in interest rates, the authorities' monetary program appeared inconsistent with the targeted reduction in the rate of inflation. Several Directors strongly advised against the contemplated introduction of indexed monetary instruments, which in their view would tend to institutionalize inflation and hinder its reduction over time.

Directors welcomed the recent measure to restrict to commercial banks the ability to guarantee promissory notes, a restriction that it was hoped would help bring the growth of interenterprise credit under control. They noted, however, that until the implementation of positive real rates on short-term deposits of enterprises with the banking system, there would continue to be a strong incentive for disintermediation.

Directors also expressed concern about the recent price control measures, including the extension of the time period for prenotification of price increases. They recalled that in the past price controls had failed to achieve their objective in Yugoslavia. They urged the authorities to maintain the liberalization of prices achieved over the past two years and to fight inflation with appropriate interest rates, credit, and other financial and income policies.

Regarding public sector expenditures, Directors urged the authorities to monitor developments carefully so as to ensure that the objective of no increase in public expenditure in real terms would be achieved. Several Directors also emphasized the need to speed up the planned tax reform, particularly the introduction of a progressive tax on the unified income of individuals from all sources.

Directors indicated their concern with the slowing of exports in recent months and noted that if that trend continued, the authorities' targeted current account surplus could be achieved only by more intensive import restrictions, which, Directors noted, would be an undesirable path to follow. Several Directors observed that the foreign exchange law adopted at the beginning of 1986 had introduced new rigidities into the allocative system and had also led to a loss of export incentives through the elimination of the foreign exchange premia. The accelerated depreciation of the dinar in late June 1986 was therefore welcomed, and Directors emphasized that the lower level of the real exchange rate of the dinar should be safeguarded and strengthened as needed, to ensure satisfactory export growth. Directors supported the steps taken or contemplated by the authorities to promote joint ventures and the development of the small-scale economy in the private sector, as it was felt that these could make a significant contribution to the performance of the Yugoslav economy.

In sum, Directors indicated that they were disappointed in the recent course of economic policy in Yugoslavia, and expressed doubts about the plausibility of achieving the main objectives of the 1986 Quantified Economic Program. The recent measures introduced would not in their view produce a lasting improvement in growth and inflation; on the contrary, Directors were concerned that the measures would likely exacerbate the problems. They, therefore urged the authorities to reverse those measures and to take resolute action to bring the program back on track while tackling forcefully the structural weaknesses of the economy.

It is expected that the next semiannual consultation with Yugoslavia will be the regular Article IV consultation, involving staff discussions, scheduled for December 1986.

4. SIERRA LEONE - OVERDUE FINANCIAL OBLIGATIONS - PROGRESS REPORT ON ADJUSTMENT POLICIES

The Executive Directors considered a progress report on Sierra Leone's adjustment policies (EBS/86/179, 8/7/86) relating to Sierra Leone's effort to eliminate overdue financial obligations to the Fund.

Mr. Mtei made the following statement:

My Sierra Leonean authorities are grateful for the recent staff visit and, more especially, for the flexibility that the Fund has demonstrated by suspending the coming into effect of the declaration of Sierra Leone's ineligibility to use the general resources of the Fund.

Since the meeting of July 16, at which time the decision to suspend the effective date of ineligibility was taken, the Government has repaid a total of $4 million toward its arrears with the Fund from its own resources, despite continued pressure on the country's balance of payments position.

My authorities have asked me to assure the Board that they are conscious of the effort within the Fund to help Sierra Leone overcome its economic difficulties and are themselves putting into place the necessary corrective measures. To this end, they have endeavored to work toward achieving a common understanding on a set of adjustment policies with the staff mission which recently visited Freetown and are in the process of implementing a number of measures, particularly with regard to the management of the exchange rate. Also, there have been substantial increases in producer price for coffee, cocoa, palm kernel, and rice. These have been dealt with in more detail in EBS/86/179. It is hoped that the present policies of the Government will act as a basis for a stand-by arrangement with the Fund. As Directors may know, the authorities have begun to seek bridging finance to facilitate clearance of the arrears.

The one question which has not been resolved concerns the timing of price increases for petroleum products. Perhaps, I should emphasize at this juncture that the authorities do not doubt that petroleum prices must be increased to prevent the re-emergence of subsidies on petroleum products due to the further depreciation of the leone when the float became operational. Directors will recall that as recently as June 27, the Government had announced price increases averaging 126 percent for petroleum products. The authorities believe that in setting the date for the introduction of new prices on September 15, as opposed to September 5 as advised by the staff, they will be able to introduce higher prices without the adverse social consequences that could very likely follow such a move during the present serious shortage of petroleum products. I fully appreciate the point made by the staff that this measure should be taken early enough to allow time to complete negotiations for the bridge loan. However, it is significant to stress that if there are serious social consequences or unrest, even the raising of the bridge loan may be prejudiced. To overcome the shortages, the Government has begun to take urgent steps to restore supplies to normal levels. But, in their estimation, this cannot be done before the beginning of September at the earliest. The Minister of Finance, who has recently been in communication with me personally, would like to assure the Board that the Government would not have hesitated to make the price adjustment earlier if it had not been convinced that serious problems would have resulted. I ask Directors to agree that the Government deserves the benefit of the doubt on this matter of timing. And I hope that between now and September 19 the authorities will be able to raise the necessary bridge loan in spite of the fact that some of these measures may be delayed until September 15.

Mr. Foot remarked that the Executive Board had been relatively generous in its treatment of Sierra Leone in recent months, having taken note of the very real political and other problems experienced by Sierra Leone. For the future, it must be a matter for the authorities to decide how to implement the adjustment measures which they agreed were necessary. Under the circumstances, he would limit his remarks to one or two points. First, he understood that the parallel market price of petroleum was already higher than the price implied on page 4 of the staff report, which might have something to do with the fact that the official rate had been fixed with much greater reference than in the past to market forces, although at a rate that on the particular week referred to in the staff paper had produced no offers of foreign exchange. In the circumstances, the rate could not be regarded as entirely appropriate. Hence, if the currency continued to appreciate, that might carry implications for petroleum and other price adjustments. Of course, the longer the delay, the greater the fiscal burden to be carried by the rest of the budget and the more difficult it would be to make up the difference elsewhere. Finally, on a related matter, while the authorities were in the best position to judge the pace of adjustment, they must realize that any delay in generating the necessary bridging finance could make it difficult for the Board to extend its generosity any further. It was to be hoped that the authorities would resolve their problems and obtain the bridging finance well before September 19.

Ms. Lundsager recalled from the previous discussion on Sierra Leone that her chair had been interested in receiving an update on developments in Sierra Leone following the recent Fund mission. She was grateful for the summary of developments in the staff report and endorsed the remarks by Mr. Foot. The report seemed to be fairly optimistic and was properly aimed at a resolution of the problem. It was to be hoped that Sierra Leone would become current in the near future and that the Board would be able to approve a Fund program. Among the encouraging signs were the recent payments eliminating the overdue obligations in the SDR Department and the measures adopted by the authorities regarding the exchange system and the liberalization of the import licensing scheme.

On the matter of petroleum pricing, Ms. Lundsager agreed with Mr. Foot that the authorities were the best judge of when to make the adjustments, but she was concerned that too long a delay would make it difficult to complete the bridging finance package by September 19. According to Mr. Mtei, the authorities had already begun to approach the banks to ensure that matters were in hand so that the financing could be arranged quickly after the measures were adopted. However, she urged the authorities to adopt the measures earlier than September 15. Experience suggested that commercial banks were reluctant to disburse amounts in a bridging arrangement until the entire package of policies had been implemented. Even if all the measures were implemented on Monday, September 15, there would be very little time left for the arrangements to fall into place and for the arrears to be cleared by Friday, September 19.

Mr. Suraisry, welcoming the payments received from the Sierra Leonean authorities and the recent measures they had adopted, said that he expected Sierra Leone to be current with the Fund before September 19, 1986.

Mr. Salehkhou agreed with others that the Fund had been flexible in dealing with Sierra Leone, and he noted that that flexibility had paid off. The choice before the Executive Board at the present meeting was whether to be a bit more flexible--by giving the authorities the time they needed to eliminate the subsidies--or to be rigid, thus risking social unrest, which could jeopardize the bridging finance. In the circumstances, he hoped his colleagues would support Mr. Mtei's request for a further extension.

Mr. Mtei indicated that he was grateful to Directors for their remarks, and he expressed the hope that the problem would indeed be resolved by September 19.

The Executive Directors then concluded their discussion of the progress report on the implementation of adjustment policies by Sierra Leone in its effort to eliminate its overdue financial obligations to the Fund.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/86/133 (8/8/86) and EBM/86/134 (8/8/86).

5. SPAIN - ACCEPTANCE OF OBLIGATIONS OF ARTICLE VIII, SECTIONS 2, 3, AND 4

The Fund notes with satisfaction that with effect from July 15, 1986, Spain has accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Articles of Agreement. (EBD/86/212, 8/5/86).

Decision No. 8362-(86/134), adopted
August 8, 1986

APPROVED: April 28, 1987

LEO VAN HOUTVEN
Secretary