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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/65

10:00 a.m., April 29, 1985

J. de Larosière, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	J.-C. Obame, Temporary
	D. C. Templeman, Temporary
	H. G. Schneider
B. de Maulde	X. Blandin
	M. Z. M. Qureshi, Temporary
H. Fujino	M. Sugita
	B. Goos
J. E. Ismael	
R. K. Joyce	
	J. Hospedales, Temporary
	H. Fugmann
E. I. M. Mtei	
	M. A. Weitz, Temporary
	E. M. Taha, Temporary
P. Pérez	
J. J. Polak	J. de Beaufort Wijnholds
	A. V. Romuáldez
	O. Kabbaj
A. K. Sengupta	A. S. Jayawardena
N. Wicks	T. A. Clark
S. Zecchini	
Zhang Z.	Wang E.

L. Van Houtven, Secretary
R. S. Franklin, Assistant

Also Present

R. M. Fernandes, Europe, Middle East, and North African Regional Office, IBRD. Administration Department: R. Tenconi, Director; H. J. O. Struckmeyer, Deputy Director. European Department: L. A. Whittome, Counsellor and Director; P. B. de Fontenay, Deputy Director; L. Hansen, H. B. Junz, W. E. Lewis, A. López-Claros, H. O. Schmitt, G. Szapary. Exchange and Trade Relations Department: J. O. Bonvicini, J. T. Boorman. Legal Department: G. P. Nicoletopoulos, Director; W. E. Holder. Middle Eastern Department: M. Zavadjil. Treasurer's Department: W. O. Habermeier, Counsellor and Treasurer. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: G. R. Castellanos, D. Hammann, G. E. L. Nguyen, P. Péterfalvy, G. W. K. Pickering, N. Toé, A. Vasudevan. Assistants to Executive Directors: E. M. Ainley, I. Angeloni, Bo T., Chen J., J. J. Dreizzen, G. Ercel, N. Haque, G. D. Hodgson, Z. b. Ismail, J. M. Jones, A. K. Juusela, H. Kobayashi, J. Reddy, D. J. Robinson, J. E. Rodríguez, M. Sarenac, L. Tornetta.

1. OFFICE IN EUROPE

The Chairman reported that, on April 27, a bomb placed in a parked car had exploded in front of the building housing the offices of the International Monetary Fund and the World Bank in Paris. Many of the windows in that building, as well as in other buildings in the neighborhood, had been damaged. A passerby had suffered injuries and been hospitalized, although his present condition was unknown.

A terrorist group called Action Directe had claimed responsibility for the bombing, the Chairman continued. In June 1982, that group had claimed responsibility for a similar bombing at the Office in Europe, and, at the time, the Fund had strongly urged the French authorities to strengthen security by posting policemen to guard the building and by banning parking in front of the building, a procedure usually followed for embassies. Unfortunately, those requests had not been fulfilled. In his view, the inaction of the authorities in providing adequate security after the June 1982 incident might well have facilitated the most recent terrorist attack; in the circumstances, the managements of the Fund and the World Bank intended to lodge a formal complaint and file charges with the French judicial authorities. In addition, a letter would be sent to the Minister of Finance and the Minister of External Relations again requesting the implementation of procedures aimed at protecting the offices and personnel of the Fund and Bank in Paris and indicating that continued failure of the host country authorities to take appropriate action would compel the two institutions to reconsider the location of their offices in Europe.

2. YUGOSLAVIA - 1984 ARTICLE IV CONSULTATION, AND REQUESTS FOR STAND-BY ARRANGEMENT AND WAIVER OF PERFORMANCE CRITERION

The Executive Directors considered the staff report for the 1984 Article IV consultation with Yugoslavia together with a request for a one-year stand-by arrangement in an amount equivalent to SDR 300 million (EBS/85/85, 4/1/85; Cor. 1, 4/26/85; and Sup. 1, 4/26/85) and a request for a waiver of a performance criterion under the stand-by arrangement approved on April 18, 1984 (EBS/85/84, 4/1/85). They also had before them a report on recent economic developments in Yugoslavia (SM/85/108, 4/15/85; and Cor. 1, 4/26/85).

Mr. Polak made the following statement:

> The excellent staff paper quite correctly places the developments of the Yugoslav economy and the evolution of the country's policies in a medium-term perspective. The successive arrangements that Yugoslavia has had with the Fund, together with the one for 1985/86 submitted for the Board's consideration today, can also best be appraised when put in this same perspective.

Together, these arrangements stretch over a period of seven years. In May 1979, when the authorities began to perceive the unsustainable nature of the expansionist policies followed during the second half of the 1970s, they took the first steps toward a policy of adjustment under the auspices of a one-year first credit tranche stand-by arrangement, with the weak conditionality that attached to such an arrangement. Somewhat stronger adjustment measures were seen as necessary and possible in 1980, when an 18-month stand-by arrangement was agreed, to run till the end of 1981. The conduct of policy during this period was not, however, such as to permit Yugoslavia to draw the full amount under that arrangement. Clearly, a more comprehensive, multiyear approach was needed; in early 1981, the Fund granted Yugoslavia one of its rare three-year stand-by arrangements, for 400 percent of its quota at that time. It is fair to say that, during the three-year period covered by this arrangement, the perception of the need for radical adjustment deepened from year to year, and--propelled by the necessities of the situation--each annual subprogram became stricter than its predecessor. This tendency continued in the following one-year program for 60 percent of quota, which was approved about one year ago and will expire (after the short extension granted by the Board on April 5 last) on May 15. When that stand-by arrangement for 1984/85 was granted, a considerable amount of light had become visible at the end of the tunnel. The year 1983 had shown a (small) current account surplus with the convertible-currency area, after years of very large current account deficits with that area. During 1983, the real effective exchange rate had also, month by month, been quite substantially devalued, so as to provide a market underpinning for an improved trade performance, which could be expected to improve further in 1984. The program for 1984/85 could further rely on the changes in domestic economic management that formed part of the long-term economic stabilization program adopted in 1983, including a series of measures to improve "financial discipline" in socialized enterprises.

The one-year arrangement with the Fund that the Board is being asked to approve for 1985/86 is intended to put the remaining task of adjustment on a solid footing and to conclude, in this way, the long financial association between Yugoslavia and the Fund. The amount of the requested arrangement, SDR 300 million, is just below 49 percent of Yugoslavia's quota. Repurchases during 1985/86 will be SDR 347 million, so that a beginning will be made in reducing Yugoslavia's debt to the Fund, which will amount to about SDR 2 billion after the last drawing under the current stand-by arrangement.

Toward the end of the 1970s and in the early 1980s, Yugoslavia was confronted with a major task of adjustment, which originated in part in domestic causes (such as an uncontrolled investment boom), and in part in causes of foreign origin, such as the worldwide debt crisis. Unfortunately, the country's social, legal, and political structure does not facilitate quick adjustments of a fundamental nature. As a consequence, adjustment has been stretched out over many years; it has also been conducted during much of that period in a less than optimal manner. Sharp slashes in investment expenditure--a major component of the early adjustment effort--were quite justified, given the extremely high ratio of investment to GNP and the low productivity of many investment activities, but, by themselves, did not suffice to turn the current account around. In the early years, real exchange rate adjustment and the attainment of positive real interest rates were consistently frustrated by higher rates of inflation than the authorities had projected. As a result, an excessive part of the adjustment in those years fell on the compression of demand, on the reduction of real wages in the socialized sector, and on import restrictions. While these measures helped to correct the current account deficit, they made adjustment harsher than would otherwise have been necessary and introduced or aggravated distortions in the economy.

In respect of these as well as other matters, the year 1984 marked--as the staff correctly observes in its perceptive report--a watershed. Much more emphasis was put on economic pricing throughout the economy, and interest rates were set on a path that would make them positive in real terms in early 1983. These measures led to a rise in imports in 1984 after years of decline and set the stage for the first year-to-year increase in final domestic demand and its components (consumption as well as investment), which both the authorities and the staff expect to take place in 1985. Finally, the new policies provided the basis for a sustained strong export performance and the end to leakages on the capital account of the balance of payments.

In spite of these achievements, it would be premature to declare that the adjustment process in Yugoslavia is completed; indeed, the continuing task of adjustment constitutes a solid reason for the arrangement with the Fund that is for the Board's consideration. Inflation is still very high at over 50 percent per annum, reflecting in part barriers that continue to exist to the allocation of real and financial resources (including foreign exchange) within the country. Further rationalization of the foreign exchange allocation system is a major task that still needs to be completed.

Further progress on these and other policy areas will stand to benefit from this further and--it is to be hoped--last program with the Fund for a long time. I strongly recommend its approval by Directors.

The Yugoslav authorities have also requested the Board to grant a waiver from the performance criterion for interest rates as it applied in the month of April. Under the current stand-by arrangement, interest rates on three-month time deposits are set quarterly, on the basis of the movement of the producer price index over the latest twelve-month period. Specifically, with an increase in the index from February 1984 to February 1985 of 68 percent, this criterion would have required the authorities to set at 69 percent the interest rate specified above on April 1, 1985, to create a real positive interest rate of 1 percent.

The sharp rise from the 54 percent set three months earlier would have had a seriously disturbing effect, for which the economic case was not obvious. Indeed, there was considerable evidence that the increase in prices in January of over 10 percent and to some extent also the increases in February and March, were affected by the price decontrol measures taken at the beginning of the year. Not only did decontrol produce a rash of price increases designed to catch up with cost increases that had built up during previous months; it apparently also induced firms to register additional price increases in order to protect themselves against future inflation as well as the risk that the authorities might reintroduce price controls, as they had done on a number of previous occasions. Thus, in some instances, prices were raised well beyond the level at which firms were in fact prepared to sell.

Since the specific formula contained in the current arrangement for the purpose of bringing about positive real interest rates would have produced a rather undesired effect, a different formula was developed for the 1985/86 arrangement, which attempts to get closer to the underlying rate of inflation at the time that the interest rate is set. This is done by a formula (somewhat reminiscent of that used to calculate the trend of exports under the compensatory financing facility) that is based on some observations of inflation rates during the past three months and a forecast of expected inflation rates for two future months. The Yugoslav authorities' proposal in their request for a waiver is that, since this new formula will be applied starting in May, and may then well produce a lower interest rate than the 69 percent yielded by the old formula, it would be advisable not to make the full adjustment in April. Instead, they have raised the April interest rate from 54 percent to 58 percent and are awaiting the approval of the new arrangement and the publication in early May of the April price index in order to set the new rate in May, based on the average rate of inflation from February to April, in conjunction with the estimated underlying inflation rate for May and June; the estimate agreed with the staff for these two months is 3.5 percent per month. As the staff notes in EBS/85/84, the holding action in April and the transition to

> the new formula in May will, at worst, have the effect of delaying by a little over one month the attainment of a positive real interest rate for three-month deposits.

Extending his remarks, Mr. Polak said that the Yugoslav authorities wished to make it clear that no subsequent Fund-supported program was contemplated, but they hoped that arrangements could be made with the Fund for enhanced surveillance. On another matter, the authorities considered the new paragraph 4e--recommended by the staff for insertion in the stand-by arrangement attached to EBS/85/85 (4/1/85)--to be unnecessary and inappropriate. They intended to make every effort to complete the negotiations with the banks as soon as possible, and they believed that it was inappropriate for the Fund, through the insertion in the stand-by arrangement of a new performance criterion, to place additional pressure on them to conclude the negotiations. Perhaps even more disconcerting than the text of paragraph 4e was the language of paragraph 6 on page 3 of EBS/85/85, Supplement 1 (4/26/85) in which the staff seemed to have set out even more rigid conditions than those contained in the paragraph proposed for insertion in the stand-by arrangement. Paragraph 4e required that

> ...the Fund finds that satisfactory arrangements have been made... for the refinancing of maturities falling due during the period from January 1, 1985 until the expiration of the stand-by arrangement.

The staff's explanation of that paragraph, on the other hand, required that

> ...a satisfactory arrangement has been concluded between Yugoslavia and the commercial banks on the refinancing of maturities falling due to commercial banks during the period from January 1, 1985 until the expiration of the stand-by arrangement.

It should be understood that it was ultimately the text of the stand-by arrangement that spelled out the relations between the Fund and a member; any more stringent conditions, whether real or apparent, in a paraphrase of the arrangement had no legal status.

Mr. Pérez observed that Yugoslavia's current problems were clearly related to the structural characteristics of the economy. The stabilization effort of 1981-82, based largely on demand management policies and import compression, had arrested a deteriorating external position and had significantly contributed to a lowering of the inflation rate to 30 percent in 1982, but it had failed to address some of the basic questions of industrial organization, price flexibility, and financial sector arrangements that must be dealt with if Yugoslavia were to resume a path of sustained economic growth.

The economy's structural difficulties were clearly reflected in the behavior of the inflation rate, Mr. Pérez continued. During the second phase of the adjustment program undertaken by Yugoslavia in 1983-84, the authorities had adopted policies aimed at correcting a number of fundamental problems, particularly those related to pricing and the exchange rate. However, the measures had in fact resulted in a sharp acceleration of the inflation rate during 1984 and early 1985. Undoubtedly, a realistic pricing policy directed toward reducing distortions of key administered prices was essential to induce a reallocation of resources into the tradable goods sector and to improve overall economic efficiency. Unfortunately, the previous long period of depressed prices and the inflationary expectations of agents in the economy had fueled inflationary pressures.

The staff felt that the underlying true rate of inflation could be significantly lower than that experienced during recent months because of the relatively restrictive monetary and credit policies followed in 1984 and those envisaged for the remainder of 1985, Mr. Pérez noted. The staff had also highlighted the difficulties encountered in estimating money demand functions, which turned out to be highly unstable because of changes in velocity provoked by ad hoc payment arrangements within the economy. In that respect, there appeared to be a conflict between the interpretation of recent inflationary trends and their relationship to money and credit performance criteria implied in the program for 1985.

The authorities had set a target for the inflation rate of 50 percent for 1985, although they had implicitly acknowledged that the target might be too ambitious, given the 11 percent inflation rate experienced in January and the flexible price policies to be implemented during the rest of the year, Mr. Pérez remarked. In the circumstances, and given the substantial real depreciation of the exchange rate observed in 1983-84, he wondered whether the policy aimed at maintaining the real exchange rate at its current level was fueling both inflationary pressures and expectations of additional price increases. That was not to say that the policy might not be needed for balance of payments reasons, but it certainly highlighted the potential policy conflicts that the authorities could encounter when seeking a permanent modification of the real exchange rate in the midst of efforts to eliminate structural rigidities. The chart on page 16a of EBS/85/85 showed that the real exchange rate for the dinar had been at a historically low point during 1984, which implied a depreciation of more than one third from the level of 1979. He wondered whether the staff considered that the 1984 level of the real exchange rate was sustainable in the medium term and whether it was consistent with an eventual lowering of the inflation rate. It might have been interesting in that regard if the staff had used a somewhat longer period to evaluate the historical level of the real exchange rate.

Although a substantial surplus in the current balance of convertible currencies had been attained in 1984, a marked deterioration had been observed in the current account balance with the nonconvertible-currency area, Mr. Pérez continued. On the other hand, export increases to convertible-currency countries achieved in 1983 and 1984 had been largely offset by reductions to countries in the nonconvertible area, while at least part of the import reduction from the first group of countries had been offset by purchases from the second group. The staff's contention was that there had been a marked reallocation of resources toward export activities; while that argument needed some qualification, it should be recognized that the overall balance of payments had registered a definite improvement.

He agreed with the staff that greater discipline in the payment arrangements of enterprises would be necessary if monetary and credit policies were to be effective in reducing inflationary pressures, Mr. Pérez said. Also crucial was the removal of impediments to the integration of domestic markets and the free flow of financial resources across the economy. The method of directly allocating investment resources and foreign exchange had serious shortcomings that had become all too evident in the past; increased reliance on market mechanisms and on the financial intermediation function of the banking system would, thus, seem to constitute necessary conditions for an improved allocation of resources. Unfortunately, the structural rigidities afflicting the economy demanded a coordinated and simultaneous attack rather than a piecemeal approach. In that regard, the effectiveness of pricing and exchange rate flexibility would be severely limited if restrictions and rigidities in the allocation of foreign exchange were maintained.

On the relationship between interest rate policy and the pattern of savings observed in the Yugoslav banking system, Mr. Pérez remarked that, while interest rates on deposits denominated in domestic currency had increased sharply, the tendency toward "dollarization"--or the holding of deposits in foreign currency--continued. According to Table 35 of SM/35/108, approximately 65 percent of deposits held by households in Yugoslavia were denominated in foreign currency. That proportion was particularly worrisome, since it was apparently the monetary authorities that absorbed the foreign exchange risk. Given the relative importance of household savings deposits, the loss that might be incurred by the monetary authorities in the event of further currency depreciation seemed sizable and constituted an important element of credit expansion. He would welcome further elaboration by the staff on that matter. In conclusion, he could support both proposed decisions, with the amendments suggested by the Yugoslav authorities.

Mr. Ismael observed that, while performance in Yugoslavia had improved in a number of respects, the economy remained fundamentally fragile. Following a decline in 1983, economic growth had resumed in 1984, the fiscal position had improved, and the share of government expenditure in gross social product (GSP) had been reduced below 30 percent. Moreover, gross fixed investment had moved to a more sustainable level, and significant improvements had been registered in the external position, particularly with respect to the convertible account.

Under the most recent stand-by arrangement, Mr. Ismael recalled, the authorities had made significant progress toward achieving the major objectives of the program, particularly in the external sector. With one exception, all performance criteria for the fourth purchase had been met. Unfortunately, price performance had been somewhat disappointing, an outcome attributed by the staff mainly to structural problems and to the price liberalization measures adopted by the authorities. In his view, price reform measures had not been accompanied by sufficiently tight monetary policy, an argument that was reinforced by the fact that, at end-1984, net domestic assets of the banking system had been increasing at an annual rate of more than 55 percent. In the circumstances, monetary policies pursued in Yugoslavia could best be described as accommodating and not geared to bringing about a reduction in the rate of inflation.

Also of concern was the high debt service ratio, equivalent to 42 percent of exports of goods and services, which left little room for either increases in imports or slippages in export performance, Mr. Ismael remarked. In the circumstances, the need for multiyear debt rescheduling for Yugoslavia was obvious, and he hoped that the creditors could agree to provide the necessary debt relief.

On the proposed stand-by arrangement, Mr. Ismael endorsed the structural reforms envisaged under the program, which aimed at the adoption of more realistic pricing policies and at allowing price signals to operate in the economy. Maintenance of an appropriate exchange rate and a positive real rate of interest were also key elements in the program, which, while it did not introduce any major new policies, should nonetheless ensure consolidation of the achievements of the previous program. On related points, he had detected a significant difference between the proposed program and other Fund programs. Usually, when a country was facing internal and external imbalances, Fund programs provided for tighter monetary and fiscal policies. In the case of Yugoslavia, however, the staff had called in the program for the maintenance of public sector expenditures in real terms at the 1984 level. In order to reduce the high rate of inflation prevailing in Yugoslavia and to support further shifts of resources to the tradable goods sector, he would have expected the program to provide for a further reduction in public sector expenditures. As that had not been done, he would not be surprised if the program fell short of meeting some of its price objectives.

With regard to performance in the external sector, Mr. Ismael took note of the indication by the staff that the positive impact of exchange rate changes on the external sector was limited by structural problems. In the circumstances, urgent implementation of structural reform measures was called for, and he endorsed the staff's emphasis on the importance of a market-oriented distribution mechanism for allocating foreign exchange.

Noting that the 1984 program had incorporated a somewhat unusual performance criterion that had placed a limit on the growth of total public sector revenue, Mr. Ismael wondered why a similar provision had not been incorporated in the 1985 program. He also questioned why the staff had felt it necessary to establish as a performance criterion a floor for the net asset position of the public sector with the banking system. Moreover, observing that, in the past, "approval in principle" had been granted to a number of countries that had not made satisfactory arrangements for financing the balance of payments gap, he wondered why the staff was recommending that the first purchase under the arrangement for Yugoslavia was to be allowed even though satisfactory arrangements had not yet been made for financing the projected balance of payments gap in 1985. Finally, since both the World Bank's structural adjustment loan and the program for which Fund support was being requested placed emphasis on the adequacy of interest rates, it would be crucial for Yugoslavia to abide by the new interest rate formula that was expected to go into effect in mid-May. In conclusion, he could support the various proposed decisions.

Mr. Goos welcomed the fact that all performance criteria under the 1984 stand-by arrangement had been met, with the exception of that concerning interest rates. That commendable result had been achieved in a difficult environment of rapidly accelerating inflation accompanied by, inter alia, a continuing erosion of income from employment and a further decline in the public sector's share in GSP and thus testified to the impressive degree of commitment to adjustment by the Yugoslav authorities, particulary bearing in mind the political and constitutional setting in which the adjustment had to take place. He had been encouraged by the rapid progress made during 1984 toward resolving the most pressing problems in the external sector. The current account surplus in convertible currencies had nearly tripled since 1983, and foreign indebtedness had declined for the first time in many years. Even more encouraging was the fact that the efforts of the authorities had increasingly focused on structural weaknesses and had culminated in the new price law and the concomitant decontrol of most industrial prices.

Given the emphasis on structural adjustment under the current stand-by program, Mr. Goos agreed with the staff and Mr. Polak that 1984 had marked a promising turnaround in economic policy, which appeared to have already led to some improvement in the underlying strength of the Yugoslav economy. Nonetheless, there remained two worrying features in the economy at present. First, progress achieved had, to a considerable extent, been due to a shift in income distribution that was probably not sustainable. Second, the economy continued to be hampered by deep-seated structural weaknesses including a continued lack of domestic competition, no integrated market, insufficient division of labor, and, hence, low economies of scale. Such factors, together with the fragmentation of markets for capital and foreign exchange, went a long way toward explaining the inefficiencies in the Yugoslav economy and the resulting high production costs and strong inflationary pressures.

It was particularly disquieting to note that inflation was on a rapidly accelerating trend, with current inflation nearly 40-50 percentage points above the inflation rate of the previous year, Mr. Goos remarked. Inflation rates of that magnitude posed a serious threat to the necessary reforms of the economic and financial system, a threat which should perhaps have been given more emphasis in the staff's analysis. According to the staff, the recent upsurge in inflation had been due to a great extent to pent-up inflationary pressures and precautionary price movements. However, it had to be remembered that the inflation was taking place in a general climate of moderate domestic demand, which, together with the high social costs associated with the recent external adjustment, clearly reflected the seriousness of widespread structural distortions and suggested that Yugoslavia still had a long way to go to reach economic viability. From that perspective, he noted with disappointment that continued Fund-supported adjustment programs since 1979 had led to very few tangible signs of structural adjustment. According to the authorities' letter of intent, "the process of structural adjustment has just begun." Following so many years of Fund involvement in Yugoslavia, that confession was certainly a sobering one, although the realistic assessment underlying it at least gave him some optimism about the future.

The new program in support of which the authorities were requesting another stand-by arrangement seemed to go in the right direction, although he would have preferred a stronger and more comprehensive program with more explicit and binding understandings on structural adjustment, Mr. Goos commented. A number of the persistent weaknesses in the economy would be addressed insufficiently under the new stand-by arrangement. In particular, he failed to see how the fragmentation of the economic and financial system would be tackled; indeed, there were even indications that the existing structural rigidities in the financial system might be compounded by the new draft banking law. The prospects of such shortcomings were clearly worrying, particularly given that the need for a fundamental reform of the economic and financial system was widely recognized within Yugoslavia, as reflected in the concrete measures toward reform that had been proposed in a 1983 internal study of the economy.

While widespread measures were often unpopular and met with political resistance, the opposition to them had to be weighed against the risk that the willingness of creditors to provide the necessary resources might be adversely affected if measures deemed appropriate and necessary by the Yugoslav authorities themselves were unduly delayed, Mr. Goos continued. Similarly, Yugoslavia's adjustment record might have an important bearing on the Fund's willingness to engage in the enhanced surveillance that was being requested following the expiration of the proposed stand-by arrangement. In that context, he welcomed the agreement expressed in the letter of intent that the Managing Director would review the stand-by arrangement with the authorities toward the end of 1985, a step that would be in conformity with the outcome of the recent Board discussion on means of strengthening Fund surveillance. In the forthcoming review, it might be appropriate to indicate to the authorities that continued Fund support--even in nonfinancial form--was predicated on a sufficient level of adjustment.

He had some difficulty with the revised provision in the stand-by arrangement relating to the financing procedures with the commercial banks, Mr. Goos observed. Apparently, negotiations between Yugoslavia and the banks were not proceeding as smoothly as had been hoped; for the time being, there seemed to be no reasonable assurance that the balance of payments gap over the period of the proposed stand-by arrangement would be filled. Consistent with established Fund policy, the appropriate response would have been to postpone Board consideration of the request for a stand-by arrangement request or to have put forward the recommendation for approval only in principle, on the expectation that such an approach would help the negotiating parties to reach early agreement. The revised provision was certainly an improvement over the original proposal for outright approval of the stand-by arrangement; nevertheless, he felt that it continued to represent a deviation from established Fund policies and entailed the risk that the Fund might extend its resources to Yugoslavia without being assured that the commercial banks would follow suit. However, the risk would apparently be limited to a rather small amount of money. Furthermore, with the agreed "standstill" on outstanding maturities in place, Directors could perhaps take the view that there would be no balance of payments gap, at least for the time being. On the understanding that the proposed procedure was being regarded as exceptional, he could reluctantly go along with it.

Remarking on some of the specific elements of the proposed stand-by arrangement, Mr. Goos hoped that the authorities, in forthcoming reviews, would put forward concrete proposals on how to tackle structural problems such as the foreign exchange allocation system. The serious deficiencies of that system seemed to be interrelated with the presumably sizable border trading arrangements, which by themselves tended to impair the efficiency of resource allocation. He would appreciate information from the staff or Mr. Polak on how the treatment of those arrangements affected the allocation of foreign exchange.

The efforts aimed at strengthening the financial discipline of enterprises and correcting the unevenly spread adjustment burden through changes in taxation were welcome, as was the authorities' continued commitment to securing realistic interest rates to improve resource allocation, Mr. Goos went on. It was clear that that allocation would continue to be hampered so long as real interest rates on certain forms of credit remained negative. In that context, he was concerned about the authorities' stated intention to lower the premiums on longer-term deposit rates, an action that would tend to slow the effort to attain positive real lending rates. Nonetheless, he appreciated the difficulty in setting appropriate rates in an environment of rapidly accelerating inflation, particularly when the underlying rate was being exaggerated by short-term fluctuations. The interest rate formula under the proposed stand-by arrangement appeared to be an improvement, as it tended to neutralize such short-term fluctuations. As such, he supported the requested waiver for the breach of the interest rate performance criteria under the existing arrangement, the arguments in favor of which seemed quite reasonable. Generally speaking, the monetary and fiscal policy stance envisaged in Yugoslavia seemed an appropriate way to meet the need for containing inflationary pressures while supporting a moderate expansion of economic activity. However, he strongly endorsed the staff's recommendation that any conflict between those goals that might emerge in the course of the program should be resolved through a monetary policy erring on the side of somewhat greater restraint.

On the fiscal side, Mr. Goos said that he had been impressed by the successful adjustment effort in recent years in public sector expenditure. The adjustment had been particularly commendable because the coordination of fiscal policy involved several thousand public sector entities. He would be grateful for information on how the task of coordination had been handled so successfully. Finally, on the external side, he noted that the balance on Yugoslavia's current account in convertible currencies had deteriorated during the first three months of 1985 from a surplus of $42 million in the previous year to a deficit of $222 million at present. He wondered in the circumstances whether the current account target of a surplus of $880 million could still be considered realistic.

Mr. Schneider stated that he could support the request for a waiver of performance criteria under the existing stand-by arrangement as well as the proposed new stand-by arrangement for 1985-86. He understood that further Fund support was needed to maintain the momentum of adjustment recently begun and to give the authorities breathing space to adopt the systemic changes required to facilitate the adjustment process. As he was in broad agreement with the staff appraisal, he would focus on two aspects of the staff approach that were "new" and therefore deserving of attention. The staff had made it clear that additional sets of demand management measures might not necessarily produce the expected results without systemic changes in the economy. One such change was related to proper management of the exchange rate of the dinar, which, in 1983 and 1984, had depreciated to programmed levels. Yugoslav imports from the convertible-currency area had been increasing in 1984, while the dinar rate for imports had been falling. The increase in imports had taken place in circumstances under which, according to the staff, "the available exchange needed is not necessarily channeled to those enterprises that would use it most efficiently." Furthermore, in spite of the program changes, "the Yugoslav foreign exchange market is characterized by an overall excess demand for foreign exchange." At the same time, the staff had noted that, because of the lack of availability of foreign exchange, credit was estimated to have risen dramatically since 1982. What the staff seemed to be suggesting was that the otherwise desired exchange rate developments had been more or less counterbalanced by systemic rigidities, while the effect on the trade balance was small or nonexistent. A similar phenomenon could be observed in some other Yugoslav programs; indeed, it seemed that much of the positive economic performance in Yugoslavia could be attributed to administrative measures that the authorities had been able to implement over the period.

Another noteworthy aspect of the staff's approach was the recognition of the importance of financial discipline for enterprises in economies like that of Yugoslavia, Mr. Schneider remarked. In economics textbooks dealing with problems of socialist economic management, the lack of financial discipline was described as a "soft-budget" situation, a problem at the root of underperformance in socialized or nationalized sectors of many countries. Economists had for some time been looking for promising solutions to the problem, and any contribution that the Fund staff might make to that effort would be greatly appreciated. In general, it was to be hoped that the staff approach followed in the Yugoslav case would lead to a new type of Fund program and stand-by arrangement for countries with problems similar to those experienced by Yugoslavia. New program designs could include long-overdue systemic changes into which demand management changes could be fitted. In conclusion, reiterating his support for the proposed decisions, he agreed with Mr. Polak that the language in paragraph 6 of EBS/85/85, Supplement 1 represented an inappropriate paraphrasing of the proposed new paragraph 4e of the stand-by arrangement.

Mr. Templeman observed that, with minor exceptions, Yugoslavia had successfully complied with performance criteria under the existing stand-by arrangement. More fundamentally, there had been a further strengthening of the balance of payments in the context of a modest resumption of real growth in 1984. However, as his chair had noted at the previous review in October 1984, success in reducing inflation had been elusive, and there was only limited evidence of the more basic structural adjustment necessary to return the economy to an adequate growth path and achieve external balance over the medium term. The staff had correctly identified the two basic remaining tasks: to continue with realistic pricing of goods and services, money, and foreign exchange; and to implement the structural measures necessary to allow those price signals to be transmitted more efficiently throughout the economy.

Despite a drop in real gross fixed investment in each of the past five years, Yugoslavia had achieved at least modest positive real economic growth in 1983, and an acceleration of growth was expected in the current year, Mr. Templeman continued. However, the steady decline in the ratio of fixed investment to GSP undoubtedly reflected some elimination of inefficient investment, and the current ratio of more than 23 percent still seemed adequate to assure long-term growth, provided that investment was sufficiently employed. The staff had noted that there remained a need to modernize the capital stock and shift to more effective production patterns, and actions to facilitate the mobility of labor and capital could play a crucial role in achieving those objectives. In fact, more rational investment decisions had been facilitated, inter alia, through the setting of depreciation allowances and inventory valuation on a replacement basis, limitations on income payments to workers in loss-making or illiquid enterprises, curtailment of subsidies to enterprises out of the joint reserve funds and their eventual phasing out by 1987, the possibility of reducing disintermediation in the form of intercompany credits, and the immediate write-off by the commercial banks of foreign exchange losses. The latter two actions would be the subject of assessment at the time of the midterm review.

The move toward more realistic interest rates had begun in 1984 to strengthen the balance of payments, as the net outflow of short-term capital in convertible currency--including errors and omissions--had declined from nearly $1 billion in 1983 to less than $250 million in 1984, Mr. Templeman noted. The increase in the current account surplus in convertible currency to nearly $900 million had also been encouraging, especially since import volume had risen for the first time in the past four years, and double-digit growth in export volume had been achieved for the second successive year. Moreover, the welcome reduction of export subsidies, the tightening of regulations regarding countertrade in 1985, and the new more liberal joint-venture law for foreign investment were all positive factors working toward the achievement of a sustainable external position.

Still, he shared the staff's concern about continued inadequacies in the exchange market system, Mr. Templeman said. It was not sufficient that a more realistic exchange rate had been attained if potential participants in the market did not have access to foreign exchange. Such a lack of access constituted a grave impediment to exploitation of export expansion and import substitution opportunities. During the previous review, his chair had supported the staff assessment that, if a true market for foreign exchange did not clearly emerge in 1985, a fundamental re-evaluation of the system would be necessary. The existing law needed to be changed in any event because parts of the law had recently been declared unconstitutional. In the circumstances, the time had come for a fundamental re-examination of the system and, in that regard, he welcomed the intention of the Yugoslav authorities to take into account the staff's assessment of possible changes in the system at the time of the midterm review.

Performance on the inflation front had been disappointing, with actual or expected inflation in the 50-60 percent range over the three-year period 1983-85, Mr. Templeman commented. While past exchange rate depreciation, price deregulation, and upward interest rate adjustments had been necessary and had clearly contributed to high rates of inflation, he had the uneasy feeling that a cost/price cycle might be at work, that inflationary expectations had not been lowered, and that the expansion of monetary aggregates might be too easily accommodating underlying price pressures. The staff had indicated in its report that the authorities' main objectives were the alignment of domestic prices with world market prices and a greater reliance on market forces in domestic price formation. Yet it was also clear that fragmentation of markets and oligopolistic tendencies in public enterprises, together with the on-off resort to price freezes, continued to constitute serious obstacles to the achievement of a lower rate of inflation. Specifically, he supported the staff's cautionary note about the damage that could be done to the adjustment effort if the authorities' credibility were to be undermined by their return to measures designed to repress inflationary symptoms rather than cure their causes. Unless inflationary expectations could be reversed and the markets for domestic savings and for foreign exchange made to function more efficiently, the underlying rate of inflation was likely to remain unacceptably high.

On monetary policy in Yugoslavia, Mr. Templeman said that he could support the proposed waiver of April 1, 1985 interest rate targets, which would henceforth be set by employing a five-month moving average rather than a 12-month rate. However, he was not certain why the staff wished to use two months of forecast data, and he would appreciate hearing staff comment on the effects of any overestimate or underestimate that might occur. If domestic savings were to be mobilized in support of efficient investment uses, deposit rates must be attractive to savers, savings must flow freely through the financial system, and the cost of capital to investors must be realistic. Problems in any one of those areas could thwart the process. He took note of the staff's conclusion that adequate progress had been made in moving deposit interest rates toward positive real levels but that lending rates continued to lag behind inflation for the bulk of new credits. It was disappointing to read in the report that structural changes such as the draft banking law--aimed at liberalizing the flow of domestic savings and at helping to keep such savings at home--would apparently fall far short of developing a full-fledged inter-bank market. The implication was that direct government intervention and subsidies would continue.

Although new rescheduling with official creditors had been agreed, subject to Board approval of the proposed stand-by arrangement, agreement on multiyear rescheduling with commercial banks had not yet been reached, and it was questionable in the circumstances whether the Executive Board should approve the stand-by arrangement at the present meeting, Mr. Templeman remarked. On balance, he was willing to go forward along the lines recommended by the staff, since the lack of agreement with the banks seemed related only to rescheduling terms and not to the amount or the certainty of adequate relief. However, he urged the authorities to conclude an agreement with the banks to complete the financing package, and he supported the performance criterion that would prohibit release of the second drawing under the stand-by arrangement in the absence of an agreement with the banks by August 29, 1985. He would appreciate an explanation of the relationship between Board approval of the payments arrears restrictions through December 31, 1985 and the new August 29, 1985 date.

Finally, with respect to the role of the Fund in Yugoslavia's adjustment effort, Mr. Templeman noted that Yugoslavia was a prolonged user of Fund resources. Indeed, if it was agreed, the proposed program would be the sixth approved by the Board for Yugoslavia since 1974; and, while there would be some small reduction in outstanding drawings as a percentage of quota, those drawings would still amount to 318 percent of quota at the end of the new stand-by arrangement. While taking note of Mr. Polak's indication that Yugoslavia's request was meant to be the final request for a stand-by arrangement in the current adjustment effort, he also noted that the authorities were seeking to refinance their foreign debt maturities falling due in 1985 and for some years beyond and that they would be seeking assistance from the Fund in monitoring economic performance and prospects in the framework of their future relations with creditors. In his view, it would be premature to comment on the form that cooperation with the Fund might take at the end of the stand-by arrangement. Despite good progress in some areas, there continued to be fundamental weaknesses in the Yugoslav economy that would need to be forcefully addressed.

Mr. Wicks noted with concern that the Fund had expended nearly SDR 2 billion in Yugoslavia over the past several years for what could be regarded, at least until the current year, as only modest progress toward adjustment, especially on the structural side. It was clear from Mr. Polak's opening statement that, within Yugoslavia itself, the perception of the need for radical adjustment had deepened from year to year, with each annual subprogram stricter than its predecessor, but the staff had noted that the thrust of policies in the earlier period had not been adequate to the task. Certainly the staff had been arguing for a more rapid and rigorous adjustment over the years; the failure to implement the required economic policy adjustments had apparently been due to the authorities' rather diffident attitude. Still, success under the existing stand-by arrangement gave him some hope that the time of diffidence was ended. Under the 1984 stand-by arrangement, macroeconomic policies had remained tight, short-term outflows had been reduced, and the current account surplus had turned out considerably higher than projected. Those developments owed much to an active exchange rate policy and structural improvements to tighten financial discipline and liberalize prices. Against that background, it was perhaps disappointing that the current stand-by arrangement was ending with yet another request for a waiver.

The task for 1985 was, first, to consolidate the progress already achieved through consistent policies implemented in a way that would retain the confidence of creditors, Mr. Wicks continued. Second, and equally important, further progress must be made on the structural side. In that regard, he would be interested in hearing about World Bank activity in Yugoslavia and whether the approach taken to reduce inflation and achieve sustainable growth would successfully address the sensitive social and political issues that were hampering the adjustment effort. The fragmentation of domestic money markets and the market for foreign exchange were among the major causes of inefficiency in the economy; and stop-go pricing policies in the past had led to a persistence of inflation. It would of course take time to convince enterprises that a new approach in policies would be permanent; he agreed with the staff that it would be tragic if the authorities once again were to resort to price controls.

The measures described in the 1985 policy memorandum were welcome, although his authorities shared the concern of the staff with respect to the potential effects of the draft banking law, Mr. Wicks commented. They also attached considerable importance to improving the foreign exchange allocation system, which was highly inefficient and artificially increased the demand for foreign exchange. Like others, he felt that the Fund was being generous in financing the 1985 program. There were no assurances that financial arrangements would be in place to underpin the program; in the circumstances, the Board discussion should perhaps have been postponed until agreement between the banks and the authorities had been reached. Alternatively, the "agreement in principal" approach should have been used. Agreement on a firm program in the way suggested by the staff gave the authorities further latitude with respect to their arrangements with the banks as well as the benefit of the first drawing under the stand-by arrangement. To argue that approval in principle placed pressure on the member to reach agreement misstated the position; the pressure was also on the bankers, who would not want to put themselves into a position in which they could be accused of bringing down a Fund program. On a related matter, it seemed odd to be asked to approve the restrictions arising from the arrears of the commercial banks until December 31 when the Fund was insisting that the debt negotiations themselves should be concluded by August 29. He would also appreciate clarification from the staff on what precise circumstances would be required for the Fund to find that "satisfactory arrangements" had been reached between the commercial bankers and the Yugoslav authorities.

On specific aspects of the proposed program, Mr. Wicks considered, the authorities should be commended for their success in reducing the ratio of public expenditure to GSP since 1980. He looked forward to the reform of the tax system, although it would be important to consider carefully the effects of taxation of interest earnings on the incentives for private savings.

It was clear from the staff papers that the conduct of monetary policy in Yugoslavia was made more difficult than otherwise by the fact that foreign deposits accounted for 40 percent of broad money, Mr. Wicks continued. Given the properly active exchange rate policy, the implication was that a good part of the money stock was price indexed; hence, it was important for the authorities to take measures to encourage people to hold assets denominated in domestic currency. On a related matter, it was regrettable that the authorities had not increased interest rates by the full amount indicated by the agreed formula. However, he recognized that recent inflation figures, particularly those for January, could significantly overestimate the underlying rate of inflation; for that reason, he was prepared to agree to the proposed waiver. The new formula for interest rate adjustment, which incorporated projections for inflation two months in advance, in many ways appeared to be more soundly based in economic theory. However, inflation had been running at approximately 4-5 percent in both February and March, and the agreed price projections for May-June could prove to be low. If so, it might become necessary to look again at the formula during the midterm review. Moreover, it was to be hoped that lending interest rates could be increased in line with market realities as a step toward the more efficient allocation of credit in the economy.

Economic performance in 1984, particularly with respect to exports to the convertible area, had been encouraging, although the positive developments had in part reflected the delay in imports into 1985, Mr. Wicks commented. Unfortunately, the 1984 export performance had not been matched in the current year: convertible-currency exports were down by 10 percent, with exports to the developing countries having fallen particularly sharply. The question arose in the circumstances whether Yugoslavia's increased market share was sustainable. Certainly there was some way to go if the projected 6 percent increase in convertible-currency exports were to be achieved during 1985.

The staff's medium-term projections made it clear that Yugoslavia would continue to face heavy debt servicing problems for the remainder of the decade, with large refinancing likely to be necessary, Mr. Wicks observed. Those prospects underlined the need to maintain export growth and to continue following an active exchange rate policy. In that regard, he welcomed the authorities' intention to continue to adjust the exchange rate of the dinar frequently, even though checkpoints were expected to be set quarterly rather than monthly. Concluding on a minor statistical matter, he hoped that the problem of double counting of foreign currency positions in Yugoslavia's international banking statistics could be eradicated as soon as possible. Like others, he could support the proposed decisions as amended.

Mr. Fujino said that he was pleased to note that the authorities had begun to tackle the deep-rooted problems of the Yugoslav economy and that their efforts had brought about substantial improvement in the external balance as well as some initial signs of economic recovery. The current account position had been drastically reversed from a large deficit in the early 1980s to a surplus of $865 million in 1984. It was particularly pleasing to note that vigorous growth in export volume in 1984 had created room for a rise in imports for the first time in four years, a development that had contributed significantly to restoring positive economic growth. A shift in resources to the export sector seemed to have taken place through a flexible exchange rate accompanied by domestic demand restraint. The experience of the Yugoslav authorities suggested that adjustment policies were not incompatible with economic growth.

A large positive swing had taken place in short-term capital flows, reflecting successive interest rate adjustments, Mr. Fujino noted. Since the improvement had been attributable partly to special factors--such as advanced payments for work abroad--it should be assessed with care. He wondered whether the capital outflows had been virtually eliminated through the subsequent adjustments in the interest rate.

While progress toward adjustment had been significant, the Yugoslav authorities continued to face difficult problems, Mr. Fujino remarked. Inflation, for example, had surged to nearly 60 percent at the beginning of 1985, and there was still no clear-cut sign of its abatement. Partly reflecting the higher than expected inflation rate, real personal income for employees in the socialized sector had fallen by some 30 percent between 1979 and 1984, and caution would be necessary to maintain the morale of those employees. The removal of inflationary expectations was thus essential to consolidate the gains in the external sector and to maintain the growth momentum that had emerged in 1984 as well as to prevent any further reductions in real income. The high inflation rate might to some extent be an unavoidable adjustment cost accompanying liberalization and exchange rate depreciation; but an important question was how the price rise could be kept to the minimum necessitated by those measures. In that regard, there seemed to be a number of other factors contributing to the recent acceleration of inflation. The first was the precautionary price movement or trend based on the past policy of on-off freezes. Any uncertainty about whether or not the latest price liberalization would be short-lived could lead to further price hikes. He urged the authorities to resist any pressure to reimpose price controls in order to eliminate those uncertainties.

Another concern in the Yugoslav economy was the adequacy of demand management restraint, Mr. Fujino considered. Progress had already been made on the fiscal side, with the public sector claim on resources in terms of GSP having been reduced from 39 percent in 1980 to less than 30 percent in 1984. He could endorse the target contained in the proposed arrangement to keep public sector expenditures stable at the 1984 figure in real terms. On the monetary side, the maintenance of a prudent and cautious credit policy was essential. At the same time, further steps should be taken to enhance the competitiveness of the dinar as a means of encouraging domestic savings. Even if domestic credit expansion were successfully tightened through control over net domestic assets, inflationary pressures would not subside so long as the money demand for the dinar grew faster than the money supply; the recent rapid increase in velocity seemed to suggest that that was precisely what had been happening. The share of foreign currency deposits had risen rapidly from 26 percent in 1980 to 43 percent in 1983; in 1984, despite substantial adjustment, the share had changed only marginally. The continued flexible adjustment of interest rates to keep them positive in real terms was important, and he could support the formula using a moving average of the inflation rate for the next three months and projections for the following two months. Of course, there were other impediments to increasing money demand. Enterprises were not allowed to hold time deposits if, for example, they reported losses in the current year, and banks were becoming reluctant to accept time deposits carrying high interest rates. He wondered whether the authorities were contemplating any specific measures to deal with those difficulties.

Market inefficiencies were also a problem in the Yugoslav economy, Mr. Fujino commented. High interest rates and a fragmentation of markets for goods, capital and labor, and foreign exchange seemed to have seriously undermined the use of resources on a country-wide basis. The authorities were fully aware of the importance of the problem and had made some progress toward resolving it, although they needed to do more. The proposed stand-by arrangement aimed at containing the inflation rate within a maximum of 50 percent in 1985; however, in view of the pressing need to reduce inflation, the target should perhaps have been somewhat more ambitious.

He could broadly endorse the staff appraisal of the Yugoslav economy, Mr. Fujino said. The fundamental objectives of the proposed stand-by arrangement were to consolidate the gains already achieved and to make further improvements through price liberalization, flexible adjustment of the exchange rate, and restrictions on subsidies for loss-making enterprises. The policy strategy was properly directed, and he could support the proposed decisions. In view of the large outstanding purchases from the Fund, he could agree to limit further access to the amount proposed by the staff.

Mr. Joyce remarked that he could support the proposed arrangement. If the measures envisaged under the program were carried out with determination, a more sustainable balance of payments position could be achieved. According to the staff, 1984 had marked a turning point in economic performance in Yugoslavia and, more important, in economic policies. Following several years of improvements in the convertible trade balance through import compression and a somewhat modest increase in exports, a substantial shift in resources had taken place toward the tradable goods sector of the economy. The current account in convertible currency had been strengthened by 4.5 percent of GSP since 1982, in no small part because of the realistic exchange rates, interest rates, and price liberalization policies implemented by the authorities.

Still, Mr. Joyce continued, structural problems such as a high rate of inflation remained and could threaten the gains already achieved. The staff had rightly urged the authorities to avoid temporary measures that would address only the symptoms and not deal with the root causes of inflation, and had noted that the measures already in place must be maintained and strengthened. In certain cases, of course, the legal, political, and economic institutions in Yugoslavia made it difficult to implement appropriate adjustment decisions. As pointed out by the staff, obstacles to the flow of domestic savings within the economy had complicated the execution of economic policy, just as market structures had contributed to recent inflationary pressures. He realized that reshaping institutions was much more difficult than changing economic policies, and progress in some areas had thus been slow. It was to be hoped that a continuation of current policies would help to bring about more substantial results in the future.

Over the past few years, much of the adjustment effort in Yugoslavia had been aimed at restraining investment spending and industrial wages, Mr. Joyce recalled. Further restraint in those areas might be counterproductive, however, in view of the aging of the capital stock and the narrowing of wage differentials. On the other hand, if restraint were to be safely relaxed in those areas, continued emphasis on structural adjustment would be needed; in that regard, he welcomed the fact that the program addressed some of the structural problems in the Yugoslav economy. However, progress toward structural adjustment had not been sufficient, and there were a number of areas in which he would have preferred more immediate action. For example, a removal of the barriers to access to the foreign exchange market would have been welcome. It was to be hoped that, at the time of the program review, proposals would be put forward to make the exchange system much more market oriented.

Continued high inflation remained a crucial problem in the Yugoslav economy, Mr. Joyce considered. While some of the inflationary pressures might have been due in part to the lifting of the price freeze in May 1984 and to other price liberalization measures introduced on January 1, 1985, the inflationary pressures nonetheless reflected fundamental disequilibria that were only beginning to work themselves out. Price restrictions at the present stage would be disastrous; they could abort the adjustment process and ultimately add to underlying inflationary pressures. In order to contain and eventually reduce such pressures, monetary policy must remain accommodating. The authorities had been pursuing an accommodating monetary policy, but its impact had been blunted by unexpected increases in circulation brought on by heavy use of interinstitutional credits, particularly secured promissory notes. Such a development, which unfortunately was not uncommon in centrally planned economies, interfered with the effective pursuit of monetary policy and contributed to the deterioration of the financial position of the enterprises themselves. In the circumstances, he welcomed the decision at least to review the conditions under which enterprises could raise credit through promissory notes. As for other aspects of monetary policy, important steps had already been taken to achieve positive real rates of interest, and he welcomed the efforts to ensure positive real returns on short-term deposits. He could support the requested waiver of the performance criterion on the adjustment of interest rates as of April 1, 1985, and he agreed with the staff that further increases in the cost of funds to the banking system should be considered in order to close the gap between deposit and lending rates.

On the fiscal side, Mr. Joyce agreed, first, that there was no compelling reason why the size of the public sector should decline any further in real terms. Second, since much of the burden of adjustment had fallen on those employed in the socialized sector, there might be some merit in broadening the tax base to include interest income on a progressive scale.

Like a number of his colleagues, he was concerned about the lack of specificity with respect to the structural adjustment measures that the Yugoslav authorities intended to introduce, Mr. Joyce commented. The staff had emphasized the need to reduce the fragmentation of markets for goods, capital and labor, and foreign exchange. Obviously, sensitive social and political issues would be involved in the effort to achieve that objective; on the other hand, political and social sensitivities did not make adjustment any less necessary. Measures to remove obstacles to the flow of savings were urgently required if the economy were to be strengthened. The proposed measures aimed at improving financial discipline in the public enterprises were welcome, but they would not count for much unless the authorities were prepared to address the more structural problems decisively.

Recalling Mr. Polak's indication that the proposed program might be the last for which Fund financial support would be requested, Mr. Joyce remarked that the Fund should be particularly concerned that Yugoslavia was headed in the right direction and with sufficient forward momentum to achieve its goals. He understood that the authorities might wish to seek Fund assistance in monitoring progress that might be achieved as a result of further adjustment efforts; while he had no objection in principle to such assistance, he could not make a final judgment on the matter until the Board had held a broad policy discussion on the subject of enhanced surveillance arrangements.

The Fund had to be assured that satisfactory arrangements were worked out between Yugoslavia and the commercial banks for the refinancing of loans falling due between January 1, 1985 and the expiration of the stand-by arrangement, Mr. Joyce said. While he could accept the approach put forward by the staff, he was in sympathy with those who had expressed some reluctance to follow it. In conclusion, because Yugoslavia had made considerable progress toward balance of payments sustainability, he could support the proposed decisions.

Mr. Zhang considered that the authorities' success in implementing three successive annual programs should alleviate any concerns about their determination and ability to take strong adjustment measures. The reallocation of resources within the economy had been resolutely pursued, and significant positive results had been achieved, although unavoidably at considerable social and economic cost. The remarkable turnaround in the current account of the balance of payments in 1982-84 had been associated with a decline in real net personal income per worker by 21 percent since end-1981 and with a fall in investment by almost 30 percent since 1980. Moreover, the rate of increase in employment had declined, leading to a rise in unemployment.

Generally speaking, the staff report tended to exaggerate the efficiency of the market mechanism in "automatically" restoring a state of general equilibrium, Mr. Zhang commented. That tendency was reflected in the staff's having judged every policy measure mentioned in the report according to the degree of liberalization that it introduced or the extent of the reduction of the Government's role that it brought about. In other words, the assessment was based on some idealized concept of the working of the market mechanism, not on actual experience in market economies. While there might well be certain advantages to the working of the market mechanism, both in private enterprise and in socialized economies, it had to be recognized that the achievement of sustained and balanced growth required a correction and supplementation of that mechanism through measures adopted by the Government. Such measures were particularly important in socialist countries, where the aim of government policy was not only to achieve balanced and steady growth but also to fulfill certain social objectives and to introduce the necessary structural changes for the purpose. At present, a number of socialist countries had embarked upon economic reforms similar to those being undertaken in Yugoslavia. In all such cases, the firm determination to continue the role of market forces and expand the scope of autonomous enterprise decisions did not at the same time reject the possibility of increased government intervention in cases where market forces proved insufficient to achieve balanced economic growth or the desired pattern of development.

The process of economic reform--even in countries like Yugoslavia where the process had been initiated many years earlier--was a long and complicated one, Mr. Zhang remarked. Governments were often forced to give up some achievements already won in the hope that progress would be resumed when conditions were more favorable. In that respect, it was difficult to agree with the staff that "it would be tragic if this correction process were to be halted by attempts once again to repress the symptoms of the underlying problem rather than continuing to cure them." That statement reflected the staff's general attitude toward any attempt by the Yugoslav authorities to restrain or influence the working of the market mechanism, even temporarily. There was no reason to believe that the introduction of temporary measures to repress certain symptoms in any way prevented the application of remedial measures aimed at the elimination of underlying imbalances.

His remarks should not be interpreted in any way as a criticism of the staff report, which contained many useful suggestions with regard to specific aspects of the readjustment process in Yugoslavia, Mr. Zhang said. It was clear, for example, that to the extent that the allocation of investment funds ceased to be centralized through taxation or obligatory transfers to the banking system under government control, a need arose for some kind of capital market providing incentives for transfers of savings to the most efficient and vital sectors or enterprises. Similarly, the staff had rightly emphasized the need for a rational system of flexible prices, reflecting changes in costs and in supply and demand, as vital to the efficient functioning of the economy. No less appropriate were the staff's comments on interest rates, on the link between the prices of domestic tradable goods and foreign prices, and on the exchange rate. However, the rationale for those comments did not preclude the need for certain subsidies demanded by social considerations or for certain temporary restrictions or other measures of government control, even affecting foreign trade. The complete rejection of such measures by the staff at the present stage of economic reform in Yugoslavia was unrealistic because it was not based on a study of the real situation. Furthermore, the difficulties arising from too rigid or too rapid an application of various "liberalization" schemes might lead to strong antireform reactions, a factor that the staff must bear in mind in evaluating reform in countries such as Yugoslavia.

He welcomed the staff's support for a resumption of growth of investment, especially since the capital stock in the country had been growing increasingly obsolete, a development that would adversely affect Yugoslavia's future growth potential, Mr. Zhang considered. However, the staff had not made any concrete proposals with regard to the design of the program. It was clear from the report that, on the one hand, the possibility of further reducing either real wages or public consumption appeared to be all but exhausted; on the other hand, the economy seemed to be reaching the limit for a continued expansion of its shares in major export markets by relying on further devaluations.

On a presentational matter, Mr. Zhang considered that some issues in the staff paper had not been well integrated; the treatment of inflation was a case in point. According to the staff, inflation "...in part must be seen as a corollary to correction of the long-repressed imbalances of the economy" and "the high inflation rate is symptomatic of the structural impediments that diminish the responsiveness of the economy to signals emanating from the improved price structure. The major obstacles in this respect are to be found in the fragmentation of the market for goods, capital, labor and foreign exchange." While those impediments might well explain the high costs in the Yugoslav economy, they could hardly be considered significant causes of inflation as reflected in the 40 percent and 50 percent increases in the cost of living in 1983 and 1984, respectively, followed by a continued large increase in the beginning of 1985. Apart from the role attributed to those impediments, the staff had indicated that the continuous high rate of inflation could be ascribed, in part, to the effect of an increase in prices of imported goods induced by the devaluation of the dinar, to changes in the system of controls, and to the adjustment of administered prices for key goods and services. The report seemed to have attributed inflation in 1983 to the release of some inflationary pressures that had built up during the previous years of price freezes and general price controls. The staff had gone on to say that, "by 1984 it was quite clear that inflationary pressures no longer stemmed from excessive consumption demand." Unfortunately, no detailed discussion of the changing relative importance of those factors upon the course of inflation could be found in the staff report. In his view, the effect of the release of the pent-up demand had been far greater than was suggested in the staff report. Even if that were accepted, however, he wondered whether the picture was really complete. Information on the movement of prices and income per worker, especially during 1984, strongly suggested that the continuing high rate of inflation in Yugoslavia might be largely due to the continuation of a wage and price spiral. If that diagnosis was correct, there was little possibility in present circumstances that the wage and price spiral could be stopped without the introduction of an incomes policy, which would imply some restrictive measures on a temporary basis.

The staff had made reference to a new "social compact," which had been designed to deal with the distribution of income, Mr. Zhang noted. The staff had also mentioned the strengthening of the links between labor productivity and income per worker, although it was not clear whether the term "income" applied to nominal or to real wages. It was doubtful that nominal wages would not be affected by the 50 percent inflation rate, irrespective of changes in productivity. Furthermore, as stated in the report, a further reduction of real income was not possible at present.

In conclusion, Mr. Zhang stated, he could support the request for a new stand-by arrangement and the request for a waiver of a performance criterion under the existing stand-by arrangement. The decision to change the formula for adjusting the reference interest rate was welcome; the new formula would provide some necessary flexibility. Indeed, the partial deindexing of that major cost component was necessary in order to reduce the rate of inflation. Also, like Mr. Polak, he found the paraphrasing of the proposed paragraph 4e of the stand-by arrangement (EBS/85/85, Sup. 1, paragraph 6) to be inappropriate and unnecessary.

Mr. Romuâldez considered that the Yugoslav authorities deserved commendation for shifting the momentum of their economy in the right direction, improving the external position--especially in the convertible-currency sector--and establishing a somewhat firmer, albeit still uneven, basis for sustainable growth. The authorities had brought the exchange rate in real effective terms to a more realistic and competitive level, appropriately increased interest rates, and begun to implement price liberalization measures aimed at making the system more credible. He particularly welcomed the recent signing of the social compact, which should help to strengthen the relationship between productivity and income.

Inflation remained the major problem in the Yugoslav economy, Mr. Romuâldez remarked. However, the fight against inflation must not lead to a weakening of the effort to liberalize the price structure, a development that might adversely affect the authorities' credibility and actually intensify inflationary pressures. In that regard, he wondered whether the assumption of a 50 percent price increase from December 1984 to December 1985 was sufficiently ambitious to signal the authorities' determination to fight inflation. The question was all the more relevant as, in some instances, prices had been raised well beyond the level at which firms had been prepared to sell. He would have preferred firmer, more clearly defined steps toward encouraging enterprises to adopt greater financial discipline.

On page 30 of its report, the staff had suggested that the fragmentation of the market was one of the major structural factors diminishing the responsiveness of the Yugoslav economy, Mr. Romuâldez noted. The staff had also indicated that efforts thus far to address the problem in the financial market had been inadequate. He wondered whether any other initiatives had been taken toward integrating the Yugoslav market and whether any role had been defined for the World Bank in that regard. Except for what was stated in Appendix III, there seemed to be little indication of a role for the World Bank in the program for 1985. Given the structural orientation of the program, the lack of Bank activity in Yugoslavia was somewhat surprising, and he would be interested in hearing how it was envisaged that the World Bank fitted into the strategy for structural adjustment in Yugoslavia. Certainly the need for structural adjustment was reflected on page 33 of the staff report with the cryptic remark that "the need for a fundamental reform of the system is widely recognized within Yugoslavia." In his view, that issue should have been addressed in the program for which Fund support was being requested. He understood that important political considerations might well have made strong and rapid structural adjustment unrealistic; still, he would have welcomed a timetable for the introduction of structural reforms.

He could support the relaxation of the limitations on the availability of exchange for foreign travel arising from the limitation on the export of Yugoslav dinars, Mr. Romuáldez stated. Performance criteria under the program seemed appropriate, and he could accept the new paragraph 4e proposed in EBS/85/85, Supplement 1. He also agreed with Mr. Polak that the proper understanding of that paragraph should in no way reflect the greater restrictiveness of its paraphrasing as set out in paragraph 6 of the Supplement. Finally, while he was in agreement with the staff appraisal of economic developments in Yugoslavia, he believed that the program might have been somewhat stronger, particularly with respect to the problems of market fragmentation and the foreign exchange allocation system.

Mr. Sengupta, supporting the draft decisions, observed that Yugoslavia had for some time been receiving Fund support, and it was important not only to review the country's economic policies but also to look closely at the policy prescriptions provided by the Fund. It seemed clear that the traditional emphasis on demand management through deregulation and liberalization had not worked in Yugoslavia, and the staff had not demonstrated convincingly that the failure of the model was the result of the authorities' failure to implement the recommended policies. Indeed, the Yugoslav authorities had shown repeatedly that their capability and willingness to adopt harsh and difficult measures in line with Fund prescriptions. The answer, thus, lay elsewhere.

In his opening statement, Mr. Polak had described the unsustainable nature of the expansionary policies followed during the second half of the 1970s, Mr. Sengupta continued. During that period, GSP and private consumption had increased annually by an average of 5.8 percent, fixed investment by 8.5 percent, and imports of goods and services by 5.7 percent. From Yugoslavia's point of view, 1973-79 had been years of some prosperity; from 1979 onward, the situation had changed, with declines in all the areas that he had mentioned except GSP, which had nonetheless increased by only 1 percent since 1983.

The Fund had been involved directly with Yugoslavia since 1979, and one could not avoid linking Fund involvement with the period of economic decline, Mr. Sengupta continued. In 1984, there had been a substantial increase in the rate of growth of exports, due mainly to the massive devaluation of the dinar. However, the increase in export volume was somewhat disturbing because the terms of trade had deteriorated in 1984 and unit values of exports had declined in both 1983 and 1984. The staff paper suggested that, in 1985, a rise in real income would be reflected in a growth in volume of exports by 6.5 percent; but the terms of trade were projected to continue to decline, even though the real effective exchange rate might not change. Also disturbing was the substantial outflow of capital. In general, it was not clear from the information in the staff paper whether the devaluation had succeeded in effecting the needed shift in resources to sectors producing import substitution and exports; and the experience of Yugoslavia could serve as a model of experiment to ask the basic question of the extent to which devaluation worked in such a system.

During the four years between 1981 and 1984, private consumption and gross fixed investment had declined, although both were projected to increase under the 1985 program, Mr. Sengupta noted. Real net personal income per worker in the socialized sector had also declined during the first four years of the 1980s, but it was not clear whether that element would rise in 1985. Even if it did, the real income position of Yugoslav workers would still not match that reached in 1979. Of course, by focusing on improvements in consumption and investment, the 1985 program was a step forward from previous programs; but it was important to see that workers' incentives were maintained through proper adjustment of wages. Social compacts signed at the end of 1984 seemed to link productivity per worker with income but did little to narrow the gap between income received in the socialized sectors and that from other sectors. The 1985 program on income distribution had not been clearly spelled out in the staff paper.

The staff's explanation of continued inflation in Yugoslavia was somewhat confusing, Mr. Sengupta considered. Clearly, demand management had not worked, and the staff had attempted to explain that, because of a sudden price liberalization, an opening up of the economy had occurred. However, the stop-go policy had not allowed the system to adjust. The high rate of inflation in January 1985 had been explained in similar terms, but the arguments had not been well substantiated. A review of inflation from a broader perspective in Yugoslavia suggested that some elements were missing, especially with respect to certain areas of price increase. For example, food prices--which weighed heavily in the cost of living--had been rising substantially and had an effect on incomes policy, on productivity, and on the relevance of price liberalization and income distribution. The pace of price liberalization was an issue that should be examined in greater depth than had been attempted in the staff paper.

The issues that he had raised should be seen in the context of the major structural adjustment effort in Yugoslavia, Mr. Sengupta considered. He was not sure whether any conclusions had been reached on measures that would form the basis of structural reform, but it was clear that an effort must be made to understand what was needed in the Yugoslav context before prescriptions were put forward. Finally, he wondered whether the large number of performance criteria for the 1985 program was particularly helpful in the special circumstances of Yugoslavia.

Mr. Fugmann agreed with others that developments in Yugoslavia in 1984 had been encouraging and reflected the authorities' growing awareness of the need for adjustment. He welcomed the improved design of the 1984 Fund program, which shared the credit for the positive economic developments in Yugoslavia in that year.

Both the staff report and Mr. Polak's opening statement had indicated that the 1985 program would be the last for which Fund assistance would be requested in the forseeable future, Mr. Fugmann continued. Instead, the authorities would seek a multiyear refinancing of commercial bank loans as well as nonfinancial Fund assistance in the form of enhanced surveillance. Such an approach seemed reasonable from the point of view of both the Fund and Yugoslavia, although it greatly increased the demands that would be placed on the ability and determination of the authorities to persevere in strengthening and broadening their adjustment policies.

Yugoslavia must push forward with the adjustment effort for three reasons, Mr. Fugmann commented. First, visible economic progress in 1984 had taken place mainly on the external front, and there was a long way to go before domestic economic problems would become manageable. There was little room for policy slippage, not because Yugoslavia's economic problems were particularly severe compared with those of many other countries, but, more important, because the authorities' credibility was at stake. Second, the highly commendable steps undertaken by the authorities had only partially succeeded in restoring confidence in official and nonofficial creditors. Third, during the Executive Board's discussion on surveillance, it had been generally agreed that the Fund should offer enhanced surveillance only when a country was well on its way toward economic adjustment. In that regard, he agreed with others that further progress on Yugoslavia's domestic front would be required for that criterion to be fulfilled.

The major objectives of the 1985 program seemed reasonable, although the authorities should take additional steps to broaden adjustment policies affecting imports, Mr. Fugmann said. Without a more liberal import regime, the authorities might be unable to reap the full benefit of the major price liberalization being implemented. Indeed, given the institutional setup in Yugoslavia, there was some risk that the inflation rate would remain high without increased price competition. He realized that import liberalization was closely related to the foreign exchange system, about which sensitivities existed. However, if the rate of inflation were not visibly reduced during 1985, the authorities might feel tempted to resort to a further price freeze, an action that could have damaging effects on external confidence in the economy.

On the effort to achieve positive real interest rates, Mr. Fugmann said, he was among those who wondered whether, despite the relevant theoretical underpinning of the new formula, it was in fact a good idea to build on a system that was bound to produce overshooting or undershooting. In his view, greater weight should be given to past price developments. Finally, like others, he could support the request for a waiver and the proposed decisions for the 1984 Article IV consultation and the new stand-by arrangement, including the staff's proposal to make further drawings beyond August 1985 dependent upon the conclusion of satisfactory financial arrangements between Yugoslavia and its creditors.

Mr. Mtei, joining others in support of the proposed decisions, observed that the adjustment process had been the major preoccupation of the Yugoslav authorities for the past four years. It was clear that they were well on their way to achieving one of their main objectives, namely, an improvement in Yugoslavia's position vis-à-vis the convertible-currency area. In that connection, it was noteworthy that the diversion of exports from the nonconvertible currency area--which had accounted in 1983 for some 60 percent of the increase in export volume to the convertible-currency area--had dropped substantially in 1984, an indication that the export sector was expanding and that the economy was beginning to benefit from the Government's flexible exchange rate policies. The other significant aspect of the improvement in the external balance was that 1984 marked the first time in four years that imports had increased, a factor that had helped to promote the rise in economic activity.

A balanced assessment of economic developments in Yugoslavia must include some concern about a number of domestic problems, including high inflation and low growth in GSP, which seemed to suggest that the authorities had placed too much reliance on demand restraint in the early stages of the stabilization program, Mr. Mtei continued. The result had been sharp declines in fixed investment, with private consumption flat or slightly declining; unemployment had also been a problem in 1984. In the second phase of the adjustment process in Yugoslavia, beginning in 1983, the authorities had taken a longer-term view of required changes, emphasizing the need to maintain reasonable growth while aiming at a sustainable balance of payments position. The staff itself had recognized that economic problems resulting from market fragmentation, lower labor productivity, and institutional restrictions could be addressed only in a longer-term framework. Such a realistic assessment by the staff meant, first, that programs could be developed with an appropriate balance between policies of demand management and those geared toward longer-term structural change. Second, it meant that the authorities were better able to see the need for, and the importance of, sustaining the adjustment momentum.

He could support the thrust of the 1985-86 program, particularly the efforts being made to maintain competitiveness in world markets and to improve the financial position of enterprises in the socialized sector, Mr. Mtei commented. However, inflation was likely to remain a problem, resulting in high nominal rates of interest. For example, interest rates on one-year deposits had been raised to 59 percent in January 1985 as part of the authorities' commitment to maintaining positive real rates. However, it was questionable how long the economy could sustain such high rates of interest. He would welcome further information on how interest rates in Yugoslavia compared with the average rate of return on investment. Given the likely adverse impact on investment if the situation persisted, it would benefit the economy if inflation could be brought under control as soon as possible.

In the external sector, Mr. Mtei welcomed the indications that the volume of exports to the convertible-currency area was expected to continue to grow in 1985. However, it was clear that the improvement in Yugoslavia's external accounts would depend crucially on whether the country was able to refinance a large portion of its external debt maturing during the period of the stand-by arrangement. It was to be hoped that the international community would take cognizance of the authorities' track record in attempting to place the economy on a sound footing and would accede to their request for debt rescheduling.

Mr. Blandin recalled that, during previous Board discussions on Yugoslavia, Directors had expressed concern about some economic developments in the country, especially inflation, and had raised doubts about whether the authorities would be able to avoid requesting waivers of performance criteria, especially given the number and complexity of such criteria established for programs with the Fund. The current situation in Yugoslavia demonstrated that those concerns and doubts had been well founded. The cost of living had risen by 69 percent since March 1984, and a waiver on interest rates had been requested. Still, all other performance criteria had been fulfilled and, in a number of important areas, the authorities had introduced measures that should lay the foundation for sustained economic growth in future.

While acknowledging that some progress had been achieved, especially during 1984, Mr. Blandin said that he was nonetheless fully in agreement with the staff that much more needed to be done. The most important challenge at present was the fight against inflation, the recent acceleration of which was the inevitable result of the depreciation of the exchange rate and the liberalization of the price system. As noted by the staff, the persistent high underlying inflation rate was also a symptom of deep-rooted imbalances in the economy that had yet to be eradicated, despite seven years of Fund-supported programs. Tackling those imbalances would not be easy, but it was the only way to improve the medium-term prospects for the Yugoslav economy. The authorities' intention not to resort again to price controls was courageous but necessary; unfortunately, inflation was the toll that had to be paid in order to achieve an appropriate price structure. The program measures aimed at winding down the inflation rate and promoting a better allocation of resources were particularly welcome. Financial discipline was clearly needed and, in that respect, incomes policy played a restrictive role. It was worth noting the authorities' decision to continue limiting income payments indirectly through laws limiting credit to enterprises. The implications of such an approach would of course have to be carefully assessed.

The sharp reduction from 1980 to 1984 of the public sector's share of GSP from 39 percent to 30 percent was impressive, although it was clear that investments could not be reduced indefinitely without endangering the productive capacity of the economy, Mr. Blandin remarked. On the fiscal side, the staff had rightly stressed the need for reform in the direct taxation of interest income. Moreover, monetary and credit policies would continue to play a central role in the Yugoslav economy, with appropriate limits having been placed on the growth of monetary aggregates. In that regard, he wondered about the extent to which recent developments on the inflation front would affect monetary policy.

He agreed with the staff that the maintenance of positive real exchange rates had an essential role to play in Yugoslavia in favoring savings domestically and by preventing stock buildups internationally through improvements in the capital account due to the incentive effect on workers' remittances, Mr. Blandin noted. On the external side, there was evidence of an increasing shift to the export sector. In that context, the active exchange rate policy--which had been crucial to the improvement in the trade balance--should be pursued. However, he was concerned that exchange restrictions remained and that the system of foreign exchange allocation, despite some improvements, was not functioning smoothly.

Progress toward structural adjustment had been disappointing, Mr. Blandin remarked. The adjustment process must thus be consolidated, and the structural impact of measures relating to prices, interest rates, and the exchange rate must be examined. Particularly on the structural side, the involvement of the World Bank could be beneficial; improved coordination between the staffs of the two institutions would be welcome. In sum, there were a number of areas in which the Yugoslav authorities were apparently making progress, as reflected in the likely pickup in investment and in the rate of growth of real GSP in 1985. However, given the external constraints, much more needed to be done. While supporting the proposed decisions, he shared the concerns expressed by Mr. Goos and others.

Mr. Weitz observed that, for the first time since the initiation of stabilization efforts in 1980, a major shift of resources to the export sector could be perceived in Yugoslavia. The current account in convertible currency had moved from a deficit of $1.6 billion in 1982 to a surplus of $0.9 billion in 1984. It was important to stress that the improvement in the trade balance in 1984 had not relied on a contraction of imports; on the contrary, imports of goods had risen for the first time in four years, while exports to the convertible-currency area had grown by almost 15 percent in volume terms. Moreover, a 7 percent increase in import volume from the convertible-currency area was envisaged for 1986, an increase that would be necessary for the growth of output and investment. The increase in exports required, at the same time, a growth in imports of raw materials and capital equipment.

Unfortunately, the positive developments must be seen against some discouraging ones, Mr. Weitz continued. For example, the initiation of the adjustment effort had brought increases in inflation to rates far higher than those of the previous decade; indeed, a record inflation rate had been registered in 1984. The increase could of course be partly explained by the rise in prices of imports induced by the devaluation as well as by changes in the system of price controls and the adjustment of administered prices for key goods and services. However, fiscal and credit policies had been restrictive for a long time, as shown by the sustained decline in domestic demand during the past several years. In general, it was difficult to detect and understand the sources of inflation in Yugoslavia and the most appropriate ways of dealing with them.

To the extent that it affected the growth of output capacity in the trade sector, the 33 percent decline in gross fixed investment in volume terms since 1979 could undermine the continuity of improvements in the external account and should therefore be reversed, Mr. Weitz continued. In the past, the burden of adjustment had relied excessively on investment and income from employment. He agreed with the staff and the authorities that, in the future, the burden should be borne more equitably by other elements in the economy. Hence, he welcomed the plan to broaden the taxation of individuals other than workers in the socialized sector by including certain assets and income from interest.

The measures included in the proposed stand-by arrangement should continue to foster the transfer of resources to export-oriented and import-competing sectors while permitting a cautious revival of domestic demand, Mr. Weitz considered. Among those measures were the following: a flexible exchange rate policy, a reduction in outstanding external indebtedness, a rise in international reserves, a commitment to price liberalization; a tightening of the financial discipline of enterprises, a policy of maintaining positive real interest rates, and the use of monetary policy to lower inflationary expectations.

All performance criteria relating to the fourth purchase under the existing stand-by arrangement had been met, except the one relating to the adjustment of interest rates, for which the proposed waiver was fully justified, Mr. Weitz said. In conclusion, he could strongly support the proposed decisions.

Mr. Zecchini observed that, beginning in the late 1970s, Yugoslavia had embarked on a series of Fund-supported economic programs aimed at the achievement of two main goals: a strengthening of the external position and a structural improvement in the functioning of the economic system, especially at the microeconomic level. Progress toward the first of those goals was urgently required in view of the increasing debt in the later 1970s and the consequent necessity for steady financial support from the banking community. It should however be noted that the authorities had achieved remarkable success in 1984 through a strong expansion of real exports and a dramatic turnaround in short-term capital flows. The cornerstones of economic policy implemented under the program--interest rates and exchange rate flexibility--had been the dominant factors underlying the favorable developments in 1984.

Progress toward structural improvement in the functioning of the economic system had been limited so far, Mr. Zecchini considered. The system of foreign exchange allocation--one of Yugoslavia's long-standing weaknesses--continued to be inadequate to the task of ensuring efficient use of available foreign exchange resources. Moreover, price liberalization had been only partially successful; indeed, because of its "on-off" nature, it had imparted a strong and partly unexpected inflationary stimulus to the economy, the persistence of which was confirmed by recent data. The strength of the inflationary process in Yugoslavia could not be explained only by reference to the abandonment of administrative controls; in that regard, it was unfortunate that the staff had devoted only a few brief and general comments to the nature and causes of the inflationary process. It would have been preferable for the staff to have explored that process in greater depth, perhaps with reference to specific sectors or areas.

One question that remained to be answered was why inflation continued stubbornly in the 50-70 percent range, despite a cautious fiscal stance and a monetary policy that could by no means be considered overexpansionary, Mr. Zecchini observed. As his chair had noted on the occasion of Yugoslavia's previous request for a stand-by arrangement, the large exchange rate depreciation of 1982-83 had contributed to the surge in the rate of price increase in late 1983 and 1984. Because of the lags generated by the regime of controlled prices, it was difficult to evaluate whether those pressures were still present. It was conceivable that the fragmented nature of the Yugoslav goods market was an important factor in the perpetuation of inflation, particularly if demand pressures were unevenly distributed across sectors and geographical areas and if downward rigidities in nominal prices existed. However, that "distributional" or "functional" cause of inflation usually gave rise to relatively moderate inflation rates when overall excess demand was absent. In sum, it appeared that inflation in Yugoslavia remained largely unexplained, and it would be helpful if the staff, in preparing future documents, could provide a more detailed analysis of inflation.

On specific matters covered by the proposed decisions, Mr. Zecchini said, he had no reason to disagree with the staff's proposals. However, it was important to look at the relationship between Yugoslavia and the Fund in a somewhat longer-term perspective in order to see what might be expected for the future. As noted earlier, Yugoslavia had made continuous use of Fund financial resources for a relatively long period, and the policies implemented during that period had aided the authorities in tackling the more immediate and urgent problems on the external side of the economy. At present, the aim should be to look toward the most appropriate form of collaboration between Yugoslavia and the Fund for attaining the remaining and more structural policy objectives while providing satisfactory guidance for the banking community. As Mr. Polak had suggested, the best form for such collaboration was probably surveillance rather than stand-by arrangement conditionality, particularly given that prospects for the balance of payments would remain favorable so long as appropriate policies were implemented.

Among the more detailed aspects of the economy covered by the proposed decisions, one related to the restrictions on current payments, particularly for travelers, subject to Fund approval under Article VIII, and another related to the waiver on interest rate policy, Mr. Zecchini noted. In addition, the recently introduced performance criterion relating to negotiations with the banks was deserving of comment. He would be interested in hearing from the staff a more detailed explanation of the proposed approval of the restrictions over the program period. In that regard, the situation of the foreign accounts and the current trends in service payments and capital flows did not seem to provide compelling reasons for such approval.

As for the request of a waiver of performance criterion, Mr. Zecchini remarked, the arguments put forward by the staff in favor of the request seemed to be based on three considerations. First, the increase in prices in the 12 months of the stand-by arrangement was not, in current circumstances, representative of the underlying inflation rate. Second, an interest rate increase could be inflationary. Third, the interest rate would in any event by adjusted in the following month. In his view, those arguments were not convincing. If a 12-month change in the price index was not representative of the underlying inflation rate, then a 5-month moving average of the sort envisaged in the future stand-by arrangement would be even less representative, since a 12-month change was equivalent to a 12-month moving average. The fact that data for two of the five months under the future system would be projections would not modify the argument, unless inflation were believed to be on a decreasing path. However, the view that high interest rates might stimulate undue price increases seemed not to take into account that interest rates had more than one distinct effect on prices. In addition to the direct effect through cost increases, there was the indirect effect through aggregate demand that tended to nudge prices in the opposite direction. In the past, the staff had usually taken what he considered to be the appropriate view that higher interest rates tended to be deflationary on domestic activity and the price level. In conclusion, he agreed that the noncompliance on interest rate policy could be viewed as of minor significance; and he could therefore go along with the requested waiver. However, as a matter of policy, waivers should be granted for strong reasons and only when new events or information might have invalidated originally agreed targets.

On the performance criterion related to the negotiations with the commercial banks, Mr. Zecchini observed that the staff's proposal constituted a departure from policies followed thus far. Indeed, the proposal significantly extended the application of the "approval in principle," a notion that had been the object of extensive discussion in the Board in October 1984 (EBM/84/155, 10/24/84) and that, by general agreement, was to be applied with rather restrictive modalities and according to specific guidelines. He wondered whether additional guidelines for the type of approval currently before the Executive Board would later be included on the Board's agenda for consideration. The case of Yugoslavia was an exceptional one justified by exceptional circumstances; however, good administration was based on the creation and application of good rules, not on recourse to exceptions.

Mr. Qureshi said that it was encouraging to note that, following a series of Fund arrangements, significant progress had been made in Yugoslavia's economic performance, especially during the course of the current stand-by arrangement. Because of a movement of resources into export-oriented activities, trade performance vis-à-vis the convertible-currency area had improved markedly to the point where it might be possible for imports--which were required for the modernization of the domestic capital stock--to expand following several years of compression. Much of the improvement in economic performance could be attributed to a shift away from excessive reliance on demand management in earlier programs and toward the adoption of structurally oriented policies in 1984 that were better suited to laying the foundation for balanced growth, a mobilization of domestic resources and the appropriate direction of those resources to the export sector. In order to consolidate gains recently made and effect further improvements, it was important for the authorities to continue to extend their recent policy initiatives while maintaining appropriately sound demand management policies.

The proposed follow-on program aimed at moving the Yugoslav economy further in the direction of balanced and sustainable growth appropriately stressed the need to maintain realistic, uniform pricing policies domestically as well as a flexible exchange rate policy aimed at preserving Yugoslavia's competitiveness abroad, Mr. Qureshi continued. The fragmentation of the market for goods, capital, labor, and foreign exchange remained an obstacle to both the design and implementation of appropriate adjustment policies. Since progress toward the removal of some of those barriers could involve sensitive social and political issues, the authorities' policy of proceeding with caution was understandable, particularly given the economy's institutional arrangements; adequate firmness should, however, be shown in carrying out adjustments that were considered feasible and were being envisaged by the authorities.

The proposed program incorporated an appropriately tight monetary stance aimed at alleviating price pressures that had intensified--in part because of the recent liberalization efforts--and at reducing the underlying rate of inflation, Mr. Qureshi remarked. Interest rate policy would, appropriately, be an integral element in the overall strategy to tighten financial discipline and improve resource allocation. To that end, and for the maintenance of positive real interest rates, the program would adopt an innovative approach akin to trend calculation under the compensatory financing facility. In view of the change in the method of calculating the real rate of interest and the difficulty associated with estimating the underlying rate of inflation, he could support the proposed waiver of a performance criterion on interest rates. However, he shared Mr. Zecchini's concern about whether the new formula for calculating the real rate of interest could be regarded as providing a better estimate of the "expected" or "underlying" rate of inflation than the formula used in the previous arrangement.

On the fiscal side, Mr. Qureshi agreed that there was a need for broadening the approach to adjustment. In the past, efforts at demand management had tended to emphasize reductions in expenditure more than increases in revenue. Since, in the future, further significant reductions in expenditure might be difficult, especially considering the amount of investment required for the replacement of obsolescent capital goods, the authorities had correctly begun to take measures for broadening taxation. Among the tax proposals reportedly receiving the authorities' attention was that relating to interest income, a measure that had also been singled out by the staff for accelerated implementation. However, he wondered whether, by lowering the after-tax rate of return to savers and depositors, the taxation of interest income might not offset part of the beneficial impact of the recommended policy of moving toward positive real interest rates, unless an appropriate adjustment for that factor was made in the level of the before-tax interest return. Staff comments on that point would be helpful. In conclusion, he could support the proposed stand-by arrangement and recommended decisions.

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

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/85/64 (4/26/85) and EBM/85/65 (4/29/85).

3. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/85/81, Supplement 1 (4/25/85) is approved.

APPROVED: February 12, 1986

LEO VAN HOUTVEN
Secretary