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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/66

3:00 p.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
	G. Ercel, Temporary
	X. Blandin
	G. E. L. Nguyen, Temporary
M. Finaish	
H. Fujino	M. Sugita
	B. Goos
J. E. Ismael	
R. K. Joyce	
A. Kafka	J. Hospedales, Temporary
	H. Fugmann
E. I. M. Mtei	
	M. A. Weitz, Temporary
	J. E. Suraisry
P. Pérez	
J. J. Polak	J. de Beaufort Wijnholds
	A. V. Romuáldez
	O. Kabbaj
	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 Africa Regional Office, IBRD. Asian Department: W. G. L. Evers, L. Mendras. European Department: L. A. Whittome, Counsellor and Director; P. B. de Fontenay, Deputy Director; P. Alonso-Gamo, E. O. C. Brehmer, L. Hansen, H. B. Junz, W. E. Lewis, A. López-Claros, D. C. L. Nellor, J. K. Salop, G. Szapary, T. M. Ter-Minassian. Exchange and Trade Relations Department: M. Guitián, Deputy Director; J. O. Bonvicini, J. T. Boorman. External Relations Department: H. P. Puentes. Legal Department: G. P. Nicoletopoulos, Director; W. E. Holder, Ph. Lachman, S. A. Silard. Middle Eastern Department: M. Zavadjil. Treasurer's Department: D. Berthet, J. E. Blalock, J. C. Corr, T. B. C. Leddy. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; M. Caiola, R. A. Elson, G. Jauregui, S. Umana. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: A. A. Agah, G. R. Castellanos, D. Hammann, P. Péterfalvy, G. W. K. Pickering, M. Z. M. Qureshi, A. Steinberg, E. M. Taha, A. Vasudevan. Assistants to Executive Directors: E. M. Ainley, J. R. N. Almeida, I. Angeloni, M. B. Chatah, Chen J., J. de la Herrán, J. J. Dreizzen, R. Fox, G. D. Hodgson, J. M. Jones, A. K. Juusela, H. Kobayashi, K. Murakami, A. Mustafa, J. Reddy, D. J. Robinson, J. E. Rodríguez, M. Sarenac, A. A. Scholten, L. Tornetta, A. J. Tregilgas.

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

The Executive Directors continued from the previous meeting (EBM/85/65, 4/29/85) their consideration of 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 by Yugoslavia 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).

The staff representative from the European Department, recalling questions about the extent to which the staff's recommended policies were appropriate in the context of an economy like that of Yugoslavia, observed that the differences in the economic policies of market and nonmarket economies often tended to be overemphasized. In most cases, the staff was dealing with mixed economies, and it was the response mechanism that was important. Considerable progress had been made toward a meeting of minds between the Yugoslav authorities and the staff about the diagnosis of economic problems and the specific instruments that should be used to deal with them. For example, it was currently fully accepted that the pursuit of both a positive real interest rate and a flexible exchange rate policy was a central element of government policy. Thus, basic policy orientation currently was taking up less discussion time than the pace of policy implementation.

With regard to the proposed changes in the foreign exchange allocation system, the staff representative remarked that, thus far, the staff had been unable to gain more than a glimpse of what was intended, but assurances had been given that staff comments would be taken into account at the same time as comments from other entities in the economy. Such an approach would reduce the "visibility" of the Fund staff and allow the authorities to act upon its recommendations without giving the impression that the Fund was dictating policy.

The causes of inflation in Yugoslavia were difficult to determine, the staff representative continued. The staff had avoided presenting a static analysis in which, on the basis of past relationships, certain proportions of measured inflation were allocated to particular policy measures or impediments. During a time of basic change and movement from strong disequilibrium to a rather better structure of relative prices, it was almost impossible to estimate what particular policy measure or impediment accounted for a given percentage of inflation. The staff had suggested that Yugoslavia had long had a higher underlying rate of inflation than surrounding countries, a distinction which might well indicate structural impediments to the flow of resources that were embedded in the kind of market fragmentation being experienced in Yugoslavia. Moreover, the staff had no doubt that the long period of repressed inflation contributed greatly to the current rate as pent-up pressures were released. The staff might be called unambitious in projecting a rate of inflation of 50 percent through the year; however, given the evidence that lags in achieving an appropriate shift of resources and in effecting appropriate changes in the behavior of economic agents were quite long, it would be unrealistic to attempt to implement a program on the basis of a lower inflation target. In fact, such an approach might have driven the authorities to take counterproductive defensive measures. In that context, and in response to a query by Mr. Zhang, she confirmed the view expressed in the staff report that it would be little short of tragic if the authorities reverted to price controls, even temporarily. As it was, the "on-off" experience with price controls meant a longer lag for enterprise managers to adjust to the new circumstances than would have existed if policy had been more stable.

In the circumstances, the staff representative observed, any market-oriented manager of an enterprise would be well advised, even in the face of soft demand conditions, to raise prices as much as possible in conjunction with the price liberalization measures, in order to establish a base from which reductions could be made in case a change in the policy was introduced. She agreed with the authorities that the measured inflation rate in the first months of 1985 was probably higher than what actual transaction prices would have indicated. A positive element was that an early response to liberalization measures was apparently being observed in Yugoslavia. Thus, according to the authorities, there were at present goods on the market that had not been seen for quite some time.

On the change in the formula for measuring inflation used to adjust interest rates on bank deposits, the staff representative recalled that, at the beginning of 1984, prices had remained flat following the imposition by the authorities of a price freeze in late 1983. Once the price freeze had been lifted, rapid price increases had occurred for a number of months. Under the old formula, which was based solely on price changes from a year earlier, the resulting measure of the inflation rate would be distorted in the opening nine months of 1985; thus, the formula needed to be changed in any event. The new formula for measuring inflation and determining interest rates was more forward looking and allowed financial transactions to be made on the basis of judgments of a continuation of actual and expected rather than past inflation only. Of course, the situation was somewhat more complicated in Yugoslavia by virtue of the existence of foreign exchange deposits. The new formula relied to some extent on past inflation, as it was based on a five-month moving average composed of the latest three months' actual observations and two months' forecast inflation. The staff had left the setting of the forecasts of inflation that would guide the October interest rate adjustment until the midterm review or until August, whichever was earlier, in order to obtain a better view of the trend of inflation after the hump that had followed the price liberalization measures. By following such an approach, the staff hoped to avoid the danger of overshooting or undershooting as much as possible. The concern about not falling behind real positive returns on three-month deposits was strengthened by the wish to ensure that holders of foreign-currency deposits were not remunerated at higher rates than depositors who invested in dinars.

In reply to a question regarding the causal relationship between Fund programs and the fall in standard of living and/or an increase in the inflation rate, the staff representative said that, while increases in the inflation rate and declines in the standard of living of the population had certainly occurred during the period of the Fund's presence in Yugoslavia, it was incorrect to argue that a causal relationship existed between those occurrences. It had taken a long time for the authorities to recognize the extent of the needed adjustment in Yugoslavia and even longer for the underlying adjustment to get under way. In the meantime, measures to shore up the situation had been taken; as those measures needed to show rapid effects, they were concentrated on compressing imports and holding back investments, in turn leading to an investment erosion sufficiently large that some reversal was needed if the growth and production potential of the economy were to be adequate to the demands of the times. As noted by Mr. Templeman, investment had indeed been sharply curtailed, although from high levels, so that the current investment/GSP ratio was not excessively low in relation either to Yugoslavia's needs or to similar ratios in neighboring countries. Of greater concern was the quality of investment. In that regard, the first structural adjustment loan from the World Bank had focused heavily on four areas: financial discipline, price policy, the provision of appropriate investment criteria, and foreign trade, with emphasis on the foreign exchange allocation system. It was her understanding that a second structural adjustment loan (SAL) was being considered and, if agreed, would be aimed at deepening the effects of the first SAL in those particular areas.

Lending rates continued to be below what the staff felt should be the appropriate cost of money, the staff representative commented. It was important to ensure appropriate costing of money to ascertain the opportunity cost of investment so as to guard against the danger that, by setting the cost of money below what it should be, the authorities were creating future loss-making enterprises, which in turn would require a continuous injection of public funds in some form or other. For that reason, the staff felt that deposit rates--which in Yugoslavia determined the cost of funds--needed to remain positive in real terms by a certain margin. Any retreat from that objective could create further problems. While the interest rate policy that was at present progressively being implemented certainly increased costs, it did so appropriately in the staff view and stimulated a supply response, bringing new supplies on stream and, more important, assuring that excessive investment in stocks did not continue. In that regard, the staff had not yet seen a drawdown of stocks to the extent desired. However, the increasing costs of carrying excess stocks, together with the measures of financial discipline that were being put in place to penalize those who held them, should produce the kind of supply response that would aid in the winding down of inflationary pressures.

Observing that enterprises not meeting their financial obligations would not be allowed to have time deposits, some Directors had wondered whether that restriction was an impediment to the working of interest rate policy, the staff representative recalled. In her view, that limitation and the interest rate policy worked together; since appropriate remuneration on time deposits was finally being paid, those not fulfilling their financial obligations should not be earning such remuneration and should rather be stimulated to meet their obligations before being allowed to accumulate financial assets in the banking system. It seemed to the staff that the measure was an appropriate way of stimulating financial discipline. The taxation of interest income--which had been mentioned by the staff as a useful measure--would not really diminish the effect of interest rate policy. In Yugoslavia, interest income was untaxed at present, so that there was certainly scope for such a measure. Moreover, to the extent that taxation was applied to foreign exchange deposits as well as dinar deposits, it would fit very well into the overall policy, especially since the concentration of restrictive policies on personal incomes in the socialized sector had led to distributional problems and the rise of a privileged class earning untaxed income from relatively large saving deposits and other income-generating sources. More generally, it would be preferable in the staff view for the authorities to move toward a uniform and progressive income tax system rather than continue to tax each source of income separately, or not at all.

As to why the staff had not insisted on specific structural adjustment undertakings, the staff representative noted that it was difficult to quantify the effects of structural adjustment measures, so that a quantitative performance criterion would be difficult to design. Moreover, experience with Yugoslavia suggested that it was not easy to design criteria that were timed to the adoption or implementation of certain laws. Besides, during the previous discussion, Directors had indicated their dissatisfaction with what some had described as an "excessive" number of performance criteria.

A great many structural measures had been or were being taken by the authorities, including the adoption of a 1 percent fee on the foreign exchange cover currently provided on foreign exchange deposits, the staff representative observed. Although the 1 percent charge was very low, the adoption itself was important, as the National Bank of Yugoslavia, having recognized the usefulness of the instrument, might well be relied upon to wield it in future perhaps even more actively than the staff might have desired. Among other important measures were the phasing out of the so-called reserve funds that had been used to help enterprises cover losses, new accounting procedures under which "phantom" windfall profits on inventories and working capital--arising out of inflation--would no longer be counted as income, and restraints on income payments to workers by enterprises that were illiquid or that were incurring losses.

The fragmentation of the markets and the problem of the foreign exchange allocation system in particular had been subjected to careful scrutiny, the staff representative remarked. Both the staff and the

Yugoslav authorities recognized the economic costs attached to the fragmentation of markets; however, some political and geopolitical advantages were associated with the basic reasons for that fragmentation, and there was some question about the extent to which the staff should be pushing the authorities to adopt far-reaching measures in that area before they were ready to do so. The dialogue between the authorities and the Fund and World Bank staffs was of course continuing, and it was felt that the advisory role of the two institutions was perhaps more important at present than a performance criterion would have been. Of course, the economic costs of some problems--such as the foreign exchange allocation system--were so great that there was a risk that the authorities would be unable to sustain the adjustment effort without introducing some fundamental changes. Proposed changes in the foreign exchange allocation mechanism would be discussed with the authorities, and the staff would be given the opportunity to offer advice on the proposed changes prior to the midterm review, and the discussion of that issue would be an integral part of the review. While the staff subscribed to the goal of full convertibility of the dinar, it was unclear whether, in the interim, the scope for innovative investment--particularly import-substituting investment--would be curtailed by the emphasis both on past ability to earn foreign exchange and on the export orientation of the policy at the moment.

The staff had suggested to the authorities that the goal of a current account surplus of more than $850 million in convertible currencies might be excessive and had asked whether the authorities should allow somewhat greater import flows to help to diffuse inflationary pressures and increase competition at an early stage while, at the same time, aiding in the modernization of investment. Data seemed to suggest that fiscal policy in Yugoslavia was quite tight; the shrinkage of the public sector and the amount of resources absorbed by the public sector compared favorably with figures recorded in other countries. For that reason, the staff felt that the main concern should be more the structure and quality of expenditure than its level. Because of its concern with expenditures, the staff had attempted to shape the performance criterion relating to the fiscal sector somewhat differently from the previous criterion. Earlier, the staff had wanted to address the question of expenditure by focusing on revenue, because it was unclear how expenditures could be monitored otherwise. However, the staff had found that the effort to adjust revenues quickly did not fit well with the institutional system in Yugoslavia. For the current program, therefore, the staff had felt that monitoring expenditures through a combination of control of revenues and the net assets of the public sector with the banking system would be more useful. The reason for the floor under the net asset position was to prevent the possibility of deficits' arising.

On the monetary side, the staff representative noted, the staff had set an indicative ceiling only for net domestic assets for end-1985 and none at all for the first quarter of 1986; those would be determined at the time of the midterm review. However, performance criteria had been put in place through the third quarter of the year and were in her view quite tight. For the year as a whole, the staff was projecting an increase in velocity of 7 percent; however, given the expectation of a deceleration of inflation in the later part of the year, a somewhat larger increase in velocity would occur in the first part of the year, reflecting a sufficiently tight monetary policy. Moreover, the authorities had argued strongly that some of the changes in financial discipline that would be applied to the banking sector would curtail the liqudity of the banks quite sharply; and those effects should begin to be evident in the second half of the year.

On the external side, a number of fundamental questions had been asked about the degree of adjustment that had been achieved, the role of the exchange rate in that adjustment, and the extent to which any gains made were sustainable, the staff representative recalled. Some Directors had pointed to a fall in exports to the nonconvertible-currency area accompanied by an increase in exports to the convertible-currency area, with similar changes in reverse on the import side. Having analyzed the situation, the staff was satisfied that sufficient evidence existed to show that the shifts were not mere substitutions; rather, there was increasingly a real shift into exports to the convertible-currency area that were not the same goods that had in the past been exported to the nonconvertible-currency area. In that respect, 1984 had witnessed some real changes to which the exchange rate adjustment had made a considerable contribution.

Of course, there had been a rise in countertrade, to some extent involving trade with developing countries, from which cash collection was sometimes difficult, the staff representative noted. Therefore, in the absence of such arrangements, there would probably have been an increase in errors or omissions as a reflection of an involuntary extension of export credit. Still, an increase in countertrade with the developed countries had also occurred, reflecting to a great extent the workings of the foreign exchange allocation system, which provided a strong incentive to enter into such trade.

Exchange rate adjustments undoubtedly added to the inflationary impetus, the staff representative remarked, but such effects were a necessary corollary to the overall adjustment. Because the relative price of imports had been too low in the past, overinvestment had occurred in projects that had subsequently been unable to pay their own way. Moreover, the price of exports had also been too low, and a preference had developed for selling to domestic markets. While remaining a believer in long lags, she had to admit that visible effects of the exchange rate adjustment had appeared earlier than she might have thought.

On the terms of trade, the staff representative observed, if the unit value of exports in foreign currency had not fallen, the Executive Directors would have argued that there might have been excessive profits on exports, in dinar terms, accruing to exporters; competition with both domestic producers and producers in third countries aimed at obtaining lasting increases in market shares could not be sustained merely by an increase in profits. In fact, declines in the unit value of exports in foreign currency were to be expected with the devaluation policy in place. The staff had seen such declines in the region generally, to some extent because unit values were traditionally measured in dollar terms. Since many exports were slated for European destinations, a decrease in dollar terms would have come about automatically with the strengthening of the dollar vis-à-vis European currencies, even if the dinar prices had held stable. In the staff view, the market gains achieved were sustainable, probably through 1986, although they could erode quickly if labor market, investment, and demand management policies deviated from those currently envisaged by the authorities.

In response to a question on real disposable incomes, the staff representative explained that real disposable income from wages was expected to be stable in 1985, which meant that disposable income generally was likely to rise by several percentage points, since income from sources other than employment in the socialized sector had risen relatively rapidly throughout the adjustment period.

The difficulties with respect to the use of statistical exchange rates were being resolved, the staff representative noted. In its report, and in discussions with the authorities, the staff had emphasized the need to move away from the use of such rates, as they tended to obscure the ability of the staff and the authorities to track the adjustment process and the foreign exchange needs of the economy. The staff had also placed emphasis on the need to generate and provide internally a monitoring base that could be employed by the authorities after the expiration of the proposed program.

Finally, the staff representative from the European Department recalled, Mr. Wicks had questioned whether the staff was being inconsistent in requesting approval by the Board until December 31 of restrictions arising from arrears to the commercial banks while insisting that the debt negotiations with those banks should be concluded by August 29. In her view, the debt negotiations might reach a final stage before August 29, but it would take some time after that for payments to be resumed on a regularly scheduled basis; therefore, it was proposed to ask for continued approval of the existence of arrears for some period thereafter. In that regard, it should be recalled that the Fund regarded as an arrearage any nonpayment of principal arising during a period of standstill while refinancing was being arranged. The staff was attempting to distinguish between that type of arrearage and the kind that might arise if talks between the creditors and the authorities broke down and "involuntary" arrears were incurred. The staff had asked for the August 29 date for limiting purchases because the first purchase--which was due at the end of May--was covered by the standstill currently in effect. Recognizing that the authorities wished to finish their negotiations with their commercial bank creditors before end-August, the staff believed that withholding the first purchase under those circumstances would put undue pressure on the authorities while giving no more protection to the Fund.

The staff representative from the World Bank, remarking on the Bank's activities in Yugoslavia, observed that one structural adjustment loan had already been fully committed, and preliminary discussions toward a possible second loan were under way. If the Bank were indeed to proceed with a second loan, the aim would be to strengthen the adjustment already achieved in the areas of pricing, financial discipline, investment selection and allocation, and foreign trade and foreign exchange allocation.

As reported to the Bank's Executive Directors at the time of the requested authorization for the release of the second tranche of the first structural adjustment loan, progress in the above-mentioned areas had been somewhat uneven, the staff representative continued. Substantial progress had been achieved in the first two areas. Somewhat slower progress had occurred in investment selection, although considerable improvement had been registered in certain basic infrastructural sectors, particularly the power sector. Even less progress had taken place in the area of foreign trade and foreign exchange allocation, and the staff was awaiting the outcome of the current deliberations in Yugoslavia regarding possible reforms in the foreign exchange allocation system.

Mr. Templeman asked whether, if the Yugoslav authorities were unable to reach agreement with the banks by June 30 and the standstill were not extended beyond that date, the Fund's having approved a restriction on arrears until the end of the calendar year would be irrelevant in terms of compliance and, hence, could have no effect on the auhorities' ability to draw under the stand-by arrangement.

The staff representative from the European Department replied, first, that there were good grounds for believing that the standstill would continue at least through August 30. It was clear that the banks were in no mood to place any of the assets in question on a nonaccrual basis; a much sharper dispute between the banks and the authorities than currently existed would have to arise before any situation of the sort described by Mr. Templeman could occur. After all, the differences between the banks and the authorities had nothing to do with the provision of new money or even the amounts to be refinanced; they were related mainly to pricing, and the proposed limitation provided in her view an evenhanded treatment of all parties.

The staff representative from the Exchange and Trade Relations Department, in explaining the chosen procedures against the alternative "agreement in principle," recalled that the staff had looked carefully at the guidelines on "approval in principle" in considering how to proceed in the Yugoslav case. However, the staff had made an effort to choose a path that would not place undue pressure on either of the parties to the potential agreement. The guidelines on "approval in principle" specified that other alternatives should be exhausted before the "approval in principle" approach was recommended and also that the procedure should be used "in cases where it would assist the member in reaching agreement with its creditors" or where it would "stimulate to action" the parties to the financing agreements. In the Yugoslav case, no stimulation was necessary;

the banks and the authorities were already making an effort to find a solution to the problem. Since it was clear that the "approval in principle" should be disallowed after 30 days, the staff had decided not to put the authorities under such a short-term constraint to reach agreement. In passing, he noted that the procedures chosen were by no means unique: other members had come to the Fund with a financing gap, and the Board had approved new money for them even though agreement had not yet been reached with the creditors. Finally, Yugoslavia was further along toward agreement with its creditors than had been the other countries to which he had referred.

Mr. Wicks recalled that the "approval in principle" guidelines had been adopted as a way of avoiding the sometimes unsatisfactory precedent that had been established on the basis of the case-by-case approach in the past. Unfortunately, the Yugoslav case represented another "untidy" precedent. Moreover, when the Board had considered the "approval in principle" procedures, they had been seen as preferable to approval of an unfinanced program. In the Yugoslav case, the alternative had been not to put the matter before the Executive Board at all.

The staff representative from the Legal Department, recalling Mr. Polak's indication that the Yugoslav authorities found paragraph 4e of the proposed stand-by arrangement to be "unnecessary and inappropriate," remarked that the staff felt that the provision was important as a way of helping to protect the Fund's own resources and the integrity of the structure of the program. Although it was perhaps unclear how "satisfactory arrangements" would be defined, the very lack of precision in those words had been intended to provide a balance under which all parties concerned--Yugoslavia, the commercial banks and the Fund--would be protected. Under the proposed technique, the matter would have to be brought back to the Board for determination of whether or not satisfactory arrangements had been reached.

On the problem of payments arrears and the restriction giving rise to them, the staff representative emphasized that there was a difference in concept between the approval of a restriction for jurisdictional purposes and the elimination of the restriction or the nonperformance under a performance criterion within an arrangement. In the Yugoslav case, because there was a different definition of the restriction for jurisdictional purposes, it was possible for the Fund to find, either before or after August 29, that suitable arrangements for refinancing had taken place, yet there would still be a restriction for jurisdictional purposes that would continue until the payments arrears themselves were legally eliminated.

Mr. Templeman inquired whether, if neither standstill extension nor agreement with the banks were in place at, say, end-June, two kinds of arrears would be outstanding, and a problem would exist with respect to the "jurisdictional" arrears and a drawing under the stand-by arrangement.

The staff representative from the Legal Department replied that the situation referred to by Mr. Templeman would result in a continuation of the restriction, which would give rise to payments arrears. From that "legalistic" point of view, there would be no change in the situation in terms of the approval of the restriction. The determination of whether or not purchases under the stand-by arrangement might be prevented was dependent upon whether or not the relevant performance criteria were fulfilled.

Mr. Templeman observed that it might be awkward for the Fund to find itself in a situation in which it was continuing to approve a restriction even though the standstill had not been extended. He wondered whether approval of the restriction could be tied to the existence of the standstill in some way.

The staff representative from the Legal Department commented that it would be difficult to make a connection of the sort suggested by Mr. Templeman because there were different sorts of standstills operating at different times. More important, the policy on approval had to be set for some reasonably extended period to avoid the need to return to the Board too often for approval of a restriction.

Mr. Zhang asked how and when the inflation problem in Yugoslavia was expected to come to an end. He also wondered whether stabilization required a more active incomes policy and, if so, what its content should be. Was there pressure for a wage-price spiral?

The staff representative from the European Department observed that the data on changes in real income from employment showed that Yugoslavia was not faced with a wage-price spiral. Rather, inflation was originating from the change in relative prices that was being put in place in Yugoslavia and from the absence of competitive forces, a shortcoming exacerbated by the sharp curtailment of imports. There was of course no way of knowing when inflation in Yugoslavia would end and how inflation could be better controlled although the measures that the authorities had been considering and to which the staff had assigned priority--such as those curtailing the use of resources by loss-making enterprises--would play a role in helping to control it. The fact that growth was beginning to resume in Yugoslavia should also help considerably. Employment policies in Yugoslavia were such that during a cyclical downturn, falling demand was translated directly into falling productivity as employment was being maintained, and even expanded in line with the growth of the labor force. Therefore productivity increases associated with a resumption of growth would be even greater in Yugoslavia than in some other countries where labor markets were also relatively rigid.

Mr. Zecchini remarked that, while there was a clear need to neutralize the peaks of the inflation profile in order to assess the underlying trend of inflation in Yugoslavia, it was also clear that, to the extent that the staff made use of a long moving average for its calculation, the underlying trend of inflation would be less likely to be distorted by those peaks. Also, if the base for the calculation were shortened, the results might become more variable, and that variability could then be transmitted to interest rates. It would be useful to keep those points in mind in assessing past formulas used for the calculation.

As to the way in which the Fund measured the expected inflation rate for the two months that were included in the five-month moving average, Mr. Zecchini continued, he hoped that the staff had a very good model on which to base its projections so that there would be no confusion about whether the measurement of "expected" inflation reflected the staff's expectations or the authorities'.

The staff representative from the European Department replied that simply taking figures for one month over the same month in the preceding year did not provide an appropriate measure of the underlying trend of inflation. For that reason, the staff had proposed switching to a five-month moving average for measuring large current inflation. To assess expected inflation, the staff normally would look at the rates that investors demanded of borrowers, which tended to give a market sense of expected inflation, but that method of measurement was not available under the circumstances of Yugoslavia. Therefore, the staff could not define inflationary expectations very well, but it was not beyond people's ingenuity to project inflation a few months in advance. The authorities would have preferred for the staff to be far more ambitious regarding the period of projection and more optimistic regarding the rate of projected inflation, but the staff had resisted such an approach, which it felt was not warranted at a time when fundamental changes were occurring in the economy. Over the next several months, some undershooting or overshooting might occur; however, as noted in the report, such deviations could not persist for more than three months. In the previous year, when the real rate of return had been well below positive levels, the staff would not have wished to run that risk. At present, with a positive real rate of return, she did not feel that it was particularly dangerous to depart by small percentages on one side or the other of the trend line so long as the market was convinced that the policies adopted would continue to be pursued. Finally, in response to a question by the Chairman, she noted that the two-month projections agreed were the product of extensive discussions with the authorities, who had moved considerably toward the staff's way of thinking on those matters.

Mr. Goos wondered about the extent to which the current account projections could still be considered realistic, given the rather disappointing developments during the first three months of 1985. On another matter, he had been struck by the reference during the discussion to political constraints in Yugoslavia that could have prevented the adoption of more comprehensive structural adjustment policies or more explicit commitments by the authorities. He was concerned about the emphasis given by the staff to such constraints in Yugoslavia, since many countries could make a similar point; there were limits to how much the Fund could take into account political and social considerations in dealing with member countries.

The staff representative from the European Department agreed that results for the first quarter of 1985 were rather disappointing. The authorities had explained that, particularly in January and February, weather-related and other special factors had adversely affected performance; however, the March numbers on industrial output showed considerable recovery, and exports were responding favorably. In that respect, the authorities had not seen any reason to cast doubt on their ability to achieve the targets that they had set. The staff had no reason to question the authorities' explanation, although a much better sense of the Yugoslav situation would be gained during the midterm review.

With regard to Mr. Goos's second point, the staff representative agreed that the measures necessary to achieve the program targets must not be put aside because of political or other constraints. Still, the staff should be sensitive to those constraints and should shape solutions to fit the way in which the authorities themselves wished to solve their problems. In the Yugoslav case, in particular, it was felt that the staff's impact could be far more significant if the visibility of the staff were reduced. That was not to say that the staff was withdrawing from involvement in any area; it had simply chosen not to make certain matters part of the performance criteria.

The Chairman noted, in response to a question by Mr. Weitz, that the "approval in principle" procedure had been designed for use in exceptional cases for which alternative methods were not available or had been exhausted. It had been recognized that in order to minimize the use of the procedure, management and the staff should undertake intensive consultations with all creditors in order to seek reasonable assurances regarding the financing of the program. When those reasonable assurances had been obtained, outright approval of the program should continue to be the normal procedure.

Yugoslavia was not asking for any new money, the Chairman continued. Indeed, it had a sizable current account surplus, and the authorities were engaged in refinancing negotiations with the banks in respect of which there seemed to be a reasonable assurance that agreement would be reached. It was understood that there were no fundamental differences of view between Yugoslavia and the banks on either the amount or the terms of the refinancing, only on pricing.

Normally, when a country on the agenda had requested Paris Club rescheduling, the Board tended to opt for outright approval of the program without waiting for the results of the Paris Club meeting, assuming there were no unusual elements involved in the request, the Chairman noted. It would be difficult to justify taking a harsher line on Yugoslavia and waiting for the issue of pricing to be resolved before adopting a decision in the Board. Still, staff and management accepted that Directors might want some protection; hence, while putting forward the Yugoslav case for approval, the staff was recommending that the second drawing under the program should be subject to verification that the assumptions regarding a positive outcome to the negotiations between Yugoslavia and the commercial banks had indeed been realized.

Mr. Polak observed that nearly all of his colleagues had pointed to rigidities in the economy and inflation--and the links between them--as the country's two main problems. One cause of the recent inflationary experience in Yugoslavia had been the on-off price controls in the economy, which had often provided the opportunity to introduce successive price increases. Another element in the relationship between rigidities and inflation was the weak financial discipline of enterprises, a problem endemic to planned economies. It was difficult to resolve the situation through tight monetary control when a large proportion of the financial assets of the economy was expressed in foreign currencies and therefore rose automatically with changes in the exchange rate. The high price increases resulting from the on-off experience of price controls could be looked upon as precautionary, until enterprises found they could not make the prices hold. It was important in the circumstances for the financial discipline of enterprises to become sufficiently tight so that enterprises could not merely hang onto stocks by getting credit from one another or from the banks. Moreover, a sufficiently tight monetary policy would have to underpin the improvements in financial discipline. It was difficult to say in the circumstances of Yugoslavia what would define a sufficiently tight monetary policy. Of course, appropriately high interest rates would be a factor and, in that connection, the transition to positive real interest rates was important.

In remarking on the rigidities in the Yugoslav economy, nearly all speakers had mentioned the foreign exchange allocation system, Mr. Polak commented. The authorities had assured the staff that its views would be taken into account in time to contribute to a constructive debate in Parliament on the new law aimed at changing the foreign exchange allocation system.

He was grateful to Mr. Zhang and Mr. Sengupta for reminding the Board that liberalization must not be the primary objective of policy in socialist countries, Mr. Polak continued. In the Yugoslav case, however, he wondered whether all existing controls could be classified as serving some socialist purpose; indeed, he had the impression on occasion that the controls had led to the opposite result. For example, as the system currently worked, wage income in the socialized sector had been compressed, while the "free enterprise" sector seemed to be doing well, as those earning income in it were increasing consumption, being subject to very little taxation. In addition, the lack of financial discipline on enterprises served little economic purpose, as it permitted loss-making enterprises to remain in business at the expense of the rest of the community.

On the negotiations between Yugoslavia and the commercial banks, Mr. Polak observed, there were no fundamental outstanding differences between the two parties. The banks had been willing to agree to a four-year rescheduling arrangement, and all that remained to be resolved were the pricing issues. Finally, a number of Directors had wondered why the present arrangement incorporated fewer performance criteria than the previous one. In some respects, the reduction was a reaction to the concerns of the Executive Board with respect to the 1984 stand-by arrangement. On the other hand, it had been clear that some of the performance criteria attached to the program in 1984 had dealt with matters that were not of great importance.

The Chairman made the following summing up:

Directors noted the recent progress in adjusting the Yugoslav economy. They found it encouraging that the turnaround in the external accounts now appeared to rest on an improvement in export performance, underpinned by sectoral shifts of resources, and not only on restrictive demand management policies coupled with import restrictions. In this connection, they also noted the progress made in correcting relative prices for goods and services and the more appropriate pricing of money and foreign exchange.

Directors welcomed the continuing and growing commitment of the Yugoslav authorities to economic and financial stabilization and the major improvements in policy formulation in 1984. They also stressed the need to consolidate the progress made thus far in restoring external equilibrium and in laying the basis for sustainable economic growth. Moreover, Directors generally emphasized their serious concern about the disappointingly slow progress in tackling Yugoslavia's fundamental structural problems and the associated lack of success in reducing inflation.

While recognizing that the current high rate of inflation was in part a corollary to the correction of the long-repressed imbalances in the economy and to the lack of consistency of price policies in the past, Directors expressed concern that the underlying rate of inflation remained high and could put at risk the attainment of the program's objectives. In this context, however, Directors commended the broad liberalization of prices put into effect early in 1985 and urged the authorities to persist in their determination not to revert to price control; they regarded it as crucial that the price mechanism be allowed to exert its intended effect on resource allocation and on saving and investment decisions.

Directors emphasized the importance of removing structural impediments to help to moderate inflationary pressures and to increase the responsiveness of the economy to the signals emanating from the improved price structure. In that respect, the continued tightening of financial discipline was seen to be important, as was the federationwide accord on incomes policy that had the potential to strengthen the link between labor productivity and employment incomes, thus spurring worker motivation. However, those positive developments were thought to go only part of the way toward improving the responsiveness of the economy; Directors pointed to a lack of specificity in the Government's short-term policy program with regard to structural policies.

While acknowledging the social and political sensitivities involved, all Directors encouraged the Yugoslav authorities more resolutely to promote the unification of the markets for goods, capital, labor, and foreign exchange. They particularly singled out the problems raised in the foreign exchange allocation system. More generally, they urged forceful moves to put in place the reform measures embodied in the authorities' Long-Term Program of Economic Stabilization.

Directors emphasized the importance of keeping monetary and credit policies sufficiently tight to help to ease inflationary pressure and to prevent investible resources from being used inefficiently. They joined the staff in encouraging the authorities to err on the side of greater restraint in choosing among strategies that sought to balance a possible threat to real growth against the need to wind down inflation. Directors generally welcomed the authorities' attempts to broaden the scope of demand management instruments, particularly taxation of individuals. They urged that these steps be accelerated--particularly the taxation of interest income--and advocated the early introduction of a unified tax system with a progressive scale. With regard to the proposed new banking law, some Directors stated that its effectiveness in reducing the fragmentation of the financial markets was uncertain and that it fell short of stimulating the development of a full-fledged interbank market.

Directors underlined the major role that interest rate policy was playing and should continue to play in the overall stabilization policy. They welcomed the significant increases in nominal interest rates for dinar deposits that had resulted in interest rates that were positive in real terms--or nearly so--for most time deposits. They noted, however, that lending rates had lagged behind deposit rates significantly, and they welcomed the measures taken to increase the cost of funds to banks as well as the measures taken progressively to close the gap between preferential and market rates. Directors stressed the importance of achieving and maintaining positive real interest rates for credits as well as deposits and of ensuring that the dinar was competitive as a domestic savings and transactions instrument. In that regard, a prospective reduction of interest premia for one-year and two-year deposits, even if warranted in terms of the interest rate structure, would be cause for concern because of its negative impact on banks' cost of funds and, hence, on lending rates unless such a reduction were accompanied by offsetting measures.

Directors observed that the pursuit of an active exchange rate policy had been instrumental in bringing about the improvement in the external current account position. They urged the authorities to keep the exchange rate under close surveillance, given the continued need for high export growth over the medium term, but it was remarked that care should be taken to ensure that depreciation did not delay structural adjustment or substitute for demand management.

Noting the problems with the present foreign exchange allocation system, Directors urged the authorities to establish a more market-oriented distribution mechanism for allocating foreign exchange. They welcomed the authorities' plans for changes in this area and stressed that the Fund should be kept abreast of both the substance and timing of these changes in order to determine their appropriateness. They emphasized the need for full discussion of these matters between the staff and the authorities in time for inclusion of comments in the parliamentary process, and they noted the authorities' willingness to participate in such discussions.

Many Directors expressed concern at the delay in the reaching of agreement between the Yugoslav authorities and their commercial bank creditors to refinance the maturities falling due during the period of the stand-by arrangement. Given those concerns, some Directors expressed a preference for approving the proposed stand-by arrangement only in principle until an appropriate agreement on refinancing eliminated the possibility that a financing gap might open up during the period of the stand-by arrangement. However, these Directors and others were satisfied that the time up to the second purchase under the stand-by arrangement should normally be ample for the authorities to reach agreement on refinancing arrangements with the commercial banks and that the safeguard provided by the new paragraph 4e of the stand-by arrangement was sufficient to protect the financial soundness of that arrangement against the contingency of nonagreement. It should be noted in this regard that the language at the top of page 3 of EBS/85/85, Supplement 1, should not be read differently from the draft text of paragraph 4e, the latter being the operative text from a legal point of view.

A number of Directors stressed the importance of a continued and improved policy of adjustment in Yugoslavia over the coming years. The modalities of further collaboration by the Fund would be determined in the light of circumstances.

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

The Executive Board then adopted the following decisions:

1984 Article XIV Consultation

1. The Fund takes this decision in relation to Yugoslavia's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1984 Article XIV consultation with Yugoslavia, in the light of the 1984 Article IV consultation with Yugoslavia conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Yugoslavia continues to maintain restrictions on the making of payments and transfers for current international transactions in accordance with Article XIV. In addition, Yugoslavia maintains a restriction on the availability of foreign exchange for travel as described in EBS/85/85 (4/1/85). In the circumstances of Yugoslavia, the Fund grants approval of this exchange restriction until the completion of the next Article IV consultation or April 30, 1986, whichever is earlier. The Fund also notes the existence of an exchange restriction giving rise to external payments arrears. In the circumstances of Yugoslavia, the Fund grants approval of this restriction until December 31, 1985.

Decision No. 7960-(85/66), adopted
April 29, 1985

Stand-by Arrangement

1. The Government of Yugoslavia has requested a stand-by arrangement for a period of one year beginning May 16, 1985 in an amount equivalent to SDR 300 million.

2. The Fund approves the stand-by arrangement set forth in EBS/85/85, Supplement 3 (5/1/85).

3. The Fund waives the limitation in Article V, Section 3(b)(iii) of the Articles of Agreement.

Decision No. 7961-(85/66), adopted
April 29, 1985

Waiver of Performance Criterion Under 1984 Stand-by Arrangement

1. Yugoslavia has consulted with the Fund in accordance with paragraph 4 of the stand-by arrangement for Yugoslavia (EBS/84/65, Sup. 1, 4/19/84) and paragraph 24 of the letter dated March 20, 1984 from the Governor of the National Bank of Yugoslavia and the Federal Secretary for Finance of Yugoslavia attached thereto.

2. The letter dated March 18, 1985 from the Governor of the National Bank of Yugoslavia and the Federal Secretary for Finance of Yugoslavia shall be attached to the stand-by arrangement for Yugoslavia, and the letter dated March 20, 1984, attached to the stand-by arrangement, shall be read as supplemented and modified by the letter of March 18, 1985.

3. The Fund finds, in the light of the letter dated March 18, 1985, that no additional understandings are necessary concerning the nonobservance of the performance criterion relating to the intention regarding the adjustment of interest rates referred to in paragraph 4d of the stand-by arrangement, and that Yugoslavia may proceed to make purchases under the stand-by arrangement.

Decision No. 7962-(85/66), adopted
April 29, 1985

2. MALTA - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with Malta (SM/85/99, 4/5/85; and Cor. 1, 4/24/85). They also had before them a report on recent economic developments in Malta (SM/85/106, 4/15/85; and Cor. 1, 4/24/85).

Mr. Zecchini made the following statement:

The year 1984 was one of gradual recovery for the Maltese economy, with GDP at market prices increasing by 1.5 percent after a decline of 0.6 percent in 1983. The increase was achieved in a context of continuing price restraint and strong export performance. Domestic prices, as measured by the retail price index, showed a decrease of 0.5 percent, following a decline of 0.9 percent in 1983. The deficit in the external trade balance, a structural feature of the development of this economy in past years, has been contained at the lowest level since the beginning of the 1980s as a consequence of a steep rise in the volume of exports by 13 percent in 1984. Coupled with a continuing surplus in the invisibles account, the containment of the external trade balance led to a shift in the current account position, which turned to a surplus of 0.1 percent of GDP from a deficit of 0.4 percent in 1983. The overall balance of payments also registered a surplus reflected in a further increase in official reserves, which are now equal to more than 18 months' imports. These positive achievements resulted not only from improved conditions in the world economy but also from the consistency of the policies pursued by the Maltese authorities, who have been able to dispel uncertainties about the future course of their policy action. In particular, firm control on wages, prices, and, to some extent, profits have been maintained for the second year in a row and has been accompanied by a cautious stance in fiscal, monetary, and real exchange rate policies.

Notwithstanding these achievements, unemployment remains a major problem. Economic recovery has not brought about an increase in the number of job opportunities sufficient to reduce the unemployment rate significantly below the 9 percent figure recorded in 1983. Furthermore, export performance still needs to be strengthened, both in terms of a more diversified geographical and item composition and in terms of enhanced external competitiveness.

In view of the overriding priority given to the need to alleviate the unemployment problem, Malta's main policy objectives for 1985 are both to preserve the momentum of the economic recovery and to reinforce the basis of the recovery. This will entail revitalizing the demand for investment in fixed capital after its stagnation in the last year and enlarging Malta's market share in world trade. To this end, the Maltese authorities aim at an appropriate combination of all policy instruments that have been used since 1982, including incomes, employment, fiscal, monetary, and exchange rate policies.

Incomes and employment policies

The wage freeze and the price controls introduced at the beginning of 1983 proved to be successful in fostering a gradual and steady approach to adjustment in a context of abated inflationary expectations and broad social consensus. In the past two years, prices outside public control have also showed a remarkable stability, and real average wages per employee decelerated significantly compared with 1981-82, moving basically in line with the overall cost-price dynamics. As a complement to wage-price controls, the Maltese authorities introduced profit controls and pursued a policy of stability in the real effective exchange rate. Profit controls nevertheless do not apply to all the sectors of the economy and have not actually prevented some rises in overall profits. The authorities do not consider this system of direct controls a permanent one since, in the longer run, it could propagate distortions and rigidities within the fabric of the economy, resulting in adverse consequences for the efficiency and the competitiveness of the economic system. However, they do see some clear advantages in keeping these controls for a limited period and thus decided to maintain them for the current year. Moreover, while the various regulations and restraints on private business may appear restrictive, they are in fact applied with substantial flexibility.

Malta's approach to adjustment has not ensured a prompt relief from the unemployment problem, which has characteristics similar to those present in the rest of Europe and, as in other European countries, cannot be alleviated by resorting to simplistic, quick measures. In order to support employment creation, the Government has allocated 1 million liri in its 1985 budget estimates to finance a new employment incentive scheme; it provides for reductions in taxes payable by existing firms that employ additional workers or a 10 percent subsidy on wages for the first six months of employment in new enterprises or productive units.

Fiscal policy

A major objective of fiscal policy for 1984 was to check the expansion of current expenditure while supporting capital expenditure along the lines specified in the development plan, thus contributing to the strengthening of the industrial base and, consequently, to the growth of export sectors and the creation of new employment opportunities. Although the objectives on the expenditure side were basically achieved, the fiscal deficit rose from the equivalent of 2.4 percent of GNP in 1983 to 3.2 percent in 1984. The main reason for the increase was the fall in tax revenues, reflecting a temporary decline both in income tax receipts--due to the price-wage freeze--and in import duty receipts. This shortfall has not been fully offset by the growth of nontax revenues; however, after adjusting the fiscal deficit for the impact of the business cycle, it is apparent that the fiscal impulse continued to be contractionary in 1984, although less so than in 1983. The same policy stance is planned for the current year, with particular attention paid to improving tax administration and with no aggravation of the tax burden on incomes.

In 1985, current expenditures will be kept at their 1984 level, while greater efforts will be made to help enlarge the country's capital base. Government capital expenditure net of lending is expected to rise by 14 percent, passing from Lm 37.4 million in 1984 to Lm 42.7 million in 1985. Due to the expected increases in revenues, the government deficit should be reduced in 1985 to 1.1 percent of GNP. Overall, fiscal policy has not recently exerted and will not exert a strong stimulus on the economy, as a more expansionary stance is not thought desirable given the consequences that it might have on the current account position of the balance of payments.

Monetary policy

The design and the conduct of monetary policy have been in line with the need to support the development projects of the country in a context of monetary stability. In view of this objective, extensive use has been made of selective credit guidelines and moral suasion. Even though banks and financial institutions are free to decide the composition of their asset portfolio, they have been discouraged from overexpanding credit to some sectors like textiles, tourism, and real estate. Credit policy continued to channel funds into priority sectors, in particular those with higher value-added content and those applying new technologies. With regard to monetary aggregates, the growth of the narrow money supply was kept below 2 percent in 1984. The higher increase recorded in the broader definition of money is due not only to the domestic credit expansion but also to statistical causes, i.e., the closure of the Government Savings Bank and the transfer of its deposit liabilities to the commercial banks. Among the sources of the increase in broad money, the Posterity Fund, which is financed mainly by drawing on the profits of the Central Bank, has not played any significant role, even though it has begun financing a large infrastructural project. The stability, if not the decline, of the price level in a context of constant nominal interest rates has resulted in real rates' reaching relatively high, positive levels. After taking into account the high elasticity of money demand to changes in nominal interest rates, the monetary authorities have refrained from allowing for a lowering of nominal interest rates to stimulate fixed investment demand. They might consider the advantages of a more flexible interest rate policy in the future, even though they see limited room for a more active role for monetary policy.

Exchange rate policy

An indispensable corollary of the anti-inflationary strategy based on incomes policy and a price freeze is an exchange policy designed to stem external inflationary pressures. Malta is a small, open economy that depends heavily on imports both for the domestic market and for the export sectors. Given the relatively low price elasticity of the demand for imports, any inflationary stimulus coming from abroad--in the absence of an incomes policy--would easily find a way into higher domestic prices and requests for increased nominal wages, which would be very difficult to resist. The result would presumably be a worsening in the current account balance. By the same token, a move to depreciate the nominal exchange rate is likely to have only a temporary, beneficial impact on competitiveness because it would trigger a pricewage spiral that would eventually bring the real effective exchange rate back to its initial point. As an additional negative consequence, the economy would be left in the difficult position of having to grapple with the consequences of the loss in price stability.

In the light of these considerations, in the past two years the Maltese authorities have accepted the nominal appreciation deriving from the pegging of the lira to a basket where strong currencies are heavily represented. At the same time, they have aimed at a price performance much better than in Malta's trading partners. In this way, they have succeeded in stabilizing the real exchange rate at a level close to the one prevailing in 1983.

If any attempt to improve cost competitiveness by a nominal depreciation is neutralized by downward rigidities in real wages, a similar improvement could be better attained by a gradual approach aimed at maintaining real wage growth below productivity gains. An improvement could also come from a depreciation of the nominal effective rate resulting from outside factors, i.e., a fall of the dollar rate with respect to the European currencies included in the basket to which the lira is pegged. In such a case, it would appear less difficult to win the social acceptance of wage restraint that is necessary for a lasting improvement in competitiveness.

Commercial policy

Commercial policy has recently come into question. The Maltese authorities remain committed to adhering to the system of free trade and multilateral payments as embodied in Article I of the Articles of Agreement. Trade policy is currently emphasizing export promotion and import substitution. The restrictions currently in place are considered a temporary stopgap means to deal with the economy's vulnerability resulting from its smallness, its heavy dependence on essential imports, and its limited capacity to penetrate foreign markets with its narrow range of exportable items. Moreover, in the opinion of the Maltese authorities, the extent of current restrictions should not be overstated. Current reciprocal trade agreements apply only to about 6 percent of total trade. They are not barter arrangements but forms of periodic settlement arrangements on a bilateral basis. Their usefulness in a temporary time frame must also be considered in the light of two elements. First, imports covered by these agreements consist of raw materials, oil, and industrial inputs that would have had to be imported in any event. Second, there is no guarantee for Malta that exports will be accepted in return even if they are not competitive. In all cases, trade takes place on a commercial basis, and goods imported or exported must be competitive both in quality and prices. In the case of agreements with non-Fund members, these arrangements make it easier for Maltese goods to have access to new markets that are tightly controlled. Furthermore, trade with the Union of Soviet Socialist Republics is carried out on a strict cash basis. As to the restrictions on imports from Italy, the Maltese authorities stress that these are limited in extent and temporary in nature. They hope that an agreement to eliminate these restrictions will be reached soon.

Mr. Clark, endorsing the staff's analysis and main recommendations, observed that notable successes in economic performance had been achieved in the short term, particularly with respect to inflation. However, those successes had to some extent been attained through the use of controls and restrictions on wages and other areas of the labor market as well as on prices, profits, imports, and credit. As others had noted during the previous consultation discussion, such controls could not be a lasting solution to the economic problems faced by Malta because, in the long run, they tended to distort the distribution of resources and reduce efficiency. He thus joined the staff in urging the authorities to work toward dismantling the restrictions at the earliest opportunity.

On the immediate problems facing the economy, Mr. Clark observed, the high unemployment rate and the weakening external position could both be alleviated to some degree through a more competitive exchange rate. Conversely, he agreed with the staff that those problems might well be exacerbated by the authorities' current gradualist approach. Since the issuance of the staff report, a substantial appreciation of the dollar had taken place, and he would be grateful for any comment by the staff on the effects of that appreciation. More generally, and without jeopardizing any improvement in competitiveness, the authorities should adjust the weights in the currency basket to reflect more accurately the composition of Malta's trade, including tourism. In passing, he noted the acknowledgment by the authorities that their bilateral trading arrangements were merely a stopgap measure and not a substitute for more fundamental reforms. He urged them to view the more general import restrictions in the same light, namely, as another symptom of an overvalued exchange rate.

On the monetary side, Mr. Clark indicated his agreement with those who felt that the current high real interest rates might be damaging to productive investment. If it was true that any lowering of interest rates would have to be matched by reinforced controls on capital flows, that requirement raised further questions about the appropriateness of the exchange rate. On the fiscal side, the authorities should make an effort to present the Government's accounts on a consolidated basis, in order that the overall effect of government activities could be assessed.

He was disappointed at the lack of statistical tables in the staff paper, Mr. Clark commented. It was often easier to see the trend of developments in an economy when data were presented in tabular form; on a more practical level, it was difficult for his authorities to comment on staff papers without having the necessary statistics. Unfortunately, papers on recent economic developments were often not available until some time after the issuance of the staff reports. On the Maltese paper in particular, he would have welcomed an effort by the staff to present some medium-term projections, particularly given the uncertainty surrounding important aspects of Malta's external position. Finally, on a more technical point, he observed that Chart 5 in Appendix II of SM/85/106 seemed to present a successful explanation of movements in Malta's international reserves. However, while the corresponding equation seemed to be estimated on the basis of changes in real reserves, the chart was plotted in terms of, and on the basis of, the actual rather than estimated real reserve level for the previous period. In that respect, the chart was somewhat misleading. For example, according to the chart, real reserves had risen by some Lm 300 million over the 15 years covered by the chart, which gave an average increase of about Lm 5 million per quarter. However, equation (5)--on which the chart was based--had a standard error of 14.4, roughly three times as large as the mean change in the variable being explained. He would welcome staff comment on that point.

Mr. Finaish observed that, because of the smallness of the economy and its outward orientation, economic performance and policy choices in Malta were heavily influenced by exogenous developments. For example, the international recession of the early 1980s had had a significant negative effect on the economy, and policy priorities had been shifted accordingly in order to improve competitiveness, stabilize prices, and aid employment. Notwithstanding the staff's reservations regarding the nonmarket policy measures adopted by the authorities, some successes had already been achieved in 1984. Positive rates of growth of real GDP and domestic demand had been restored, while the price level had declined further. In addition, the growth in the volume of merchandise exports had exceeded export market growth, and the external position had remained satisfactory. Nonetheless, some weaknesses persisted in business fixed investment, employment, and external competitiveness.

The policy strategy adopted by the Maltese authorities to mitigate the consequences of the recession used a gradual approach and increased government control, Mr. Finaish commented. The main elements of their strategy were a wage-price freeze accompanied by profit controls and emphasis on trade reciprocity and supportive financial policies. In appraising the Government's strategy, it was important to take into account the authorities' assessment of what was economically feasible and acceptable in Malta's circumstances. Such an approach could lead to the conclusion that, while a prolonged departure from the free-market mechanism carried the risk of distorting the efficient allocation of resources, government control and guidance during a particularly difficult period of adjustment could be useful.

The authorities' gradual approach to reducing competitiveness had employed a wage-price freeze and stable exchange rates to contain real wage growth below productivity growth and to shelter the economy against imported inflation, Mr. Finaish observed. The authorities' concern that a discretionary evaluation could lead to a wage-price spiral and, hence, to no significant improvement in competitiveness was understandable in view of the heavy reliance of the Maltese economy on imports and the high import content of its exports. Moreover, trade reciprocity had helped Malta's exports to penetrate new markets at a time when protectionist measures were on the rise and when the "infant" Maltese industrial enterprises lacked extensive experience in marketing abroad. Nonetheless, the authorities regarded both the wage-price freeze and trade reciprocity as only temporary means of improving export performance.

The overall stance of the financial policies pursued in Malta was consistent with the authorities' record of good economic management, Mr. Finaish said. Fiscal policy had been directed toward supporting the ongoing external adjustment, while monetary policy continued to emphasize long-term development objectives. The small increase in the fiscal deficit in 1984 as a percentage of GNP had not altered the contractionary stance of the cyclically adjusted fiscal impulse. Furthermore, although the authorities continued to rely on foreign financing of the fiscal deficit, they had restricted borrowing to loans with interest rates not exceeding 3 percent in order to avoid balance of payments difficulties. The authorities had also remained cautious in the use of monetary policy for economic stabilization, and they continued to use selective controls to allocate credit in accordance with development priorities. The maintenance of the structure of nominal interest rates, together with the decline in the price level, had given rise to relatively high real interest rates, which might have been partly responsible for the weak performance of fixed investment.

In the circumstances, Mr. Finaish concluded, monetary policy could perhaps play a more active role in support of the stated adjustment and development objectives of the authorities. In that regard, he had noted from Mr. Zecchini's statement that the authorities might consider the advantages of a more flexible interest rate policy in the future, even though they saw limited room for a more active role for monetary policy. Finally, while the medium-term prospects for the Maltese economy were generally satisfactory and a continuation of the recovery was likely, the authorities might find it necessary to reassess the effectiveness of their present gradual policy approach with a view to speeding up the restoration of external competitiveness, the reduction in unemployment, and the general policy responsiveness to external developments.

Mr. Pérez remarked that, since he was in broad agreement with the staff appraisal, he would focus on what he viewed as the main problem in the current stance of Malta's economic policy, namely, the inadequate position of the exchange rate of the lira. It was clear from the staff report that Malta was suffering from a lack of competitiveness that implied a threat to the authorities' employment goals. In view of the openness of the economy, the reluctance of the authorities to use exchange rate depreciation to improve Malta's competitive position was understandable. Still, the inadequate composition of the currency basket vis-à-vis the actual pattern of trade demanded some action by the authorities. The strategy that they had been following since 1983 in order to restore competitiveness had produced, in his view, uncertain results and had made it difficult for the authorities to reach the employment target. The uncertainties arose because the attainment of a positive margin between real wages and productivity could be offset through the revaluation of currencies represented in the basket, whose proportion, in relation to the external flow of goods and services, was inadequate. The strategy made attainment of the employment targets difficult because any appreciation in those currencies heavily represented in the basket would have to be compensated through an increase in productivity perhaps higher than that achieved by freezing prices and wages, and any such appreciation could thus bring about a loss of employment. Moreover, persistence in the current price policy could lead to serious distortions, including undesirable consequences for employment in the long run. Finally, he welcomed the authorities' decision not to renew in 1985 the multicurrency practice implemented in the tourist sector during 1983 and 1984. With an appropriate exchange rate policy, that practice would not have been required in the first place; he hoped that it would be avoided in future.

Mr. Grosche stated that he was in broad agreement with the staff analysis and recommendations and could support the proposed decision. Given the serious problems to which Malta's economy had been exposed in the early 1980s, he welcomed the shift in economic priorities that had occurred in 1983-84. Apparently, that shift had already led to tangible improvements in prices and toward stabilization in the external account, although questions had been raised about the longer-run sustainability of those improvements. For example, the wage and price freeze implemented by the authorities, together with the control of profits, had been aimed mainly at the symptoms of inflation and had not addressed its underlying causes. Similarly, trade policies that relied on bilateral agreement might be useful in the short run, but they unavoidably would create distortions in the longer run. Accordingly, his authorities strongly recommended an early return to more market-oriented policies accompanied by appropriately restrictive demand management policies aimed at containing the upward pressure on inflation that was to be expected as a result of decontrol. Such an approach would greatly facilitate the task of maintaining international competitiveness while avoiding the severe drawbacks of the current policy stance.

Fiscal policy in 1984 had apparently been supportive of the adjustment process, although less than in 1983, Mr. Grosche noted. He was concerned that the assessment of the policy stance was being hampered by what appeared to be a considerable shift of expenses out of the regular budget; in the circumstances, he strongly supported the staff's suggestion that the national accounts should continue to be handled on a consolidated basis.

An appropriate assessment of Malta's monetary policy stance was complicated by conflicting evidence, Mr. Grosche observed. Although real interest rates were positive and relatively high--mainly as a result of the price freeze--the velocity of money had declined sharply since 1981-82, suggesting an oversupply of money. Perhaps a more restrictive stance was necessary to avoid inflationary pressures. In any event, greater monetary restraint would appear to be necessary as a precautionary move aimed at avoiding an inflationary spiral that might result from a sizable appreciation of the dollar or a substantial relaxation of price controls. Another feature of monetary policy giving rise to concern was the use of selective credit controls. In his view, monetary policy was a global instrument; if used for particular sectoral purposes, it was bound to create distortions and might reduce the overall effectiveness of the policy.

On the external side, the staff's arguments in favor of pegging the lira to a trade-weighted basket were convincing, Mr. Grosche remarked. The high rate of the dollar and the yen in the existing basket had led to a strong appreciation of the lira and significant fluctuations in the exchange rate. In view of the restrictiveness of the exchange and trade system, his recommendation was for a more flexible exchange rate policy, which need not lead to a wage-price spiral; if accompanied by appropriate macroeconomic policies, a flexible exchange rate policy could facilitate the task of improving and maintaining the strength of international competitiveness and could thus help the authorities to meet their objective of reducing unemployment.

Of particular concern was the increasing recourse by the authorities to exchange and trade restrictions, Mr. Grosche commented. While in general agreement with the staff's assessment of those restrictions, he was uncertain how the trade arrangement operated. In particular, he had been puzzled by the indications that the arrangement focused mainly on primary products that would have been imported in any event by Malta and that there was no guarantee for Malta that its exports would be accepted in turn. In that respect, he failed to understand the rationale of the arrangement and would welcome some further explanations by Mr. Zecchini or the staff. His authorities were also concerned about the existing trade restrictions directed against Italy and Japan, which constituted discriminatory trade practices. Early removal of those restrictions would certainly be welcome. More generally, because there was no plan for early elimination of the restrictions, he could support the proposed decision not to approve them.

The staff representative from the European Department noted that it was still too early to measure the effects on Malta of the depreciation of the dollar. It was also difficult to provide any projections for the Maltese economy over the medium term. Even short-term forecasts for 1985 were complicated by the authorities' reluctance to make estimates. On other matters raised by Mr. Clark, additional data in tabular form were available in the paper on recent economic developments in Malta. Questions on Chart 5 in Appendix II of SM/85/106 might more efficiently be answered on a bilateral basis.

One of the advantages for Malta of reciprocal trade agreements was that the authorities would obtain the right of the first bid for an export contract, and they could use the imports of raw materials and semifinished products as a bargaining chip in negotiations on the export contract, the staff representative commented. Of course, the exports had to be competitive, but the agreement was a first step toward opening up new markets for Malta.

On monetary policy, the staff representative recalled, Mr. Grosche had asked whether greater monetary restraint might be necessary, given the excess liquidity in the economy, a condition prevalent in most sectors. High liquidity in the nonbank public sector was a reflection of the lack of a securities market and the inability to invest abroad. At the moment, there was no sign that the excess liquidity in the economy would be used; credit demand was sluggish, and the staff agreed with the authorities that there was no reason for tightening monetary policy. In a discussion of the matter, the authorities had pointed out to the staff that they preferred to use other means--namely, incomes and fiscal policy--in order to achieve their goals. In the circumstances, prospects for moving toward a tighter monetary policy were limited.

Mr. Zecchini, adding to his earlier explanation of exchange rate policy in Malta, remarked that it was important to make comparisons between the past two years and the previous two-year period in terms of inflation and growth. Assuming that Malta had decided to pursue an incomes policy affecting wages, salaries, prices, and profits, there was little room for allowing external inflationary pressures to upset the design of those policies. It was difficult in Malta to achieve a social consensus for reducing real wages, a factor that was crucial in assessing the ability of exchange rate policy to improve external competitiveness on a lasting basis.

As to comments on the oversupply of money in Malta, Mr. Zecchini noted, to some extent, statistical factors had altered the validity of annual changes. Moreover, it was important to make a distinction between narrow money and broad money before examining any link between monetary measures and inflation. As he had noted earlier, the large increase in broad money could be explained to a great extent by the closure of the Government Savings Bank and the absorption of its deposits by the commercial banks, a development that could also explain the change in the velocity of money. It was still too early to draw any firm conclusions for the medium term from those developments.

In his opening statement, he had attempted to explain Malta's bilateral trade agreements, Mr. Zecchini commented. While those explanations perhaps did not give a full answer to some of the questions that had been raised by his colleagues, they certainly clarified the way in which his Maltese authorities looked at the problem. The authorities stressed, first, the vulnerability of the Maltese economy based on its smallness, its heavy dependence on essential imports, and its limited capacity to penetrate foreign markets with only a narrow range of exportable items. Second, many of the countries involved in the bilateral agreements were not Fund members. Those countries followed a course of action for economic management in which their markets were tightly controlled; hence, as the staff had noted, the bilateral agreements were a means of opening more tightly controlled markets. In that respect, it was too soon to characterize those agreements as creating significant distortions in the external accounts, particularly as they applied to only about 6 percent of all trade. Finally, on the proposed decision concluding the 1985 Article XIV consultation with Malta, his authorities were troubled by the words "and to adopt a liberal system of payments and transfers for current international transactions," which seemed to convey the inaccurate impression that Malta did not have a liberal system of payments and transfers. He would propose changing the final sentence of the decision to read: "The Fund encourages Malta to eliminate these restrictions as soon as possible and to adhere more strictly thereafter to a liberal system of payments and transfers for current international transactions."

The Chairman made the following summing up:

Directors noted that Malta had relied since early 1983 on a wage-price freeze, supported by anti-inflationary measures and tight fiscal policies, in response to a loss of competitiveness. These measures resulted in a small decline in prices and kept the growth in real wages below the underlying growth in productivity in 1983-84. Directors noted that, at the same time, there had been a large nominal effective appreciation of the Maltese lira and thought that this development limited the desired improvement in competitiveness and the rise in employment.

Directors took note of Malta's restrained fiscal policy in 1983-84, which was consistent with the emphasis on external adjustment and on price stabilization. They felt, however, that a comprehensive assessment of fiscal policy required the integration of extrabudgetary operations into the budget figures and their presentation on a consolidated basis. Directors observed that monetary policy had also tended to restrain domestic demand with the emergence of relatively high positive real interest rates.

While commending the authorities on the short-term results of the policies followed in 1983-84, a number of Directors noted that government action had concentrated more on the symptoms than on the causes of the weaknesses in Malta's economy.

The improvement of competitiveness was considered important because of the unemployment problem and because of concerns about the level of transfer receipts from abroad in the medium term. In that context, Directors noted the lack of information on the medium-term prospects of the economy.

Directors felt that the gradual approach to improving competitiveness might well have several drawbacks: a possibly permanent loss of market shares in traditional export markets, the damage done to the allocative function of prices by a price freeze maintained over a long period, and the postponement of a return to full employment. However, greater reliance on administrative intervention in the economy might have been inimical to business investment.

Directors encouraged the Maltese authorities to re-examine the appropriateness of the composition of the currency basket so that it better reflected the pattern of Malta's external commercial relations. They also noted with concern that Malta had in the recent past intensified the restrictiveness of its exchange and trade system, and they encouraged Malta to eliminate the restrictions as soon as possible.

It is expected that the next Article IV consultation with Malta will be held on an 18-month cycle.

The Executive Directors then turned to the proposed decision, which it adopted with the change recommended by Mr. Zecchini.

The decision was:

1. The Fund takes this decision in concluding the 1985 Article XIV consultation with Malta, in the light of the 1985 Article IV consultation conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes that Malta has in the recent past added several restrictions on payments and transfers for current international transactions including restrictions arising from a bilateral payments arrangement with a Fund member. The Fund encourages Malta to eliminate these restrictions as soon as possible and to adhere thereafter more strictly to a liberal system of payments and transfers for current international transactions.

Decision No. 7963-(85/66), adopted
April 29, 1985

3. NICARAGUA - SETTLEMENT OF FINANCIAL OBLIGATIONS TO THE FUND

The Executive Directors considered a staff paper and proposed decision on the settlement of Nicaragua's financial obligations to the Fund (EBS/85/105, Sup. 1, 4/26/85).

Mr. Pérez made the following statement:

I am pleased to inform the Executive Board that my Nicaraguan authorities have sent instructions today discharging all overdue obligations to the Fund, including quarterly charges and net SDR charges. With this payment, Nicaragua becomes fully current with the Fund and wholly restores normal relations with this institution.

Nicaragua's overdue obligations with the Fund have long been outstanding. On several occasions, my authorities and I have clearly and fully explained Nicaragua's special circumstances and the difficulties that the authorities have had in discharging those obligations, even though they had intended to do so at an earlier date. Throughout the whole period, however, the authorities have remained committed to settling their obligations to the Fund as rapidly as possible, and significant progress was made even before this date. Today's payment clearly underscores the positive results that can be obtained through a flexible handling of these matters, taking into consideration the particular circumstances in each case.

My authorities have instructed me to remark on their appreciation for the helpful efforts made by the Managing Director and the Fund staff in this regard. My authorities remain committed to strengthening further Nicaragua's relations with the Fund.

During our most recent Article IV consultation with Nicaragua on March 4, we indicated that the authorities, fully aware of the need for redressment, have adopted, since the beginning of 1985, a set of comprehensive measures in the fiscal, monetary, and external sectors to pave the way for a reduction of financial imbalances facing the Nicaraguan economy. Since that time, important new stabilization measures have been adopted, especially corrective price increases in public services and essential commodities, further reducing or eliminating government subsidies. Among such increases, gasoline prices have more than doubled, and diesel prices have virtually tripled; telephone, water, and electricity rates have increased by more than 100 percent. Urban transportation rates have also recently tripled, and the prices of essential foodstuffs have increased substantially. Wages, on the other hand, have lagged well behind in real terms.

As significant as those measures are, the Nicaraguan authorities consider that this is only the beginning in a series of adjustments that must be made before equilibrium is restored. The Fund's counsel in this regard has been important, and the Nicaraguan authorities would like to strengthen consultations with the Fund even more in the future. As we have stated before, my authorities value the Fund's advice highly and would like to have an evaluation of their adjustment program. In order to see what corrections could be introduced to strengthen the adjustment effort, the authorities will continue to cooperate with the Fund in finding appropriate solutions to their balance of payments problems.

Mr. Grosche said that he was pleased to note that Nicaragua had been able to settle its outstanding obligations to the Fund and welcomed the indication by Mr. Pérez that the authorities remained committed to restoring and strengthening Nicaragua's relations with the Fund, a commitment that had already prompted them to take comprehensive measures aimed at achieving balance of payments equilibrium. The payment by Nicaragua of its overdue obligations provided a clear indication that the existing procedures for handling such obligations were effective and should be continued.

Mr. Suraisry remarked that he too was pleased that Nicaragua had fulfilled its financial obligations to the Fund, and he welcomed the authorities' intention to strengthen the adjustment process and to deal with imbalances in the economy. As Nicaragua was current in its obligations to the Fund, the authorities were in a position to benefit from the Fund's expertise and assistance in the adjustment effort. Expressing the hope that Nicaragua's action would set an example for other countries in arrears to the Fund, he supported the proposed decision.

Mr. Hospedales commented that his authorities were also pleased that Nicaragua had fulfilled its financial obligations to the Fund and that normal relations between Nicaragua and the institution had been re-established. The Nicaraguan economy was undergoing stress, and he looked forward to positive results from the adjustment program being implemented. In that regard, he was encouraged to note that the authorities would be following the Fund's advice and guidance in evaluating their current adjustment program with a view to strengthening the adjustment effort in the years ahead.

Mr. Templeman welcomed the settlement by Nicaragua of its overdue financial obligations to the Fund, an action that was necessary for Nicaragua's continued proper relationship with the institution, for the integrity of the Fund's financial position, and for the Fund's own credibility vis-à-vis the outside world.

Mr. Finaish said that he too welcomed the settlement by Nicaragua of its financial obligations to the Fund. The fact that the authorities had been able to discharge their obligations at a time when the difficulties facing the country had been growing was a reflection on the priority attached to the maintenance of good relations with the Fund. It was to be hoped that the Fund would be in a better position to engage in constructive discussions with the authorities on the actions and policies necessary to avoid a recurrence of overdue obligations in the future and, more broadly, to place the economy on a more viable course.

In the proposed decision, Mr. Finaish inquired whether paragraph 2 was necessary; as he understood it, the limitation on Nicaragua's use of the general resources of the Fund was automatically terminated upon the settlement by Nicaragua of its obligations. Perhaps paragraph 2 should be changed to read:

> The Fund notes that, as Nicaragua became current in its obligations to the Fund on April 26, 1985, the limitation on Nicaragua's use of Fund resources was terminated as of that date.

Mr. Polak stated that, like others, he was happy that Nicaragua had discharged its overdue financial obligations to the Fund. The Nicaraguan case confirmed that the approach that the Fund had been taking to overdue obligations was essentially correct and should be maintained. Nicaragua's desire to avail itself of the Fund's advice in connection with its adjustment program deserved commendation, and the Fund should make an effort to respond to any request for an evaluation of the adjustment program that Nicaragua might make. In conclusion, he could support the proposed decision as amended along the lines suggested by Mr. Finaish.

Mr. Fugmann remarked that the welcome fulfillment by Nicaragua of its overdue obligations to the Fund was important for the country itself and as an example for others with overdue obligations to the Fund. It was to be hoped that the normalization of relations between the Fund and Nicaragua would pave the way for Fund assistance to Nicaragua in its economic adjustment efforts.

Mr. Joyce, Mr. Mtei, Mr. Zecchini, Mr. Jayawardena, Mr. Kabbaj, Mr. Romuáldez, Mr. Ercel, Mr. Obame, and Mr. Weitz welcomed the settlement by Nicaragua of its overdue obligations to the Fund and supported the proposed decision as amended by Mr. Finaish.

The staff representative from the Legal Department agreed with Mr. Finaish that paragraph 2 of the proposed decision was not necessary, although the staff had considered it to be appropriate as a way of clarifying Nicaragua's position in the Fund after it had become current in its financial obligations to the Fund. If the paragraph were to be retained, Mr. Finaish's suggested language would meet the intention of the staff.

Mr. Pérez indicated that the Nicaraguan authorities were appreciative of the flexibility demonstrated by the Fund in reacting to Nicaragua's problems. The situation had been managed with skill--making possible the achievement of compliance by Nicaragua with the rules and principles of the Fund--and with understanding of the constraints placed on Nicaragua during a difficult period.

The Executive Board then adopted the following decision:

1. The Fund welcomes the settlement of Nicaragua's financial obligations to the Fund.

2. The Fund notes that, as Nicaragua became current in its financial obligations to the Fund on April 26, 1985, the limitation of Nicaragua's use of the general resources of the Fund was terminated as of that date.

3. The Fund has reviewed Decision No. 7720-(84/88) (6/6/84).

Decision No. 7964-(85/66), adopted
April 29, 1985

APPROVED: February 12, 1986

LEO VAN HOUTVEN
Secretary