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10:00 a.m., November 27, 1985

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

Executive Directors	Alternate Executive Directors
	Mawakani Samba
C. H. Dallara	M. K. Bush
	H. G. Schneider
B. de Maulde	S. de Forges
M. Finaish	T. Alhaímus
	M. Sugita
G. Grosche	B. Goos
J. E. Ismael	
A. Kafka	
T. P. Lankester	
H. Lundstrom	H. Fugmann
M. Massé	L. Leonard
	G. W. K. Pickering, Temporary
E. I. M. Mtei	
	B. Jensen
	J. J. Dreizzen, Temporary
	J. E. Suraisry
	G. Ortiz
J. J. Polak	
C. R. Rye	A. V. Romuáldez
G. Salehkhou	O. Kabbaj
A. K. Sengupta	
S. Zecchini	N. Coumbis
Zhang Z.	Jiang H.

L. Van Houtven, Secretary
B. J. Owen, Assistant

Also Present

IBRD: M. Farsad, Europe, Middle East, and North Africa Regional Office, African Department: A. D. Ouattara, Director. Asian Department: Tun Thin, Director; L. H. De Wulf, F. Le Gall. European Department: L. A. Whittome, Economic Counsellor and Director; P. de Fontenay, Deputy Director; N. L. Happe, H. B. Junz, P. C. Leme, W. E. Lewis, T. H. Mayer, H. O. Schmitt, G. Szapary. Exchange and Trade Relations Department: M. Guitián, Deputy Director; J. O. Bonvicini, J. T. Boorman, L. Hansen, G. G. Johnson. External Relations Department: H. P. Puentes. IMF Institute: I. Vandot, Participant. Legal Department: G. P. Nicoletopoulos, Director; W. E. Holder. Middle Eastern Department: M. Zavadjil. Research Department: N. M. Kaibni, L. A. Wolfe. Secretary's Department: A. P. Bhagwat, B. J. Owen. Treasurer's Department: W. O. Habermeier, Counsellor and Treasurer. Western Hemisphere Department: S. T. Beza, Associate Director. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: M. B. Chatah, L. P. Ebrill, S. Ganjarerndee, G. Nguyen, P. Péterfalvy, D. C. Templeman, K. Yao. Assistants to Executive Directors: I. Angeloni, J. de la Herrán, R. Fox, G. D. Hodgson, W. K. Parmena, J. Reddy, M. Sarenac, S. Simonsen, B. Tamami, A. J. Tregilgas, H. van der Burg.

1. YUGOSLAVIA - REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered a staff paper on the review under the stand-by arrangement for Yugoslavia for the period May 15, 1985 to May 15, 1986 (EBS/85/243, 10/31/85; and Cor. 1, 11/7/85).

The staff representative from the European Department noted that provision had been made in the draft decision for an additional review, which the staff hoped would be held when the Executive Board discussed the report for the 1986 Article IV consultation sometime in February or March 1986. The review would cover not only the performance criteria that still had to be set for the remainder of the stand-by period but specific measures to curtail the excessive accumulation of inventories. The fact that the rate of inflation in October had turned out to be disappointingly higher than had been hoped gave added importance to the need for an additional review.

Mr. Polak made the following statement:

In April, when the Board last discussed Yugoslavia and approved the current stand-by arrangment, many Directors referred with agreement to the staff's observation that "the year 1984 marked a watershed in many ways, not only in terms of economic performance but perhaps even more so for economic policies" (EBS/85/85, 4/11/85). That observation by the staff still provides a good starting point for our discussion today, in particular since it differentiates between the authorities' continued efforts to make the necessary policy adaptations and the actual economic performance, which, of course, depends on many exogenous influences as well. Indeed, during 1985 several such influences led to a weaker than projected--or hoped for--economic performance. Because the environment was less rewarding in terms of overall economic performance, the authorities' continued willingness to strengthen and widen structural and systemic changes required significantly increased efforts on their part.

I shall first elaborate on this dichotomy between policy action and actual performance and then add a few remarks on both the policy side and the performance side of developments in 1985.

The actual performance of the economy in 1985 shows that it is essential for Yugoslavia that the needed reallocation of resources--shifting them to more productive uses--be achieved through an increase in demand and economic growth. Inasmuch as the structural measures so far implemented were needed to create market incentives for resource shifts in the right direction, increased demand and faster economic growth are needed to prevent the inevitable economic and social costs of such shifts ending up by having negative effects on productivity.

The Yugoslav authorities persisted in maintaining, and where necessary improving, their general policies with respect to prices. The real effective exchange rate has been kept stable and real interest rates broadly positive. During our April discussion the Board "commended the broad liberalization of prices put in effect early in 1985 and urged the authorities to persist in their determination not to revert to price control," as noted in the Chairman's summing up (EBM/85/66, 4/29/85). The authorities followed the Board's advice. In so doing, with "the price surge"--after liberalization--that "was greater and more sustained that the authorities expected" (EBS/85/243) and with the inflation rate still resisting a clear downward trend, the authorities did not have an easy task. It is reassuring that on the basis of a thorough analysis of the May and October adaptations of the price-policy--on those two occasions the authorities' steadfastedness must have been under heavy pressures--the staff concluded that there was no intention to open the door to administrative control of prices. I may add that the thoroughness displayed by the staff is evidence of welcome close monitoring of the developments in this area.

However, a glance at the revised figures for the 1985 program in Tables 1 and 2 is sufficient to conclude that some initial success regarding the major task of qualitative improvements on the supply side did not prevent the need for downward revisions of the annual rates of growth for private consumption by 5.5 percentage points, for investment by 11.5 percentage points, and for final domestic demand by about 6 percentage points. It did not prove possible to reverse, as had been expected for 1985, the prolonged and therefore highly worrisome trend of decline in real personal incomes in the socialized sector. However, some encouragement can be derived from the fact that the rate of decline is estimated to be lower than in any of the preceding five stand-by years--1980-1984--and that at least part of the decline is attributable to the restrictions affecting loss-making enterprises. These domestic demand factors combined with weaker than expected export demand--not to mention the adverse effects of the severe winter at the beginning of 1985 and the drought that caused an estimated drop in agricultural production in 1985 of no less than 9 percent--led to revised projections that show a significant lag of total output behind the original projection. And the 2.5 percent increase in GSP that had originally been projected for 1985 cannot be considered as overly ambitious.

For the third year in a row the performance of the external sector is expected to remain broadly satisfactory. While the current account performance during the first half of this year was somewhat below target--indeed, not much below target given the exogenous circumstances--this was compensated in the overall balance of payments outturn by a considerably improved cash inflow on account of trade. The staff indicates that "higher domestic interest rates combined with increasingly effective credit restraint surely contributed to this improvement" (EBS/85/243), which is a highly welcome development. For this year as a whole the current account surplus is estimated at US$650 million. That implies a downward revision of some $100 million from the original target--taking into account the effects of using actual instead of "statistical" exchange rates in trade statistics. Nevertheless, the target for external reserves--the projected increase of US$200 million--is still attainable.

Turning to future policies, I would personally like to add my voice in support of the staff's call for further enhancement of the overall efficacy of demand management policies and the policies concerning financial discipline. With persistent inflation that leaves no room for complacency, these same views are fully shared by the Yugoslav authorities. Several welcome improvements in the accounting rules were already implemented to that end during 1985, with further measures being contemplated in the policy documents for 1986. Finally, major improvements concerning financial discipline are expected from the new banking law. The authorities also reacted recently to an excessive buildup of inventories by supplementing the earlier measures aimed at making the accounting practices stricter with measures to tighten credit policies. By a Federal Assembly decision that is expected to be taken on the day of our discussion banks will not be allowed to grant new credits or to renew or extend the repayments periods on credits already granted to those enterprises that keep inventories of finished goods above normal working levels. For the decision to be operationally effective, the Federal Executive Council is to specify the criteria and modalities for its implementation. As this will take place in the weeks ahead, the staff felt that the effects of these measures needed to be thoroughly reviewed on the occasion of the forthcoming Article IV consultations, which would be concluded before the next purchase under the stand-by arrangement.

In Yugoslavia, it appears that the liquidity overhang continously resists ever tightening monetary policy and higher than expected inflation. Therefore, quite rightly, monetary policy needed to be tightened in the second half of this year. The NDA ceilings for the last quarter were determined on the basis of the revised assumptions regarding inflation and GSP with a correspondingly revised rate of monetary growth. Broad money is projected to grow in 1985 by 54 percent instead of 44.5 percent as initially assumed. This encompasses a notable change in the assumption on velocity. Contrary to earlier assumptions, no decline in the velocity--which grew significantly faster than projected in the first half of 1985--is to be accommodated.

Also, a revision was needed to take account of an increase of DIN 65 billion in net foreign liabilities but this has been done only partially--DIN 51 billion was added--in order to tighten the original program.

To this description of the most recent measures on monetary policy and financial discipline, I would add that the authorities continue to attach great importance to the maintenance of real positive interest rates. They counted on the new formula for adjusting interest rates as an effective means to calm down the persistent inflationary expectations. Therefore, the authorities consider keeping the formula as indeed essential, even though it may produce somewhat erratic fluctuations in interest rates in the very short run.

The staff observed that "fiscal policy has exercised a somewhat greater restraint than originally planned" (EBS/85/243). A further decline of 1 percentage point is expected to be added in 1985 to a 12 percentage points decline in the public sector's share in GSP that had been recorded over the period as six stand-by years--1979-1984. Here, under circumstances that are clearly described, additional measures were needed to allow for the federal budget to be brought in line with the more recent projections regarding inflation. It should be emphasized that the share of federal budget expenditures in GSP will remain unchanged. My Yugoslav authorities fully share the staff's concern that borrowing by the federal government from the National Bank of Yugoslavia "would be a first step in the wrong direction" (EBS/85/243). They are, however, confident that such a step may well prove to be unnecessary, as they expect the federal budget revenues to be greater than was assumed when the budget revision was being prepared. Indeed they regard the provision for borrowing from the National Bank of Yugoslavia as a contingency measure; they expect not to have recourse to it--or only for an insignificant amount and, in any event, to repay any borrowing after a short period from increased revenue.

I cannot omit to mention Appendix V to the Review report, which presents a very useful contribution to our understanding of the ongoing efforts by the authorities to improve the foreign exchange allocation system. We can expect to be informed of the outcome of these efforts soon, as the proposed new law has reached an advanced stage on its way through the appropriate legislative procedures.

Finally, I have a question about the very last paragraph of the staff paper, which could be misinterpreted, combining as it does a call for improvement--called both "crucial" and "essential" in the Government's "ability to track the economy and to monitor responses to policy measures on a current basis" with the question of enhanced surveillance, which the Government will formally request from the Fund in the spring of next year. Members will recall that the Board gave its informal agreement to the expected request in its meeting of July 22, 1985 (EBS/86/171, 7/19/85). It is of course true that any country can benefit from better and more current statistics, and Yugoslavia is certainly not an exception to that rule. But I would not want the impression to gain ground that at this late stage Yugoslavia is being asked to install new and better monitoring techniques as a precondition for enhanced surveillance.

Mr. Schneider observed that the staff paper was not only very informative but reflected the kind of caring commitment for the improvement of the Yugoslav economic situation that was a necessary precondition for a successful dialogue between the Fund and any of its members.

The various positive aspects of recent economic developments in Yugoslavia made it evident that the central authorities had started to draw the necessary conclusions from past mistakes and had committed themselves to a policy of correction and adjustment, Mr. Schneider continued. The authorities apparently intended to strengthen their position vis-à-vis the disintegrating forces of the many autonomous, semiautonomous, geographical, political, and economic units, and to implement measures that would impose the integrating mechanisms of the market on the country as a whole. The central authorities' growing willingness in their endeavors to rely on market-oriented rather than administrative methods was especially welcome, even if the administrative approach reappeared constantly in certain areas.

It also had to be recognized that the Yugoslav economy was not yet free of problems, Mr. Schneider remarked. A decade of false expectations, economic mismanagement, and deteriorating performance could not be overcome in one or two years with the help of one or two stand-by arrangements. Therefore, his remarks praising recent results should be seen as offering encouragement to the Yugoslav authorities to increase their efforts and accelerate the adjustment process so that Yugoslavia could enter the next century as a modern, fully developed European country. To that end, he would concentrate his observations on the weaknesses existing in the Yugoslav economy.

The continuing high rate of inflation was the most disturbing element, Mr. Schneider observed. A question that had been raised for some time with respect to Yugoslavia's economic development was why it was the only country in Europe with not only a double-digit rate of inflation but one nearing the triple-digit range. Admittedly, there had to be room for flexibility in the adjustment process, and structural measures, such as price liberalization, might involve large price movements for a limited time. But if the staff was right in saying that in accounting for the disappointing inflation performance the factors "of greater importance were delays in the effectiveness and implementation of structural measures aiming to increase the efficiency of resource allocation," then the high rate of inflation was to a far-reaching extent a problem of the Yugoslav authorities' own making. While such high inflation might reduce the authorities' political room for maneuver, in the longer run it would impede the implementation of the necessary structural measures and would make a smooth adjustment process extremely difficult.

The continuing policy of insufficient budget restraint, both on a macroeconomic and microeconomic level, was a related matter of concern to him, Mr. Schneider said. To cite fiscal policy in 1985, when federal revenues had been constrained, the authorities had sought additional financing rather than expenditure cuts. He fully agreed with the staff that "the decision to borrow from the central bank--for the first time in several years"--was a step in the wrong direction. As for monetary and credit policy, a significant increase in inventories had been accommodated. In the staff's words, "the financing of stocks was considered preferable to price cuts," in spite of the fact that the high rate of inflation was the major problem in Yugoslavia.

The staff seemed to doubt, with good reason, the effectiveness of existing restrictions on personal income payments by loss-making and illiquid enterprises, Mr. Schneider added. If republican and provincial legislation took precedence over and was more lenient than federal law, there would be little hope of further improving the effectiveness of price and other market signals. In that connection, he asked whether Yugoslavia had a bankruptcy law or whether one was under preparation.

He could cite other examples of insufficient budget restraint, Mr. Schneider said. What he wished to emphasize was that without a tighter budget policy, it would not be possible to achieve the necessary restructuring of the economy and the stabilization of the balance of payments position. Considering the importance of the latter objective, the continuation of the present budgetary stance could easily necessitate administrative measures that would lead nowhere in the long run.

The continued presence of, and in several respects the reappearance of, administrative mechanisms in the Yugoslav economy raised several questions in his mind, Mr. Schneider remarked. The newly introduced transitional foreign currency allocation system tended to freeze the current production and export structure, according to the staff, by rewarding past inefficient uses of imports and maintaining the "export at any cost" orientation. That aspect of the transitional system was all the more dangerous because it might become permanent, in the view of the staff, who could perhaps elaborate on that point.

The compartmentalization of the credit system and other institutional constraints seemed to demonstrate the impracticality or inefficiency of the financial intermediation system, Mr. Schneider considered. In that connection, he would appreciate comment by the staff on the ongoing reform of the banking system.

The staff saw a risk that price rises might force the authorities to return to administrative price control, Mr. Schneider observed. Since the basic feature of the present stand-by arrangement and of the whole Yugoslav adjustment effort had been the freeing of the price system from administrative intervention, he would appreciate an additional explanation by the staff. The Fund had the responsibility to draw the Yugoslav authorities' attention--at the earliest possible stage--to the threat to the stand-by arrangement if slippages with respect to price liberalization occurred.

In concluding, Mr. Schneider reaffirmed his support for the dialogue between the Fund and Yugoslavia. In that respect, he shared fully the staff view that "if a conflict arises between the dual goals of continued import growth and further reductions in external debt, the balance--under appropriate management policies--should be struck in favor of the former, albeit not to an extent that would once again increase debt levels."

Mr. Goos said that he commended the Yugoslav authorities for having met all the performance criteria, some of them by quite comfortable margins. Considering the widespread weakening in the external sectors of neighboring countries, the projected performance of Yugoslavia's balance of payments in convertible currencies also appeared acceptable, although the shortfalls in the prospective program targets underlined the need for giving continued attention to external development.

Nevertheless, the overall performance of the economy was quite disappointing, Mr. Goos remarked. For more than five years, Yugoslavia had been engaged in continuous cooperation with the Fund on adjustment efforts, including structural reforms aimed at strengthening the efficiency and competitiveness of the economy. So far, the current adjustment program had apparently failed to produce tangible improvements in the underlying economic situation. That discrepancy between formal adherence to program criteria and actual developments once again raised the issue of the effectiveness or even the usefulness of Fund programs in nonmarket economies--a subject that the Executive Board would discuss early in 1986. More important, however, was the fact that the fundamental economic reform deemed necessary and urgent by the authors of the Kraigher report, as well as by the staff, were yet to be implemented, notwithstanding commendable efforts by the Federal Government. He recalled that when the Executive Board had considered the request for the current stand-by arrangement at EBM/85/66 (4/29/85) his chair, like others, had questioned its adequacy in terms of strength and comprehensiveness. Unfortunately, with the benefit of hindsight, that criticism seemed to have been justified.

Accordingly, the main points of concern expressed at the time of the stand-by arrangement's approval appeared to remain valid, Mr. Goos remarked. It was particularly worrisome that for the remaining program period there were virtually no concrete and binding undertakings by the authorities with respect to structural measures. To his mind, that indicated a continued lack of sufficiently persistent adjustment efforts, as did the fact that the authorities had been unable to determine their policies for 1986 at the time of the review discussions. The latter failure constituted a clear deviation from the originally agreed adjustment program, a deviation that was certainly regrettable and that deserved clarifying comments from the staff or Mr. Polak. The inability to conclude the review on time should have been known much earlier in the year, if not at the very beginning of the program. Generally speaking, he had the impression of a continuing tendency on the part of the Yugoslav authorities to address economic difficulties by way of ad hoc regulations and administrative controls rather than by decisive reforms of structural weaknesses.

The most prominent indications of the structural deficiencies that persisted in the economy were undoubtedly the continued inflationary pressures and the strong increase in inventories, despite a pronounced decline in final demand, Mr. Goos stated. While the staff was right to have insisted on a further tightening of monetary and credit policies under such conditions, it was interesting to note that that course of action, by further restraining domestic demand, could complicate one of the major program objectives--namely, the reallocation of resources to more productive use. The staff had stated clearly that such a reallocation of resources would have been stimulated in an environment of growing demand. The staff might wish to comment on that apparent conflict--which Mr. Polak had also dealt with in his statement--although it did not really exist. Obviously, the factor limiting an efficient reallocation of resources was to be found in structural impediments like the lack of competition among enterprises owing to the continued fragmentation of the markets for goods, labor, and foreign exchange. In addition, insufficient wage differentiation was undermining workers' motivation to perform efficiently, and the tendency to distribute the bulk of enterprise profits seemed to restrict the ability to expand investment and employment opportunities. Accordingly, a large part of the productive capacity appeared to be obsolete, thereby rendering the task of catching up with the technological advances made in the industrial countries increasingly difficult.

In such circumstances, maintaining--or even stimulating--the unhealthy expansionary environment reflected in continuing high price increases, and the strong buildup of what were probably to a large extent idle stocks was bound to be counterproductive because it would perpetuate and reinforce inefficiencies, Mr. Goos went on. Thus, the continued inability of the authorities to tackle underlying structural problems not only prevented them from reaping the potential benefits of the recent price liberalization but would also have to be compensated by all the more restrictive overall financial policies in order to balance the external accounts. Clearly, such an approach fell considerably short of a satisfactory and, in particular, a sustainable solution. Therefore, he urged the authorities to take the necessary structural steps without delay. It would be more than unfortunate if private and official creditors, which had provided quite generous support so far, were left with the impression that such steps would again be postponed. Last but not least, it was worth recalling the point made in the summing up of the Executive Board's previous discussion that "the modalities of further collaboration by the Fund will be determined in the light of the circumstances"; those circumstances would certainly have to include Yugoslavia's track record under previous and current stand-by arrangements.

On a specific point, Mr. Goos noted the reference by Mr. Polak to a Federal Assembly decision to be taken that day on the bank financing of excessive inventories of enterprises. Given the importance of progress in that area, he asked whether the staff considered the measures envisaged under that decision to be sufficient or whether additional measures would be required, a matter that he understood would be discussed in detail on the occasion of the forthcoming additional review. Since he shared the staff's concern about the persistent rigidities in the banking system and the continued although declining, subsidization of export credit--which was a major stumbling block to a more efficient resource allocation--he would, like Mr. Schneider, be interested in learning more about the intended reform of the banking law. In that context, information on specific measures or new instruments aimed at tackling the problems of inter-enterprise credit and the overall inefficiency of the banking system would be most welcome, including information on specific steps that might be envisaged to iron out regional disparities in the provision of liquidity.

He welcomed Mr. Polak's reassurance that the authorities continued to be committed to maintaining real positive interest rates, Mr. Goos commented. However, he had noted with concern that real interest rates on a large number of credit instruments continued to be negative and that the yield differential in favor of foreign currency deposits had remained. Further progress in those respects was clearly called for, not least to discourage excessive inventory holdings.

There were indications throughout the paper of a sizable and perhaps growing shadow economy, Mr. Goos observed. For instance, the staff had referred to the increase of real disposable household income and to a possible statistical overestimation of the weakness of demand. Staff comment on that point, including the possible impact on visible accounts, would be welcome.

The continued stagnation of registered tourism receipts appeared to indicate the existence of a considerable degree of tax evasion, Mr. Goos said. Against that background, the staff advice to the authorities to take steps aimed at increasing the taxation of household income from sources other than employment was well taken, although he acknowledged the difficulties of successfully implementing such steps.

Finally, Mr. Goos stressed that he fully shared the staff's concern about the transitional system envisaged for the allocation of foreign exchange. Such a system would clearly represent a retrogression toward more administrative control and a freezing of inefficient production and export structures. Unfortunately, there was at least a danger of a similar retrogression in the area of price liberalization. While it was reassuring to note that the May and October adaptations of pricing policy were not meant to reintroduce price controls, they were nevertheless disquieting. They could further stimulate inflationary pressures if enterprises perceived them as indicating a return to the past policy of on-off price controls. Furthermore, experience suggested that the temptation eventually to use existing monitoring systems for the purpose of price control had often been irresistible, despite originally good intentions to the contrary. He supported the staff appraisal and proposed decision.

Mr. Zhang observed that once again the staff paper brought generally good news to Yugoslavia's external creditors. Notwithstanding adverse exogenous factors, such as the severe winter at the beginning of 1985, followed by a drought and lower than expected demand for Yugoslavia's exports, the remarkable turnabout in the current account during the past two years had continued and would result in an increase in foreign exchange reserves by some $200 million in 1985. Once again, the authorities had adhered to their firm commitment to reduce their external debt.

He was rather doubtful that the Yugoslav authorities would share the contentment of their creditors, Mr. Zhang added. After successive stand-by arrangements, it had been necessary to improve the overall domestic economic situation sufficiently in 1985 to lessen the heavy economic and social costs imposed upon the domestic sector by the large-scale external adjustment. However, apart from the achievement in the external sector, few of the projected improvements in the domestic sector would be realized, and the overall performance of the economy was generally rather disappointing. For instance, the staff expected no output growth for 1985; real personal income and private consumption continued to fall and the decline in investment would be no less than 9 percent. Some consolation might be found in the fact that it had been possible to keep total imports close to their projected level, together with a 21 percent increase in capital goods imports, during the first half of the year.

All those developments pointed to the necessity for both creditors and international institutions to focus their appraisals in future more on overall trends in the Yugoslav economy than on developments in the external sector only, Mr. Zhang considered.

The staff had described in detail various aspects of current economic developments and had analyzed the implications of the individual policies being implemented, Mr. Zhang remarked. But useful and informative as the staff paper was, it neither provided a sufficiently comprehensive picture of developments nor identified clearly the most pressing current problems and policy priorities. He felt that the detailed descriptions had made him lose sight of the overall picture. In point of fact, the essence of the staff paper was that not only had the authorities firmly adhered to their commitment to a general course of adjustment but that they had achieved considerable success in implementing various adjustment measures during the past few years. The most important achievement had been the strengthening and the sharp improvement of Yugoslavia's external position.

Under present circumstances, that favorable result should be interpreted as meaning that the most pressing problems facing the Yugoslav economy had been dealt with properly and that the priorities set had been observed strictly.

However, such an interpretion might be simplistic, Mr. Zhang said. Right now, it could be generally agreed that many of the adjustment measures that the authorities had been compelled to adopt at one time or another to cope with their external liquidity difficulties were indeed also essential for the necessary longer-term adjustment and structural transformation of the Yugoslav economy. With the general course of adjustment having been established and continued, there was a growing awareness and consensus in Yugoslavia that those measures could be incorporated in the body of basic government policies and the economic system itself. Furthermore, he understood that the process that would eventually bring about crucial changes in the various key systemic laws was under consideration. That process would necessarily go deeper and farther into the institutional and structural characteristics of the present economy than had the content--or what should have been the content--of successive Fund-supported programs.

The staff had made an effort to analyze the broad technical details of the systemic features of some of Yugoslavia's problems, Mr. Zhang noted. Undoubtedly, the analyses that would be extremely useful to the authorities included those of financial disciplinary problems, what the staff had identified as "institutional barriers" within the banking system, and particularly the impediments to the adaptation of the new foreign exchange system during the transitional period.

A general point that he wished to raise in that connection was the Fund's proper role in a process of systemic adaptation like the one being carried out in Yugoslavia and that went far beyond the adjustment normally visualized in a Fund program, Mr. Zhang said. Should the Fund's continuous involvement in a country's adjustment and transformation process not in principle be an evolving one that would change the program to meet the policy objectives and priorities of the authorities as changing circumstances warranted? It was particularly important for the Fund to pay proper attention to the political and social, as well as the economic, objectives of a country's policies and also recognize the fact that initiatives for a change of policy could often come only from the authorities themselves and not be imposed upon a country from the outside.

In the particular Yugoslav context, there was no certainty that the present line of action by the Fund would not run the risk of widening the mismatch between the policy objectives and priorities prescribed by the Fund, on the one hand, and those regarded by the Yugoslav authorities as the most necessary under present circumstances, on the other hand, Mr. Zhang observed. He had specific questions in that respect: whether the staff should not become as deeply concerned as the authorities with the problems of economic growth, investment, real personal income, and unemployment--which, incidentally, was not even mentioned in the report.

Since the demand management policy required in successive Fund-supported adjustment programs had been successfully implemented, the adjustment measures should perhaps be reoriented toward increasing domestic growth as desired by the authorities; furthermore, indexation arrangements for the exchange rate, interest rate, and prices having been established, their unfavorable inflationary effects should be of as equal and genuine concern to the Fund as to the authorities. He had touched upon those issues during previous deliberations by the Executive Board on Yugoslavia. He wondered whether the time had not arrived to leave the authorities to work out for themselves the best way through the second phase of the adjustment process--namely, the transformation of adjustment measures into an improved economic system. It was a matter for the judgment of the Board and the staff.

On a technical point, Mr. Zhang said that it seemed to him that the staff had questioned the uniform application of monetary policy instruments in Yugoslavia regardless of portfolio structure or regional differences. He was inclined to think that the uniformity of monetary policy would help to break down regional barriers in the form, inter alia, of differences in the capacity and propensity to save. He asked whether the staff had any experience with other countries that tailored regional monetary policies to meet specific regional requirements.

After six years of close cooperation between the Yugoslav authorities and the Fund, with the result that the Government's ability to track the economy and to monitor policy responses had shown continued improvement, as pointed out by the staff, he joined Mr. Polak in asking why the commercial banks had deemed it necessary to request, for purposes of monitoring a multiyear rescheduling arrangement, a further improvement in that respect, Mr. Zhang said. He asked what the motive of the banks was and what the implications were for Yugoslavia in the future, as well as for other countries, if the procedure was applied more widely.

The program was generally on track, Mr. Zhang considered, and therefore he could support the proposed decision. Nothing that he had said should be taken as a criticism of the staff. His concern was only about the possible need to take a fresh look at the Fund's general approach as more countries moved under enhanced surveillance procedures. For countries in that position, the Fund should concentrate its attention on broad policy performance--ensuring that the economy remained on a satisfactory track--and become more relaxed with respect to the secondary aspects of economic policy--which in any event it might be difficult to keep on adjusting. He hoped that his statement would provoke a future debate in the Executive Board.

Mr. Lundstrom said that he was in broad agreement with the staff appraisal, although on the whole he would have taken a slightly less concerned view of actual macroeconomic developments in 1985. Obviously, that was not true of inflation, which must be a cause for serious concern, as emphasized by the staff representative's comments in that respect.

The inflation was partly the foreseeable result of the effective implementation of policies of price liberalization. What was worse, however, was that the prospects of breaking that trend were bleak as long as progress in other areas of needed structural reform was lagging. In such a situation, the authorities would not be able to reap the benefits of price liberalization.

Therefore, a more coordinated approach to structural reform was required, Mr. Lundstrom continued. There was a clear need for further steps in respect of financial discipline of enterprises, monetary and credit policies, and the politically sensitive foreign exchange allocation system. He was in agreement with the staff's recommendations in those areas of reform, but he was not in a position to judge how far such reform could be taken in the present Yugoslav context. But the problem was that the present degree of price liberalization could be jeopardized if it was not supported by effective action in the field of structural reform, a concern he shared with previous speakers. In that connection, he had noted that the composition of imports had been improved through an increase in imports from the convertible currency area, although he was disturbed by the staff assessment that the revised foreign exchange allocation system might "actually increase existing rigidities in the economic system and perpetuate the need for high import protection."

As for money and credit policy, even after having read the staff paper he did not fully understand how the economy could remain so liquid after the successive tightening of that policy, Mr. Lundstrom remarked. He asked whether the staff could shed any further light on the issue.

He strongly supported the staff view that the authorities must improve their ability to track the economy and to monitor responses to policy measures on a current basis if the envisaged enhanced surveillance arrangement was to fulfill its purpose, Mr. Lundstrom stated. He would be interested in whatever information was available on the discussions between the World Bank and the Yugoslav authorities on a second structural adjustment loan. In April, the Executive Board had been informed that such discussions had been initiated in late March. A World Bank mission was presently in Belgrade to continue those discussions, and he asked what the likely result would be and what the timetable was. Such a structural adjustment loan could strengthen the prospect for a successful enhanced surveillance arrangement in Yugoslavia, whose structural problems were truly overwhelming.

To end on what might be a rather formalistic note, Mr. Lundstrom remarked that unless he was mistaken, the Yugoslav authorities had not lived up fully to their commitments under paragraph 4(f) of the stand-by arrangement and the second paragraph of the letter dated March 15, 1985. The reason was that no performance criteria for the remainder of the program period had been established in connection with the review as had been envisaged. Even though he was fully aware that the midterm review did not govern the third purchase under the arrangement, it would have been preferable to present the problem more straightforwardly to the Executive Board. However, he had no objection to the proposed decision and the changes in procedures suggested therein.

Mr. Ismael said that the performance of the Yugoslav economy had been less than satisfactory under the current stand-by arrangement and indeed over a somewhat longer period of time. A cursory glance at the data provided in Table 1 of EBS/85/243 illustrated that fact: in the four-year period between 1982 and 1985, gross social product (GSP) had shown no improvement at all in real terms. Inflation, measured in terms of retail prices, had increased from an annual rate of 31 percent in 1982 to 74 percent in 1985. While the current account balance in convertible currencies had improved since 1982, the growth in the external debt service ratio--from 35 percent to 43 percent--implied that the rate of growth in debt accumulation and debt service charges had exceeded the rate of growth in exports of goods and services. Hence, the rate of debt accumulation in the 1982-85 period might have been excessive.

In considering that information against the background of the Fund's continuous involvement with Yugoslavia since 1979 and the provision of Fund resources in an approximate amount of SDR 2 billion, he was hesitant to come to a firm judgment about the overall success of the Fund's role in the country, Mr. Ismael stated. Nonetheless, continued involvement by the Fund appeared inevitable, and he welcomed the authorities' intention to request enhanced surveillance in 1986. The instruments of demand management policy might have to be tightened further, and more progress on structural reform would be unavoidable if enhanced surveillance were to produce positive results. In addition, he had some sympathy for Mr. Polak who had concluded his statement with a remark concerning the quality and timeliness of statistics. Any remaining major statistical deficiencies would no doubt have affected the design and implementation of previous Fund-supported programs and should have been remedied at an early stage or indeed been made a precondition for a stand-by arrangement with the Fund.

He welcomed the better than expected financial performance of the public sector, particularly the shrinkage in the public sector outside the federal budget, a process that should be continued further, Mr. Ismael considered. As for the implications of a possible revenue shortfall in the federal budget, he agreed with the staff and Mr. Polak that central bank financing of any revenue shortfall would be "a first step in the wrong direction." He had been somewhat reassured by Mr. Polak's remarks on the attitude of his authorities in that connection, and he hoped that the provision for recourse to the central bank would prove to be an unnecessary contingency plan.

The tightening of monetary and credit policies, in order to mop up excess liquidity, was appropriate although he shared the staff view that it might need to be strengthened further, Mr. Ismael noted. A further increase in the real rate of interest might be desirable as it would increase the cost of stock accumulation, releasing in the process resources for more productive investment. At the same time, the real yield differential between dinar denominated and foreign currency denominated time deposits would be narrowed. In spite of the tightening of monetary policy in 1985, the economy had been able to accommodate a much higher nominal amount of transactions than had been envisaged under the program. That interesting development suggested that monetary policy was perhaps not an effective instrument for influencing nominal GSP in the Yugoslav economy. He asked whether the staff could explain the great instability in the velocity of money and comment on its implication for the effectiveness of monetary and credit policies.

Admittedly, persistent high inflation and the failure of exports to rise more rapidly were in part attributable to the structural problems of the economy, Mr. Ismael said. The need for greater price liberalization, for fostering a more competitive environment, and for reform in the system of foreign exchange allocation were some of the areas where the staff felt that further reforms were necessary; and he agreed. However, he would greatly appreciate an update on the status of the World Bank's involvement in structural reform in Yugoslavia, particularly in the state enterprise sector.

Referring to Yugoslavia's compliance with the performance criteria, Mr. Ismael noted with interest that Table 16 in the staff paper showed that actual performance in June was so close to the limit with respect to net domestic assets and external reserves that no safety margin had been left for slippages. He understood that that margin had increased in September; nonetheless, he underscored the prudential considerations arguing for keeping an ample margin between the ceilings and actual performance. He also asked for an explanation of the reasons behind the delays in introducing measures to limit the issuance and guarantees for promissory notes and an indication of the time frame within which those measures could be completed. He supported the proposed decision.

Mr. Zecchini noted that the Yugoslav economy had not performed in a fully satisfactory way under the program and indeed the Fund seemed to be confronted with a case in which observance of the formal performance criteria was insufficient to guarantee the attainment of the final program objectives: a reduction of inflation, a steady and well balanced rate of growth, and the improved working of market mechanisms. It would be recalled that the possibility of a divergence between the end goals and adherence to performance criteria under the arrangement had been one of the central issues in some of the Board's recent discussions on conditionality. A proposal had been advanced at that time to consider the formal establishment of "monitoring variables" to permit closer control of program developments in light of the final objectives.

Such monitoring variables, either formal or informal, would be useful in Yugoslavia's case to indicate the need to modify certain aspects of the program design, Mr. Zecchini continued. At a minimum, the variables might provide an opportunity to reorient the analysis of the Yugoslav economy to concentrate more closely on those crucial microeconomic aspects to which most of the current problems seemed to be linked--for instance, enterprises' pricing policy, and their decision-making concerning production, inventory accumulation, and fixed investments. He maintained the view that his chair had expressed in the April discussion--namely, that the Fund's analysis had been lacking so far in that area.

In considering first the problem of inflation and its causes, Mr. Zecchini observed that the rate of price increase was currently 70-80 percent, depending on the index considered, against a program projection of 50 percent for 1985. Earlier in 1985 it had been thought that most of the inflationary impetus was being provided by the price liberalization measures implemented in January and by the ensuing wave of precautionary price increases. Unfortunately, however, the desired reduction of inflation during more recent months, although significant, had not been as great as hoped, as Chart 1 showed. At the same time, the exchange rate of the dinar had been adjusted just enough to compensate for the inflation differential with trading partners, so as to leave the real effective exchange rate broadly constant, as illustrated in Chart 4. Therefore, exchange rate policy could not be presumed to be the cause of inflation as it had been back in 1983.

Once price liberalization, exchange rate policy, and financial policy had been ruled out as causes, the Yugoslav inflation remained, as had been noted during the April discussion, a largely unexplained phenomenon, Mr. Zecchini remarked. That being so, he reiterated his suggestion that the staff analysis be deepened in the direction of the microeconomic determinants of price increases for producers of freely priced goods, focusing perhaps on some specific sectors that might be the most illuminating. In that respect, the discussions held by the staff in Yugoslavia might usefully be expanded to include meetings with representatives of those entrepreneurial segments of the economy that might have a more direct perception of the current impulses to price increases. An analysis along those lines could be made as part of the forthcoming review and Article IV consultation and be annexed to the report on recent economic developments.

The topic of inflation and price deregulation could be one of the issues on which the Board should concentrate in discussing conditionality with reference to planned economies, Mr. Zecchini remarked. Moreover, the staff seemed to consider the contribution of exchange rate policy to inflation to be significant in stating that "it would be unrealistic to expect a dramatic improvement partly because of the policy of maintaining the real effective exchange rate." He hoped that that statement was not to be interpreted--and would not be interpreted--to mean that real exchange rate appreciation could be an appropriate anti-inflationary policy in the face of price pressures originating elsewhere in the domestic economy. Further explanation by the staff of that point would be useful.

Similarly, a microeconomic approach would be useful to explain the recent increase in the pace of accumulation of enterprises' inventories, Mr. Zecchini considered. In fact, there was likely to be a link between the rate of inflation and the build-up of inventories for two reasons.

On the one side, high inflation and the ensuing lower real interest rates on credit and financial assets constituted a stimulus to hold inventories. On the other side, some price rises might be instrumental in helping firms to finance larger stocks. The analysis of that phenomenon should be microeconomic, first of all, to verify the existence of the phenomenon itself, since the aggregate data appeared likely to be misleading; and second, in order to look at the economic incentive for producers to hold inventories and its modalities. For instance, were stocks financed with new credit diverted from more productive uses, or were firms substituting liquid financial assets for real stocks? It should be possible to find an appropriate policy response on the basis of that analysis.

In the external sector, the Yugoslav authorities appeared to have been following the appropriate course by gearing the exchange rate to developments in the inflation differential, Mr. Zecchini considered. That course had permitted the consolidation of the major gains in the foreign accounts achieved in 1985 and that were at the basis of the restoration of market confidence in the Yugoslav economy. The decrease in the growth of export volume was understandable in light of the marked reduction in the growth of world trade. That made it all the more important for the authorities to pursue a new policy of firm exchange rate management in order to avoid any loss of market shares. As Tables 5, 6, and 7 in the staff report showed, an expansion of the volume of imported goods had been necessary to compensate for the reductions in imports in previous years. It would be very useful to have some detailed information on the actual commodity composition of those imports as an additional indirect way to shed light on inventory accumulation. In that respect, the staff's reference to the increase in imports of capital goods was heartening but did not rule out the possibility that at least some imports might have ended up contributing to the build-up of idle inventories.

As for money and credit policies, it was encouraging to note from Chart 3 that 1985 had brought about an increase in the ex post measure of the real interest rate on three-month deposits, Mr. Zecchini remarked. Of course, measuring the level of real rates was a difficult task, one that called for the use of theoretical hypotheses and occasionally a little imagination. For example, the real rates in Chart 3 were obtained by deflating the nominal deposit rate on a maturity for the three following months by actual inflation in the previous five months. Whether or not that measure was appropriate, some increase must have taken place from the depressed levels of early 1985--which was commendable--but he wondered whether it had been sufficient in light of subsequent price developments and also in view of the build-up of inventories. He recalled that the Executive Board had acted on April 29 (EBM/85/66) to waive the performance criterion on interest rates in order to correct an alleged anomaly in the indexation mechanism for interest rates that would otherwise have necessitated raising the three-month deposit rate to 69 percent; a more modest increase to 58 percent had been deemed to "correspond better to the underlying rate of inflation" (page 2, EBS/85/84). With the benefit of hindsight, and of Table 3 and Chart 1 in the staff report, an interest rate of 69 percent would have been more appropriate. In any event, he wished to reiterate his conviction that an appropriate--namely, a positive level of real interest rates--was crucial to attract savings into domestic financial assets, induce firms to look closely at the link between production and demand, as well as to avoid undue hoarding of both domestic products and imports. Lending and deposit rates were equally important in that respect.

In conclusion, recent developments in the Yugoslav economy, although they continued to be relatively satisfactory on the external side, gave rise to some debate in other important respects, Mr. Zecchini said. In that respect, the view of his chair was that a more extensive analysis by the staff of the microeconomic working of markets was required to account for the recent pricing and inventory behavior of the business sector. That was all the more important if, as now seemed likely, Fund assistance to Yugoslavia was bound to continue on an extended basis. Moreover, greater expertise in the field would be most advantageous, given the growing Fund involvement in countries engaged in the deregulation of goods markets.

Mr. Sugita said that he had been pleased to note the determination and commitment with which the authorities had implemented appropriate pricing, exchange rate, and interest rate policies in 1985 in order to consolidate the progress made in the external sector in 1984. The real effective exchange rate had been kept stable, and a positive real rate of return had been maintained on dinar deposits. Financial discipline over enterprises and banks had also been strengthened. However, domestic demand had failed to pick up in 1985, and the balance of payments prospects had deteriorated. While external factors might have been partly responsible for such under-performance, the importance of implementing structural measures more effectively and expeditiously had also been underscored.

As he was in broad agreement with the staff analysis, he would confine his remarks to three specific areas of concern, Mr. Sugita said. First, the divergent trend of final demand and supply was disturbing. To the extent that it could be explained by excessive stock building, further tightening of credit conditions would be called for. However, if the stock building reflected statistical deficiencies, a question arose as to the reliability of statistical data in monitoring the economy. As the Fund was on the verge of entering into an enhanced surveillance arrangement in the context of a multiyear debt rescheduling arrangement, it was imperative that the quality of statistics be improved. He urged the staff to pursue that matter further on the occasion of the forthcoming Article IV consultation discussions.

Second, the rate of inflation, although it had been decelerating in recent months, was still high and much higher than originally projected, Mr. Sugita continued. While that might have been attributable to some extent to price liberalization, a general price increase of the order recorded seemed to point to insufficiently tight credit conditions. A more ambitious target for bringing down the rate of inflation might be desirable for the year ahead in order to enhance the overall efficiency of the economy.

Third, the transitional arrangement for the allocation of foreign exchange did not seem to be in line with general measures of liberalization aimed at better resource allocation, Mr. Sugita considered. Although the arrangement was intended to be temporary, it did not fit well in the present phase of structural adjustment and indeed might hinder the whole adjustment process. He recognized the difficulty and complexity of the problem, because a constitutional issue was involved, but he urged the authorities to keep the matter under constant review and to make efforts to improve the system so as not to impair the progress they had made in other respects. He supported the proposed decision.

Mr. Lankester observed that the Yugoslav program was essentially on track in terms of the quantitative performance criteria having been met and of the authorities having kept to the undertakings that they had entered into with the Fund. But a number of developments gave cause for concern: inflation was too high, consumption and investment--instead of stabilizing--remained on a declining trend, and the external position was still fragile, the prospects for the current account surplus for 1985 having been revised downward. Some of those developments might be temporary or beyond the authorities' control, but they did have roots in the economy's continued structural weakness and in weaknesses in macroeconomic management.

The composition of GSP was extraordinary, Mr. Lankester said, referring in particular to the very large amount of stock building, which was increasing as a percentage of GSP. In 1985, stock building was estimated to account for 22 percent of GSP, up from 19 percent in 1984 and from 16 1/2 percent in 1983. The figures for other European countries, as estimated by the Organization for Economic Cooperation and Development, were as follows: the Federal Republic of Germany, 1 percent; France, 1 1/2 percent; the United Kingdom, 0; and Italy, 1/4 percent. While stock building in Yugoslavia was helping to bolster GSP, the question was for what purpose. The policies being pursued by the Yugoslav authorities would be more sustainable if a larger share of GSP went into consumption and investment. If the stock building trend went into reverse, the economy would be at risk without compensating increases in consumption and investment. By the same token, a reduction in stock building would seem to offer opportunities for consumption and investment to increase in excess of the rate of GSP growth in the coming year or two. The Federal Assembly decision to which Mr. Polak had referred, and under which credit to enterprises with inventories above normal working levels would be restricted, should be helpful in reducing inventories. However, if the result was simply a fall in inventories, in the absence of a mechanism to switch resources into other areas, GSP would simply fall further. The staff paper had not explored that question sufficiently. He doubted whether the solution was to be found in either monetary or fiscal policy; possibly a different wage policy was needed.

The signs with respect to inflation were also discouraging, Mr. Lankester continued. Industrial producer prices had risen by 66 percent in the year ending October; and the staff was projecting a 77 percent increase for the year to end-December. Continuation of tight financial policies and greater efforts to increase financial discipline in the enterprises seemed to be needed. The intention to bring the provisions of provincial law into line with those of federal law in that area in 1986 was welcome. It was also necessary for the consequences of recent changes in accounting practices to be fully felt by banks and enterprises.

It was essential for the current monetary policy to be continued if inflation was to be brought down, Mr. Lankester added. The agreed interest rate formula had achieved the objective of keeping real interest rates on time deposits positive, but little progress seemed to have been made on the lending side beyond the introduction of the positive real discount rate and a narrowing of the differential between that rate and selective credit rates. Most commercial bank lending rates remained negative in real terms, and the widespread availability of subsidized credit seemed to be one reason for the excessive rise in stock building. The beginning of the breakdown of institutional and regional barriers to the flow of funds was an encouraging sign but only a first step, given the extent of existing rigidities. Therefore, he encouraged the speedy adoption of the new banking law, with the minimum change from the current draft.

The emerging shape of the foreign exchange allocation system left something to be desired, Mr. Lankester remarked. He had serious doubts that the authorities were on the way to achieving a fully market-determined exchange rate. The transitional arrangements relied too heavily on administrative guidance and did nothing to encourage the influence of the market or promote changes in the industrial export structure. The volume of exports had fallen short of expectations as a result of inclement weather at home and weakening markets overseas. The export projections for 1985 as a whole might be difficult to achieve; yet a strong export performance was essential if the authorities were to attain their goals of reducing the level of debt and the debt service ratio over the medium term and find room for essential imports. The authorities' renewed commitment to stabilizing the real exchange rate was therefore encouraging but it would not be enough: marketing efforts would have to be intensified and domestic efficiency improved.

He would be interested in knowing more about the nature of the Fund's future involvement in Yugoslavia and also about the discussions that the World Bank had been having with the Yugoslav authorities on the proposed structural adjustment loan, Mr. Lankester commented. Initial discussions had been held in the Paris Club on the possibility of an official multiyear rescheduling arrangement, which would clearly call for continued involvement of the Fund in one form or another. The various possibilities included a follow-on stand-by arrangement, or a classical stand-by arrangement under which Yugoslavia might not necessarily need to draw; alternatively, some form of enhanced monitoring could go hand in hand with an official multiyear rescheduling arrangement. The question would then arise as to the type of review mechanism, what the targets would be, and whether they would be set by the Fund, perhaps in consultation with the Paris Club creditors, and how those targets would be linked to the continuation of the multiyear rescheduling arrangement.

In any event, Mr. Lankester concluded, Yugoslavia definitely needed better statistics on its economy. The staff had understandably been confused in its analysis of the microeconomy, as was evident from its comments on stock building and the various sources of demand. Whatever the rights and wrongs of the need for statistical improvement in connection with enhanced surveillance and the multiyear rescheduling arrangement with private creditors, the Fund should continue to encourage the authorities to improve their statistics greatly in order to permit a better understanding of the economy. Indeed, that would be essential if there were to be an enhanced monitoring arrangement in connection with an official multiyear rescheduling arrangement.

Mr. Pickering noted that although Yugoslavia's economic performance had been generally weaker than projected in the spring of 1985, the authorities had achieved a number of successes to date under the current stand-by arrangement. A policy of price flexibility had been initiated, fiscal policy remained broadly appropriate, and credit policies had been tightened through the year. Furthermore, external policies seemed to be improving and structural adjustment was under way. But despite progress in certain areas, policy developments in the first nine months of 1985 could be characterized as generally disappointing since weakness was still evident in a number of policy areas.

The broad liberalization of prices, which had entered into force in January 1985, was a major structural measure supported by the program, Mr. Pickering continued. The authorities' decision to return to some form of price controls shortly after the Executive Board's approval of the stand-by arrangement was a matter of concern. They had tried to resist the heavy pressures to do so, as noted by Mr. Polak in his statement, but the slippages were nonetheless unfortunate since they undermined the authorities' credibility and reduced the prospects for moderating inflationary expectations. The authorities needed to persist with their original intention to eliminate price controls and to allow the price mechanism to exert its intended effect on resource allocation as well as on savings and investment decisions.

Inflation continued to be an important area of concern and the most obvious sign that something in the economy was amiss, Mr. Pickering commented. The reduction of inflation must remain a priority. If inflationary pressures were to be contained and eventually reduced, a less accommodating monetary policy was essential. He urged the authorities to carry through with the measures to encourage financial intermediation and to strengthen the financial discipline of enterprises. On the latter point, he welcomed the decision to limit the growth of inter-enterprise credit and the staff's commitment to monitor inventory accumulation. The results should be made available before the completion of the next review.

The authorities were to be commended for maintaining a stable real effective exchange rate throughout the period of high inflation, Mr. Pickering said. However, the system of foreign exchange allocation was a matter of concern; the failure to develop a system that functioned properly was disappointing. He understood that the authorities were aware of the need for consistent and fair foreign exchange regulations, and he recognized that internal difficulties had prevented a consensus from emerging. Nonetheless, the administrative measures that continued to be applied on an interim basis were unsatisfactory; greater flexibility in the system as a method of encouraging convertibility was essential.

Although high inflation partly reflected an underestimation of the deleterious effects of price freezes implemented in earlier years and problems with the Fund's understanding of how monetary policy worked in Yugoslavia, Mr. Pickering said that he shared the staff view that delays in the implementation of structural measures designed to increase the efficiency of resource allocation were a major contributing factor. That was reflected most forcefully in the continuation of high inflation at a time of easing domestic demand.

It had been noted in the original letter of intent of the Government of Yugoslavia that "the process of structural adjustment has just begun," Mr. Pickering recalled. Based upon the staff assessment in EBS/85/243, the process still had a long way to go. Following so many years of significant Fund involvement, it was regrettable that more progress had not been achieved. A new phase of Fund involvement was likely to be opening up, as a result of the agreement with the banks and the possible provision of enhanced surveillance by the Fund when the current stand-by arrangement came to an end. Therefore, it would be important for the Fund to focus not only on the appropriateness of demand management policies, but also on the pace and adequacy of structural measures that would stimulate sustained economic growth.

In that connection, one of the major problems that the Fund had faced in the past, and would continue to face, was the inadequacy of appropriate statistical data in Yugoslavia, Mr. Pickering stated. The independent evaluation that would have to be fostered in the spirit of enhanced surveillance meant that Yugoslavia would have to provide more reliable statistical data. It would be somewhat less than satisfactory if Mr. Polak's remarks were interpreted to mean that that improvement would not be an important element of the Fund's recommendations in enhanced surveillance for Yugoslavia.

The stand-by arrangement approved in April 1985 had called for a mid-year review to take place before November 30 "in order to reach such understandings with the Fund as may be necessary," Mr. Pickering noted. The staff paper made specific reference to the requirement that that review should result in setting those performance criteria for the remainder of the program that had not been set at the outset. That understanding was clearly consistent with the Fund's guidelines on performance criteria and phasing that had been agreed in March 1985. Two of those guidelines should be highlighted: first, that every effort should be made to include performance criteria initially for as much of the 12-month period of the arrangement as possible; and second, that as a general rule indicative targets would be included at the outset for that part of the 12-month arrangement for which performance criteria were yet to be established. Given the spirit of those guidelines and the letter of the stand-by arrangement, the current review should perhaps not have been completed unless all performance criteria for the remainder of the program period had been established. The staff had indicated that it had not been possible to complete the review as envisaged because the Yugoslav authorities had been unable to determine policies for 1986 before early December. After roughly six years of close Fund-Yugoslav cooperation, it was unfortunate that that timing problem had remained unknown until the September 1985 mission. Perhaps there were other reasons for the delay which the staff had chosen not to mention. He raised the point not because there was any risk to the Fund's resources, since the phasing of purchases was not altered by the delay. Rather, he wished to underline the importance that his chair attached to the need for performance criteria to portray a clear indication of policy direction. To the extent that those criteria became less forward looking, their significance was weakened. The prolonged presence of the Fund in Yugoslavia made such shortsightedness unfortunate; in that sense, it was regrettable that the general procedures had not been followed in the case of Yugoslavia. But the point was a minor, procedural one that would not interfere with his full support of the proposed decision.

Mr. Dallara said that, like other Directors, he had approached the review not only in terms of Yugoslavia's current stand-by arrangement but against the background of its economic policies and close relations with the Fund over a number of years. The extent of that relationship was reflected in Yugoslavia's six Fund-supported programs since 1974 and the fact that it ranked second among all Fund members in its outstanding obligations to the Fund in the credit tranches as a percentage of quota. He also joined Mr. Pickering and others in asking why the staff had accepted the lack of performance criteria for the remainder of the program.

Commendable progress had been made in a variety of areas, Mr. Dallara continued, most of all in substantially strengthening the current account balance in convertible currencies and in setting in motion over a period of years some very important reforms in pricing policies, as well as in structural and institutional reforms. But it was in the latter areas where, like other Directors, he felt less confident about Yugoslavia's economic performance and prospects.

Progress on the balance of payments front had been particularly good, the current account balance in convertible currencies having moved from a deficit equal to 2 1/2 percent of GSP in 1982 to surpluses in 1983-85 in the range of 1/2 percent-2 percent of GSP, Mr. Dallara noted. Furthermore, the substantial real effective depreciation of the dinar and the adoption of a system for avoiding overvaluation in future was a cause for some confidence that the strengthening of the external accounts would be durable. The move toward more realistic and flexible interest rates clearly had helped and should continue to help to ensure that foreign exchange earnings were repatriated and that an incentive existed for Yugoslav citizens to keep capital at home. Yugoslav performance in those areas deserved commendation.

Viewed in the broadest terms, considerable progress had been made in pricing policies, Mr. Dallara observed. The exchange rate adjustments to which he had referred seemed to have re-established Yugoslavia's international price competitiveness. Interest rates--the price of capital--had reached a positive real level on the deposit side as a result of the formula being used for automatic adjustments; he viewed that progress as an important element of cooperation with the Fund over the past few years. The price of labor, at least in loss-making and illiquid public enterprises, was now tied to the economic performance of the enterprise. Similarly, the price decontrol action taken at the beginning of the year had gone some distance toward releasing pent-up inflation and allowing for a more realistic pattern of relative prices within the economy.

All that being said, however, pricing policies remained less than market determined in a number of areas, Mr. Dallara added. The exchange rate was still set by the monetary authorities. Interest rates on the lending side, although less negative in real terms than previously and with the differential between preferential and other rates having been reduced, were still in need of further adjustment toward a more realistic and unified level. Whether or not wage rates in loss-making enterprises were really being contained was also difficult to determine. Failure to relate wages closely to the actual financial performance of enterprises would no doubt hinder labor mobility and impede economic efficiency and the creation of new job opportunities. Finally, a number of prices of goods and services remained subject to direct government determination or to prior approval by the Federal Bureau of Prices. Furthermore, the revisions in price controls introduced in May and October, although explained in the staff report as not representing a return to greater administrative involvement in price setting, raised some doubts and could adversely affect inflationary expectations, particularly if the authorities acceded to the temptation to try to influence prices for which prior notification was still required. Therefore, he underscored the particular importance of transparency in the implementation of pricing regulations in coming months. For example, it would be interesting to know whether prices for goods sold in both the domestic market and in export markets were being established in such a way as to create any relative incentives in favor of sales in domestic versus foreign markets.

The staff paper contained a status report on the extent to which greater financial discipline in the public enterprise sector had been achieved, as a result of such measures as limits on personal income payments, more realistic depreciation allowances, and more restrictive access to, as well as the higher cost of, credit, Mr. Dallara noted. Evidently, the effects of those measures were beginning to appear and to reveal some underlying weaknesses in the balance sheets of some enterprises. He supported the suggestion by the staff that, should financial reorganization of public enterprises or of the banks seemed called for, the authorities should not hesitate to consider it.

On monetary matters, there was some evidence that the chronic problem of excess liquidity in the economy was gradually being reduced, Mr. Dallara commented. A much higher than expected inflation rate had been accommodated by monetary policy in 1985 and credit did not appear to have been tight enough or, perhaps, costly enough to have inhibited a large buildup of inventories--even if the data on stock building overstated the actual situation. He had been very interested in Mr. Lankester's comments and would welcome the staff's views on the inventory problem, which suggested the need for a continued reduction in excess liquidity. It also raised the issue of the fragmented and isolated or, at least, segmented credit markets in Yugoslavia, which appeared to frustrate capital mobility, the mobilization of domestic savings, and the efficient allocation of investments. The absence of a national financial market might be considered natural in light of the decentralized political structure. But that fact should not obscure either the rather high price that had to be paid as a result in terms of the freedom and efficiency of financial flows or the need to integrate financial markets as much as possible.

The lack of a national market for foreign exchange was another weakness in the economy that had involved the Fund in considerable efforts with Yugoslavia in recent years, Mr. Dallara remarked. His chair, in its statement to the Executive Board in April 1985, had urged the Yugoslav authorities to take into account the staff's views on ways to create a true national market for foreign exchange. Yet the staff paper, and Appendix V in particular, suggested that the new system under consideration could actually be a step backward. While the authorities continued to aim at eventual full convertibility of the dinar and the creation of the national market, those objectives still seemed far off in the distant future. In fact, the transitional foreign exchange market arrangements that might be approved by the Federal Assembly before the end of 1985 would tend to freeze export earnings and import demand into historic patterns, thereby reducing the prospects for export diversification and efficient import substitution, both of which were necessary to protect the balance of payments on a sustainable basis.

In sum, considerable progress had been made on economic adjustment, especially in restoring external balance and in moving toward liberalization of pricing policies, Mr. Dallara stated. But as other Directors had stressed, inflation remained high, even on a decelerating trend; economic growth was inadequate; and more needed to be accomplished on structural and institutional reforms. Fiscal policy had been quite prudent, even if there still appeared to be a chronic excess of liquidity in the economy. Considerable effort and perseverance had been shown by the Yugoslav authorities in recent years. Therefore, it was to be hoped that when the stand-by arrangement came to an end, Yugoslavia's economic performance and prospects for sustainable economic growth with financial stability would have improved further, thereby offering assurance of continued improvement in economic performance over the medium term. He would appreciate receiving any available information concerning Yugoslavia's structural reform efforts in cooperation with the World Bank. Disbursements had already been made under one structural adjustment loan. In the period ahead, structural adjustment would become increasingly important, and close collaboration with the World Bank might be particularly useful to the Yugoslav authorities.

In that connection, there was an expectation that Yugoslavia would be cooperating with the Fund under an enhanced surveillance arrangement, Mr. Dallara remarked. For the good of Yugoslavia and for the credibility of the Fund, it was important that any such arrangement work well. The Fund staff would have to be able to monitor developments in the Yugoslav economy with accuracy but without its in-depth and frequent contacts during the period covered by recent stand-by arrangements. Therefore, he urged the authorities to cooperate closely in improving statistical data in terms of its frequency, comprehensiveness, and accuracy. He would be interested in the staff response to Mr. Polak's statement on Fund data requirements in Yugoslavia because it seemed to him that when a member country moved into an enhanced surveillance arrangement, the provision of timely and complete data was essential. It would be surprising if the staff would be able to spend much time in member countries' capitals under such arrangements or mobilize such data itself. It should be incumbent on the member to assemble and disseminate ample data.

Taking up Mr. Lankester's point about the form that enhanced surveillance would take, Mr. Dallara recalled that the Board's informal agreement, which had been noted in Mr. Polak's statement, left open questions of detail. The Executive Board would need to focus closely on the matter early in 1986; so far, it had reached an agreement in principle but not on any particular techniques. There were various options; but whatever technique proved satisfactory for private creditors might not be satisfactory for official creditors, should a multiyear rescheduling arrangement with them materialize. He also supported the point made by Mr. Pickering on the need for structural reform in connection with any enhanced surveillance arrangement.

Finally, Mr. Dallara recalled that the Executive Board had been asked one week previously to approve, on a lapse-of-time basis, a decision that satisfactory arrangements had been made between Yugoslavia and its major commercial bank creditors on the refinancing of certain maturities falling due so that Yugoslavia could make the scheduled drawing under the stand-by arrangement on November 29. That decision had been adopted, but he had agreed to it most reluctantly. His authorities had not been pleased with the considerable delays associated with final agreements between the Yugoslav authorities and the banks on the various rescheduling modalities. As he understood it, the more recent delays had been largely attributable to the banking community. Nevertheless, the repeated appeals to the Executive Board to interpret the provisions of the stand-by arrangement rather liberally in order not to delay Fund drawings, even though the formal conclusion of debt refinancing with the banks was not on schedule, were unfortunate. It might have been better to bring the most recent decision to the Executive Board at the present meeting, even though that would have involved a delay in the drawing by the Yugoslav authorities and perhaps created an unwarranted and unnecessary inconvenience for them. It was on the basis of those very considerations that he had been prepared to accept the decision. But more generally, he believed that the Fund should think twice about whether such a liberal interpretation of provisions in stand-by arrangements was in the long run the most effective way to encourage the satisfactory conclusion of the financing arrangements that were essential to Yugoslavia's financial well being.

Mr. Salehkhou noted that the overall economic performance of Yugoslavia under the current program, which aimed at consolidating the favorable trend that had begun emerging during 1984, had been weaker than expected, according to the staff paper. Although all performance criteria had been met, the introduction of economic reforms was, not unexpectedly, a slow process.

On the supply side, large-scale stock building, accounting for more than 20 percent of GSP in 1985, had taken place at the same time as production had outpaced domestic demand, and the growth of imports was estimated to have been stronger than that of exports, Mr. Salehkhou said. While the staff attributed the holding of excess inventories to the fact that lending rates continued to lag behind real positive rates on time deposits, he suggested that the major reason might be high inflation. After all, it would seem quite rational for enterprises to carry large inventories that were valued at higher prices. Given the lack of a unified rate of interest in the Yugoslav economy and the existence of heavy interest rate subsidies, it was difficult to see how a monetary prescription--namely, one of totally market-oriented higher and positive real interest rates--would solve a problem that appeared to be fundamentally a symptom of structural defects in the economy. After all, the existence of major structural problems had been acknowledged by the staff.

Furthermore, the staff had suggested that "the degree to which stocks are likely to be drawn down...will depend on the extent to which producers feel sufficient economic pressure to sell excess inventories at market-clearing prices," Mr. Salehkhou observed. He asked what the staff meant by sufficient economic pressures to sell at market-clearing prices and how and by what means those pressures would be exercised. In light of the staff's position on economic reform, he assumed that that pressure was not to be imposed by means of an administrative measure; or was it? However, the staff meant that the incentive must be created by market forces--namely, higher prices--surely the result would be a strengthening of inflationary expectations which, as the staff admitted, already existed in the economy. It seemed to him that the staff was offering a "chicken and egg" proposition by suggesting that stockpiling had contributed to inflation, that inflation was a major cause of stockpiling, and that in order for inflation to be reduced, stockpiling must be reduced, for which purpose it was necessary to reduce inflation. It would seem more reasonable for the staff to offer more concrete measures to enable the economy to break out of that vicious circle.

While he welcomed the authorities' undertaking to specify measures to limit the growth of stock building to a normal market level prior to completion of the midterm review, Mr. Salehkhou said that he would appreciate the staff's views on the degree of efficiency and effectiveness of whatever related measures had so far been implemented to augment the effective cost of carrying inventories.

On the demand side, there had been a further discouraging fall in purchasing power, which was posting its sixth consecutive annual decline, Mr. Salehkhou noted. During the first six months in 1985, real net personal income per worker in the socialized and economic sector had continued to decrease by about 1.9 percent and 3.6 percent, respectively, over the corresponding period of the preceding year, partly affecting the decline of private consumption expenditure. In that respect, he found it difficult to share the staff contention that that decline partly reflected some increase in the propensity to save in response to the significant improvement in yield on savings deposits. That point had particular relevance in view of the staff statement that "still, any recorded drop in private consumption might be overstated since unrecorded sales in the private sector appear to be growing sufficiently rapidly to account for an increasingly significant share of actual consumption." In fact, that statement confirmed that economic behavior in an inflationary environment tended to increase private consumption expenditures rather than savings, although in Yugoslavia the continued decline in real personal income had already decreased purchasing power, and hence reduced the propensity to save.

The external economic performance of Yugoslavia during the first six months of 1985 had been weaker than targeted, Mr. Salehkhou observed. The overall current account surplus had been limited to a surprising \$117 million, well below the projected figure and the outturn for the corresponding period of the preceding year. He asked the staff whether it could elaborate further on the underlying causes. It appeared that the effects of policy measures--such as exchange rate adjustment to compensate for inflation differentials between the domestic and international markets--would take time to be felt in the external sector in the present transitional period. In that respect, he had taken note of the considerable increase in reserves in September 1985, the improved cash flow associated with trade movements, and the authorities' tendency to remain committed to maintaining a liberalized price system and to take corrective measures to improve the allocation of foreign exchange in order to achieve full convertibility of the dinar, with some exceptions.

Finally, Mr. Salehkhou commended the Yugoslav authorities for having achieved all the performance criteria under the current stand-by arrangement and supported the proposed decision.

Mr. Sengupta said that most of the concerns he had raised in April 1985 during the Executive Board's discussion of Yugoslavia's request for a stand-by arrangement remained valid. In sum, although the Yugoslav economy had grown at a satisfactory rate in the 1970s, its performance had deteriorated from 1979 onward in spite of a number of consecutive Fund-supported programs having been almost fully implemented. With the exception of the reserves position and possibly the balance of payments position, most objective indicators such as the growth of employment, investment, social and personal consumption, and gross social product, the policy actions taken by Yugoslavia in accordance with the Fund-supported program had not been very satisfactory.

He wished to add his voice to that of Mr. Zhang in mentioning once again that where there was a risk of a mismatch between the Fund's prescribed policy objectives and the nation's policy objectives in the long run, the Fund should avoid involvement, Mr. Sengupta continued. It was an issue to bear in mind at a time when Yugoslavia's policy might need to be turned back more in the direction of structural than short-term adjustment.

The Yugoslav authorities were to be commended for adhering to the program targets and criteria in the stand-by arrangement, in spite of adverse exogenous circumstances, Mr. Sengupta concluded. There were worrisome developments in respect of investment, exports, and inflation, but the serious way in which the authorities were grappling with the problems gave reason to hope that they would be able to turn the corner and resume economic growth at an early date. He supported the proposed decision.

Mr. Ortiz noted that the economic situation in Yugoslavia remained difficult, despite the fact that the country had had Fund-supported programs continuously since 1979. According to the information in Appendix II of EBS/85/243, Yugoslavia had made all the purchases available under the various stand-by arrangements, meaning that it had continued to satisfy the performance criteria. However, during the 1980s, economic activity had stagnated, and the inflation rate had been on an upward trend, especially since the second half of 1983. As a consequence, real net personal income per worker had declined steadily, by approximately 35 percent since 1979.

The public sector had been recording modest surpluses during the past few years and it had been drastically reduced in size, Mr. Ortiz continued. As a proportion of GDP, public expenditures had been cut by more than 11 percentage points from 1978 to 1984. Another positive result obtained during that period was the turnaround in the balance of payments in convertible currencies, which was also registering moderate surpluses. However, in spite of those more favorable trends, the debt/GDP ratio, which had registered a discrete jump in 1982/83, had stabilized at around 42 percent, a level comparable to that of major debtor countries in the Western Hemisphere.

For a country that had been in compliance with Fund programs for a number of years, and in which the scale of the public sector in the economy had been greatly reduced, Mr. Ortiz continued, the obvious question was why the economy had not been stabilized and the basis for growth established. From the staff paper and from Mr. Polak's statement, it was apparent that the major remaining problems were not macroeconomic, as Mr. Zecchini had pointed out, but had their roots in the microeconomic characteristics of institutional factors. Thus, the issue was how to resolve the conflict inherent in policy advice directed at movement toward market-determined flexible prices and decentralized decisionmaking in an economy organized to a large extent around the concepts of economic planning and centralized decisions on resource allocation.

Developments in the real sector of the economy were quite puzzling, Mr. Ortiz remarked. In 1985, final domestic demand was expected to fall about 4.5 percent while output would remain flat, the difference being accounted for mainly by increased inventories. It was apparent from Table 2 that stock building had been increasing steadily since 1981--with the exception of 1982--in the face of stagnant economic activity and had substantially exceeded output in that period, accounting for a large proportion of GSP. While some stock building could be expected at the beginning of the downward trend of the business cycle, it hardly seemed reasonable that that behavior should continue for a number of years. Moreover, the significant increase in stock building in 1985 raised the question why the price liberalization efforts undertaken since 1984 had not succeeded in arresting the trend.

Price liberalization and the increases in administered prices in the context of the authorities' present exchange rate policy could be expected to lead to inflationary pressures, which, however, had eased somewhat in more recent months, Mr. Ortiz remarked. The timing and magnitude of future administered price increases would have to be considered very carefully since discrete increases in those prices all too easily could lead to building in permanent elements of inertia in the process of price formation.

Personal income had been declining steadily, and aggregate demand had consistently fallen short of expectations, Mr. Ortiz commented. Whereas the public sector appeared to be generating moderate surpluses, there would seem to be some scope for stimulating private consumption--for instance, through tax cuts or other related measures.

The staff assessment was that Yugoslavia's economic performance in 1985 had been mixed, Mr. Ortiz added. Although the member had complied with all the performance criteria, the balance of payments, inflation, and growth results had fallen short of expectations. The sluggish export performance had been attributed to external factors, with the unsatisfactory experience of other countries in the region having been cited as evidence of generally weaker than expected demand. Inflation, on the other hand, had been explained by the price liberalization and increases in controlled prices. Curiously enough, the slow pace of economic activity was attributed partly to excessively loose credit conditions during the first part of 1985. The point had been made that excessive credit availability had facilitated the accumulation of inventories in the face of falling demand because firms had decided to build up stocks instead of cutting prices to stimulate sales. It was an interesting hypothesis but the staff paper did not provide an adequate explanation for the decision of firms to accumulate inventories rather than to increase sales, especially since accounting practices had been modified to eliminate phantom profits from enterprise accounts.

The fiscal stance in 1985 would turn out to be slightly more restrictive than originally planned, according to the staff, Mr. Ortiz noted. However, the figures in Table 2 suggested that fiscal policy had been substantially more restraining, especially in respect of investment spending. Perhaps fiscal policy had been too restrictive to begin with, especially considering that the public sector was recording surpluses at a time when private consumption had experienced a decline for the fourth consecutive year. Again, an obvious consideration was that a moderate fiscal stimulus to boost domestic demand might be in order.

He had been particularly interested in the staff appraisal of the rigidities in the financial sector, Mr. Ortiz remarked. Clearly, it seemed inconsistent to set the same credit ceilings and reserve requirements for financial institutions that served different sectors of the economy and were situated in regions of the country having different credit needs. The utilization of only one mechanism of credit control, such as reserve requirements, should suffice to regulate the expansion of liquidity and at the same time would permit the formation of an interbank credit market which might allocate financial resources more efficiently.

He fully agreed with the staff and Mr. Polak that greater discipline on the part of enterprises was much needed if monetary policies were to be at all effective in curtailing inflationary pressures, Mr. Ortiz said. He had been encouraged by Mr. Polak's assertion that the authorities had resisted pressures to resort to price controls in spite of the inflationary surge occasioned by the corrective price action taken. Without elaborating further on the importance of structural reforms, to which many previous speakers had alluded, he agreed with the staff that enhancing the overall efficiency of the economy would depend to a great extent on the maintenance of a competitive environment for allocating imports and foreign exchange. He supported the proposed decision.

Mr. Dreizzen remarked that while he commended the Yugoslav authorities for their success in meeting all the performance criteria under the current stand-by arrangement, like others, he was also concerned about the negative trends of inflation and growth in Yugoslavia. The Executive Board had before it the case of a country that had been unable to deal successfully with those trends despite having fully met the performance criteria under its arrangement with the Fund. Once again, the need for the Fund to increase its efforts aimed at improving the design of the programs it supported had been highlighted. He looked forward to the forthcoming discussion on the theoretical aspects of, and experience with, program design.

Referring first to the revision of the macroeconomic forecasts for 1985, Mr. Dreizzen recalled that according to the program approved by the Executive Board in 1985, inflation had been expected to fall and both consumption and fixed investment to reverse the downward trends recorded in the 1980s. He had been disappointed to note from the staff paper on the review that an increase of about 25 percentage points in the inflation rate and further declines in consumption and fixed investment were forecast for 1985.

As for inflation and the Fund's prescriptions for dealing with it, Mr. Dreizzen continued, several Executive Directors had asked the staff during the previous discussion of Yugoslavia in the Board to deepen its analysis of the major sources of the inflationary process in the country, Mr. Dreizzen noted. In that respect, the staff had concluded in its appraisal that "...an underestimation of the effects of the price liberalization implemented early in the year was an important factor accounting for the disappointing performance. But of greater importance were delays in the effectiveness and implementation of structural measures." Although the staff recognized that the inflationary pressures had not been caused by excessive global demand and that "money and credit policies became increasingly tight during the year," the net domestic assets limit had been tightened compared with the limit foreseen in the original arrangement. That did not seem consistent with developments in recent years showing that the traditional emphasis on demand management, while causing a very serious decline in output and living standards, had not worked to reduce Yugoslavia's inflation rate.

The stop-and-go nature of anti-inflationary policy might reflect the difficulties of detecting and understanding the sources of inflation in Yugoslavia and the most appropriate ways to counter them, Mr. Dreizzen considered. Moreover, there might be some kind of paradox in simultaneously having, on the one hand, an exchange rate policy that while improving external competitiveness, had pushed up the inflation rate and, on the other hand, a tight monetary policy that while trying without success to reduce inflation, had also impeded export performance by failing to provide credit for working capital in the export sector. Higher nominal interest rates might also have fueled inflationary expectations. On structural reform, the Yugoslav authorities' key task at the current stage of the adjustment process was structural change, as they had stated in the supplement to their memorandum of September 30, 1985, in Appendix I to EBS/85/243, Mr. Dreizzen noted. The aim was to improve efficiency, particularly by reducing the fragmentation of markets for goods, capital, labor, and foreign exchange. Success in those areas would help to solve the most important difficulties relating to growth and inflation. In that respect, he asked for further information about the current stage of the negotiations with the World Bank on the second structural adjustment loan. He also enquired whether the sharp fall in gross fixed investment and the prolonged recession had undermined the process of structural reform in Yugoslavia.

As for the external sector, the projections in Table 1 of Appendix IV of the staff paper clearly showed that Yugoslavia's medium-term prospects were solid, Mr. Dreizzen remarked. The debt service ratio would fall from 43 percent to 27 percent, and total debt would decline from $19 billion to $16 billion between 1984 and 1990. The agreements reached by Yugoslavia with its official and private creditors on the multiyear rescheduling of medium- and long-term debt constituted an important step toward a strong external position which would allow Yugoslavia to direct its efforts at deepening the structural reforms that were needed. He supported the proposed decision.

The staff representative from the European Department observed that the Article IV consultation mission would be leaving for Belgrade shortly, and the staff intended to seek the answers to some of the questions that had been raised regarding structural issues on which it needed to deepen the dialogue with the authorities.

In negotiating the stand-by arrangement with the authorities early in 1985, the staff representative recalled, the staff had enquired whether the authorities would be able to agree on quantitative performance criteria for 1986 to any meaningful degree, and they had seemed to feel that they could. When that had proved not to be possible in September, it had seemed appropriate first of all to set the performance criteria for the end of 1985 and to set the remaining ones in the context of an additional review.

As for the modalities of enhanced surveillance by the Fund, the staff representative mentioned that it had been made clear during the earlier discussions in the Executive Board that the request by Yugoslavia for enhanced surveillance would not be a formality and that the Executive Board would have an opportunity to consider the modalities, which therefore would have to be discussed previously with the staff. By its very nature, enhanced surveillance required the staff and the authorities to pull together data that might not always be assembled in the normal course of formulating domestic policy. Thus, although the frequency of staff visits to the member country should lessen under an enhanced surveillance arrangement, in-depth discussions would continue. At the same time, it would be necessary to make provision to peruse the type of data and make the same kind of early warning assessments as during the staff's more frequent visits in the context of a stand-by arrangement. Therefore, in referring to the enhanced monitoring process in the staff paper, the intention had been to indicate that it would be essential to ascertain, in cooperation with the Yugoslav authorities, how to implement the process of enhanced surveillance. The authorities would quantify their targets for the years to be covered by the arrangement, as they always did, but they would then also quantify the path along which those annual targets were to be achieved. It was against that background, and taking into account the structural adjustment to be undertaken, that the whole process of enhanced surveillance would be carried out in a medium-term framework.

If there was a distance between the objectives of a Fund program and the means with which the authorities might wish to achieve those objectives, the staff representative remarked, the program was unlikely to be successful over time. If in negotiating a program the staff tended to take an adversarial approach, it was usually because of the need to reach a certain goal with speed, but that role had to be translated into an advisory one to ensure the success of the programs negotiated. The long-term economic stabilization program of the Yugoslav authorities could almost have been written by the Fund staff. Thus, there could be no quarrel about its objectives. Part of the problem lay in the methods and the speed with which those objectives were being achieved. On price policy, the authorities had attempted to carry out a major and almost complete price reform without having put in place some of the attendant structural changes that would have made the price reform both more successful in shifting resources as well as less inflationary in its initial effects. That had been the crux of the staff's discussions with the authorities.

The data on inventory accumulation were subject to considerable doubt, the staff representative noted. After all, if 20 percent of output was going into inventory year after year at a minimum, warehouse construction might have been expected to increase. Therefore, the staff intended to pursue the matter of the structure of output and demand with the authorities. Looking at the mainspring of economic growth since the 1970s, it would be observed that 37.5 percent of total output had gone into fixed investment at the height of the growth cycle, largely to investment that in the event had not yielded economic rates of return. Based on the authorities' forecast for 1985, investment would still be some 21 percent of GSP, which was not necessarily a low share if the quality was good and met the need for modernization of the economy. Similarly, consumption had fallen from 55 percent to 48 percent of GSP; if consumption had been sustained, despite the large decline in real income from employment, it had to do with the fact that household incomes in general had fallen by much less. Preliminary figures indicated that household income would rise in real terms in 1985, partly because households held savings in the form of foreign currency deposits and partly because of the growth in the private sector and the shadow economy. In that connection, she noted that it would be very difficult to ascertain the extent of the growth of the shadow economy.

Even if inventory accumulation was not as large as the figures appeared to indicate, the ability to pile up inventories while prices continued to rise was no doubt connected directly with the difficulties in improving financial intermediation and the financial discipline of enterprises, the staff representative observed. There were currently very few financial assets into which enterprises could place short-term excess liquidity that would be protected from erosion through inflation. Thus, inventories were a convenient alternative that explained in part the large increase in the extension of credit outside the banking system. It was crucially important therefore to tackle the whole question of inter-enterprise credit and of the issuance of promissory notes without bank guarantees. The authorities had hoped to be able to make a specific proposal with respect to the amount of such promissory notes by the end of 1985, but that had not proved possible. The issue would have to be taken up by the Article IV consultation mission. The lack of variety in financial instruments, the failure to curtail the extension of inter-enterprise credit, and the interest rate structure together, provided the answer to many of the basic questions that had been asked. Export activity was not being affected adversely by a lack of export credit, given the large subsidy element in lending rates. Moreover, the exchange rate adjustment mechanism offered considerable assurance to exporters of more or less inflation-proof liquidity in dinars, thereby reducing their credit needs vis-à-vis those of domestically oriented enterprises. However, the access of exporters to credit was rather greater than their needs, and the cost of that credit was much less than could be obtained from on-lending to other enterprises in a tight credit situation. Export paper was probably being discounted at low interest rates and the proceeds then on lent to other enterprises; access to such a margin should be limited to the banking system and preferably eliminated as speedily as possible. Therefore, the unification of the interest rate structure was crucial if monetary policy was to be made more effective. Many of the necessary structural changes were to be brought about under the new banking law, which was presently being formulated. However, although the role of the National Bank of Yugoslavia and the banks of the individual republics and provinces in the interbank market was to be enhanced, she did not believe that that role had been specified in the law. The staff felt that the matter needed to be discussed urgently because monetary policy could be considerably more effective if the National Bank could pursue a more active liquidity policy, including open-market operations.

Enterprises did not have to operate under significant budget constraint, the staff representative from the European Department noted. That was one of the reasons why it was difficult to achieve policy objectives and why harsh measures and long time lags were involved. Bankruptcy laws did exist in Yugoslavia, and they had, in fact, been strengthened in 1984. However, when a particular enterprise represented virtually the only employer in a particular region, it was very difficult to make the decision to close it down. It would seem necessary to encourage a much more active restructuring or merging policy.

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

2. EXECUTIVE DIRECTOR

The Chairman bade farewell to Mr. Zhang on the completion of his service with the Executive Board.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/85/170 (11/25/85) and EBM/85/171 (11/27/85).

3. ADVISORS TO EXECUTIVE DIRECTORS - REMUNERATION

The Executive Board approves, with one objection, the recommendation to increase the remuneration of Advisors to Executive Directors as set forth in EBAP/85/283 (11/21/85) and Supplement 1 (11/29/85).

Adopted November 26, 1985

4. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 85/28 through 85/30 are approved. (EBD/85/293, 11/20/85)

Adopted November 26, 1985

APPROVED: July 11, 1936

LEO VAN HOUTVEN
Secretary