November 10, 1980

MEMORANDUM

To: Mr. Hood
Mr. Whittome
Mr. Finch
Mrs. Lachman
Mr. Wittich

From: Geoffrey Tyler GT

Subject: Yugoslavia--Stand-By Arrangement: Modification and Waiver

The attached draft letter from the Yugoslav authorities requests a waiver of three performance criteria for September 30, 1980 and modification of two such criteria for December 31, 1980. A draft Board paper should be with you for comments on November 12, 1980.

The matter must be dealt with with particular urgency, since the mission is to return to Belgrade at the end of November. Could you please inform me by Wednesday morning whether or not the wording of the draft letter causes any problems, so that I can telex the Yugoslav authorities regarding the draft?

Attachment

cc: G-T I dont follow the argument of the last three sentences on page 3. Could you explain please.
I think also you need the small change suggested on p4.
JMW 10/11

DRAFT/11/3/80

Belgrade, Yugoslavia

November , 1980

Dear Mr. de Larosiere:

1. In our letter of May 16, 1980 addressed to you, we described the economic and financial program adopted by the Government of Yugoslavia as a major stabilization effort to achieve, inter alia, a substantial reduction in the current account deficit of the balance of payments. In support of the program the Fund approved on June 6, 1980 a stand-by arrangement that included as quantified performance criteria, quarterly targets on (1) net domestic assets of the banking system, (2) net credit of the National Bank of Yugoslavia to the Budget of the Federation, (3) outstanding foreign debt in convertible currency with original maturities of more than one year (excluding purchases from the Fund), and (4) the cumulative decline in net convertible foreign assets of the National Bank less exceptional financing in convertible currencies by commercial banks.

2. On September 30, 1980 the performance criteria relating to net domestic assets of the banking system, net credit of the National Bank to the Federation and the cumulative change in net convertible foreign assets of the National Bank were not observed for reasons that are described below, which were not foreseen when the program was established. However, we believe that the most important objective of the program, namely a substantial improvement in the current account of the balance of payments, is being achieved and that the inability to meet some of the performance criteria on September 30, 1980 does not indicate that the basic program is not being firmly implemented.

3. During the first nine months of 1980, substantial progress has been made in reducing the current account deficit of the balance of payments. Export volume increased by 11 per cent with respect to the same period of 1979 and export value by 32 per cent. The value of imports over the same period rose by 8.5 per cent but the volume of imports declined by 10 per cent. Thus, developments in the trade account have been more favorable so far in 1980 than was projected at the time of the formulation of the program, when we expected export volume for the whole year to rise by 8 per cent and import volume to decline by 9 per cent. On services account there have been both favorable and unfavorable developments. On balance higher service payments, especially for interest, are likely to lead to a somewhat smaller surplus on services than we originally expected. However, we expect that the current account deficit will be about US$ 2.0-2.3 billion (equivalent to about 3 per cent of GSP), compared with the target of US$2.5 billion described in our letter of May 22, 1980, and appreciably below the deficit of US$3.7 billion recorded in 1979.

4. The improvement in the current account was achieved in part by an active exchange rate policy designed to restore the competitiveness of the Yugoslav economy. Over the first months of 1980 the effective exchange rate of the dinar continued to be depreciated. Moreover, on June 6, 1980 the dinar was depreciated from Din 21 to Din 27.3 per U.S. dollar to reinforce the efforts being made to improve the current account of the balance of payments. By end-September 1980 the effective trade-weighted exchange rate had depreciated by 42 per cent per unit of foreign currency with respect to December 1979.

5. While there were favorable developments in the current account of the balance of payments, developments in the capital account have been

different from our original expectations. In particular, during the first nine months of the year, difficulties were encountered in obtaining the desired amount of medium-term and long-term foreign loans from commercial banks to the nonbank sector. Disbursements fell short of the levels planned when we formulated our economic program for 1980, and outstanding medium-term and long-term convertible debt, which amounted to US$12.3 billion at the end of 1979, amounted to US$ 13.3 billion in September 1980, considerably below the level of US$14.2 billion originally envisaged. We expect that gross medium-term and long-term borrowing in convertible currencies will accelerate sharply in the current quarter but the level of such debt outstanding at the end of 1980 is unlikely to exceed US$ 13.1 billion. 660?

6. The shortfall in foreign medium-term and long-term borrowing required us to make extensive use of short-term foreign borrowing and to run down gross international reserves. As a result, net international reserves of the National Bank declined by more than the amounts envisaged in the stand-by program. By September 30, 1980 the cumulative decline from December 31, 1979 in net convertible foreign assets of the National Bank of Yugoslavia, less exceptional financing by commercial banks, which had been targeted at US$500 million, amounted to US$ 937 million. In view of the favorable developments in the current account, and the expected acceleration of medium-term and long-term convertible foreign borrowing in the remainder of 1980, we estimate that the deterioration described above will be partly reversed. Accordingly, we expect that the cumulative decline in net convertible foreign assets of the National Bank, less exceptional financing by commercial banks, should not exceed US$ 1,600 million between December 31, 1979 and December 31, 1980.

7. Domestically, an important aspect of our policies had been to reduce demand pressures. Our success can be judged by the fact that, based on results for the first eight or nine months of the year, real fixed investment is expected to decline by about 2 per cent in 1980 compared with 1979, real private consumption may rise by only about 1 per cent, and real public sector expenditure may decline by about 8 to 10 per cent. Real social product in 1980 is expected to be only about 2.5 per cent greater than in 1979, when the increase was 7 per cent.

8. By itself, the above reduction in domestic demand pressures should have helped bring about a reduction in inflation. Unfortunately, the combination of the high rate of increase of the foreign exchange price of imports, including oil and other raw materials, the depreciation of the effective exchange rate of the dinar and necessary adjustments in some administered prices led to an acceleration of the rate of inflation and currently retail prices ~~were~~ are 30 per cent higher than a year earlier.

9. With nominal social product expected to rise by about 32 per cent in 1980 compared with our original expectation of a rise of only 22 per cent, some increase in monetary expansion above originally planned rates has become necessary. When we originally formulated the monetary program, the increase in the money supply between December 31, 1979 and December 31, 1980 was to be 22 per cent. We have now increased this target to 24 per cent. Consistent with this target and the fact that the net foreign assets of the banking system have declined by more than we originally estimated because of lower foreign borrowing by the nonbank sector, we have found it necessary to permit the net domestic assets of the banking system to increase by somewhat more than

originally planned. Thus, the level of net domestic assets of the banking system on September 30, 1980 was Din 1,449.6 billion compared with the original target of Din 1,381 billion and we have raised the limit for December 31, 1980 to Din 1,538 billion from the original target of Din 1,466 billion.

10. We originally set limits of Din 77.4 billion for September 30, 1980 and Din 77.9 billion for December 31, 1980 on net credit of the National Bank to the budget of the Federation, which stood at Din 68.7 billion on December 31, 1979. Principally because revenues of the Federal budget did not increase by as much as anticipated, partly because of the slow growth of imports, the Federal Government had borrowed Din 77.9 billion net on September 30, 1980, which is the amount programmed for the year as a whole. However, we do not intend to raise the latter limit so that for the year as a whole the Federal budget will not add to liquidity by more than the planned amount.

11. The Yugoslav Government believes that significant economic progress has been made so far in 1980 and it intends to continue with the stabilization effort in 1981. We believe that the changes in the performance criteria for September 30 and December 31, 1980 described in paragraphs 6, 9, and 10 above are consistent with the implementation of the stabilization program and request the necessary waiver with respect to the above mentioned performance criteria for September 30, 1980 and the necessary modification of those for December 31, 1980. Yugoslavia intends to take any further measures that may become necessary to achieve the aims of the stabilization program.

Yours sincerely,

Ksente Bogoev
Governor, National Bank of Yugoslavia

Ing. Petar Kostic
Federal Secretary for Finance

Yugoslavia: Quantitative Performance Criteria
for 1980 in Stand-By Arrangement

| | 1979 December 31 Actual | 1980 June 30 Actual | 1980 Sept. 30 Actual | 1980 Dec. 31 Forecast | 1980 Ceiling Under Program June 30 | 1980 Ceiling Under Program September 30 | 1980 Ceiling Under Program December 31 |
|---|---|---|---|---|---|---|---|
| | | | | | (Proposed new ceilings in brackets) | | |
| Net domestic assets of the banking system; in billions of dinars | 1,201 | 1,368 | 1,450 | 1,538 | 1,321 | 1,381 (1,450) | 1,466 (1,538) |
| Net credit of the National Bank to the Budget of the Federation; in billions of dinars | 68.7 | 77.9 | 77.9 | 77.9 | 76.4 | 77.4 (77.9) | 77.9 |
| Cumulative change in net convertible foreign assets of the National Bank; in millions of U.S. dollars 1/ | ... | -972 | -937 | -1,600 | -900 | -500 (-937) | -- (-1,600) |
| Convertible currency debt outstanding; in billions of U.S. dollars 2/ | 12.3 | 13.1 | 13.3 | 13.1 | 13.6 | 14.2 (14.2) | 14.7 (13.1) |

Source: Data supplied by the Yugoslav authorities.

1/ Net of exceptional borrowing by commercial banks.

2/ Debt outstanding in convertible currency with original maturities of more than one year. Excluding outstanding purchases from the Fund and increases in exceptional borrowings by the commercial banks in 1980. Valued at exchange rates prevailing on December 31, 1979.

470882 cc: [illegible]

Belgrade November 20, 1980

SOCIALIST FEDERAL REPUBLIC OF YUGOSLAVIA
**FEDERAL SECRETARIAT FOR FINANCE**
11070 BEOGRAD

ORIG: EUR
CC: MD
DMD
MR. RUDING
LEG
RES
ETRD
SEC
TRE

Mr. J. de Larosiere

Managing Director
International Monetary Fund
Washington, D.C., 20431
U.S.A.



Dear Mr. de Larosiere:

1. In our letter of May 16, 1980 addressed to you, we described the economic and financial program adopted by the government of SFR Yugoslavia as a major stabilization effort to achieve, inter alia, a substantial reduction in the current account deficit of the balance of payments. In support of the program the Fund approved on June 6, 1980 a stand-by arrangement that included as quantified performance criteria, quarterly targets on (1) net domestic assets of the banking system, (2) net credit of the National Bank of Yugoslavia to the Budget of the Federation, (3) outstanding foreign debt in convertible currency with original maturities of more than one year (excluding purchases from the Fund), and (4) the cumulative decline in net convertible foreign assets of the National Bank less exceptional financing in convertible currencies by commercial banks.

2. On September 30, 1980 the performance criteria relating to net domestic assets of the banking system, net credit of the National Bank to the Federation and the cumulative change in net convertible foreign assets of the National Bank were not observed for reasons that are described below, which were not foreseen when the program was established. However, we believe that the most important objective of the program, namely a substantial improvement in the current account of the balance of payments, is being achieved and that the inability to meet some of the performance criteria on September 30, 1980 does not indicate that the basic program is not being firmly implemented.

3. During the first nine months of 1980, substantial progress has been made in reducing the current account deficit of the balance of payments. Export volume increased by 11 per cent with respect to the same period of 1979 and export value by 32 per cent. The value of imports over the same period rose by 8.5 per cent but the volume of imports declined by 10 per cent. Thus, developments in the trade account have been more favorable so far in 1980 than was projected at the time of the formulation of the program, when we expected export volume for the whole year to rise by 8 per cent and import volume to decline by 9 per cent. On services account there have been both favorable and unfavorable developments. On balance higher service payments, especially for interest, are likely to lead to a somewhat smaller surplus on services than we originally expected. However, we expect that the current account deficit will be about US$ 2.0 to 2.3. billion (equivalent to about 3 per cent of GSP), compared with the target of US$ 2.5 billion described in our letter of May 22, 1980, and appreciably below the deficit of US$ 3.7 billion recorded in 1979.

4. The improvement in the current account was achived in part by an active exchange rate policy designed to restore the competitiveness of the Yugoslav economy. Over the first months of 1980 the effective exchange rate of the dinar continued to be depreciated. Moreover, on June 6, 1980 the dinar was depreciated from dinars 21 to dinars 27.3 per US dollar to reinforce the efforts being made to improve the current account of the balance of payments. By end-September 1980 the effective trade-weighted exchange rate had depreciated by 42 per cent per unit of foreign currency with respect to December 1979.

5. While there were favorable developments in the current account of the balance of payments, developments in the capital account have been different from our original expectations. In particular, during the first nine months of the year, difficulties were encountered in obtaining the

desired amount of medium-term and long-term foreign loans from commercial banks to the nonbank sector. Disbursements fell short of the levels planned when we formulated our economic program for 1980, and outstanding medium-term and long-term convertible debt, which amounted to US$ 12.3 billion at the end of 1979, amounted to US$ 13.3 billion in September 1980, considerably below the level of US$ 14.2 billion originally envisaged. We expect that gross medium-term and long-term borrowing in convertible currencies will accelerate sharply in the current quarter but the level of such debt outstanding at the end of 1980 is unlikely to exceed US$ 13.1 billion.

6. The shortfall in foreign medium-term and long-term borrowing required us to make extensive use of short-term foreign borrowing and to run down gross international reserves. As a result, net international reserves of the National Bank declined by more than the amounts envisaged in the stand-by program. By September 30, 1980 the cumulative decline from December 31, 1979 in net convertible foreign assets of the National Bank of Yugoslavia, less exceptional financing by commercial banks, which had been targeted at US$ 500 million, amounted to US$ 937 million. In view of the favorable developments in the current account, and the expected accelaration of medium-term and long-term convertible foreign borrowing in the remainder of 1980, we estimate that the deterioration described above will be partly reversed. Some short-term borrowing will be repaid and the gross international reserves will increase. However, because much of the new borrowing will be done by the National Bank, its net convertible foreign assets, less exceptional financing by the commercial banks, will decline further. However, the cumulative decline in net convertible assets of the National Bank, less exceptional financing by commercial banks, should not exceed US dollars 1,600 million between December 31, 1979 and december 31, 1980.

7. Domestically, an important aspect of our policies had been to reduce demand pressures. Our success can be judged by the fact that, based on results for the first eight or nine months of the year, real fixed investment is expected to decline by about 2 per cent in 1980 compared with 1979, real private consumption may rise by only about 1 per cent, and real public sector expenditure may decline by about 8 to 10 per cent. Real social product in 1980 is expected to be only about 2.5 per cent greater than in 1979, when the increase was 7 per cent.

8. By itself, the above reduction in domestic demand pressures should have helped bring about a reduction in inflation. Unfortunately, the combination of the high rate of increase of the foreign exchange price of imports, including oil and other raw materials, the depreciation of the effective exchange rate of the dinar and necessary adjustments in some administered prices led to an acceleration of the rate of inflation and currently retail prices are 30 per cent higher than a year earlier.

9. With nominal social product expected to rise by about 32 per cent in 1980 compared with our original expectation of a rise of only 22 per cent, some increase in monetary expansion above originally planned rates has become necessary. When we originally formulated the monetary program, the increase in the money supply between December 31, 1979 and December 31, 1980 was to be 22 per cent. We have now increased this target to 24 per cent. Consistent with this target and the fact that the net foreign assets of the banking system have declined by more than we originally estimated becouse of lower foreign borrowing by the nonbank sector, we have found it necessary to permit the net domestic assets of the banking system to increase by somewhat more than originally planned. Thus, the level of net domestic assets of the banking system on September 30, 1980 was Din 1.449.6 billion compared with the original target of Din 1.381 billion and we have raised the limit for December 31, 1980 to Din

1.538 billion from the original target of Din 1.466 billion.

10. We originally set limits of Din 77.4 billion for September 30, 1980 and Din 77.9 billion for December 31, 1980 on net credit of the National Bank to the budget of the Federation, which stood at Din 68.7 billion on December 31, 1979. Principally because revenues of the budget of the Federation did not increase by as much as anticipated, partly because of the slow growth of imports, the Government of SFR Yugoslavia had borrowed Din 77.9 billion net on September 30, 1980, which is the amount programmed for the year as a whole. However, we do not intend to raise the latter limit so that for the year as a whole the budget of the Federation will not add to liquidity by more than the planned amount.

11. The Yugoslav Government believes that significant economic progress has been made so far in 1980 and it intends to continue with the stabilization effort in 1981. We believe that the changes in the performance criteria for September 30 and December 31, 1980 described in paragraphs 6, 9, and 10 above are consistent with the implementation of the stabilization program and request the necessary waiver with respect to the above mentioned performance criteria for September 30, 1980 and the necessary modification of those for December 31, 1980 the government of SFR Yugoslavia intends to take any further measures that may become necessary to achieve the aims of the stabilization program.

Yours sincerely,

Dr. Ksente Bogoev
Governor, National Bank of Yugoslavia

Ing. Petar Kostic
Federal Secretary for Finance

cc: EED

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SOCIALIST FEDERAL REPUBLIC
OF YUGOSLAVIA
FEDERAL SECRETARIAT FOR FINANCE
11000 BELGRADE

Belgrada, May 16, 1980

Orig: EUR
cc: MD
DMD
MR. AMUZEGAR
LEG
RES
ETR
TRE
SEC

Mr. J. de Larosière
Managing Director
International Monetary Fund
Washington, D.C., 20431
U.S.A.

Dear Mr. de Larosiere:

1. The Yugoslav economy is passing through a particularly difficult period. The current account of the balance of payments was in deficit by US$ 1.3 billion in both 1977 and 1978 and domestic prices were increasing at rates well in excess of 10 per cent. Domestic activity was buoyant, with real gross social product increasing by 7.9 per cent in 1977 and 6.6 per cent in 1978. A relatively rapid rate of growth was considered necessary to prevent a serious problem of unemployment. However, it added to the existing domestic and external pressures. Moreover, as the growth of world economic activity decelerated, various restrictions were placed against important Yugoslav exports in some markets.

2. The Government decided in 1979 that a stabilization effort was required to moderate domestic pressures and to contain the deficit in the current account of the blance of payments to a level that would not require excessive foreign borrowing. Accordingly, the target for the increase in real gross social product was reduced to 6 per cent and the aim was to reduce the general rate of price increase from 15 per cent in 1978 to around 13 per cent in 1979. With regard to the balance of payments, the current account deficit was to be kept to US$ 1 billion, which would have implied that the debt service ratio for foreign debt in convertible currencies would remain below 20 per cent. These targets were to be achieved by the implementation of an integrated set of domestic and external policies, which included, *inter alia*, more restrictive credit policies and an exchange rate

policy designed to maintain the external competitiveness of our economy. The stabilization program was supported by a stand-by arrangement with the Fund equivalent to SDR 69.125 million agreed to on May 23, 1979, covering the first credit tranche.

3. For several reasons, the course of events in 1979 deviated from the original plan. We probably had underestimated the underlying pressures on the economy that existed at the end of 1978 and which continued in the first part of 1979. As a result, domestic activity in the first half of the year was higher than we intended. Although additional measures were taken that reduced rates of growth in the second half of the year, the increase in real gross social product in 1979 as a whole is estimated to have been 7.1 per cent, some one percentage point above the target. However, there were important factors, all beyond our control, that prevented us from achieving our other goals. Above all, there was the unexpected and large increase in oil prices. Oil prices for Yugoslavia rose on average from US$ 101 per metric ton in 1978 to US$ 143 per metric ton in 1979. In addition, natural gas imports increased sharply in 1979, principally in order to fill a newly completed pipeline, while cereal imports increased because of a particularly poor corn harvest in 1978 and a bad wheat crop in 1979. The value of imports of these three commodity groups was almost US$ 1 billion higher than in 1978. Another major exogenous factor was the earthquake in Montenegro in April 1979, which adversely affected tourism not only in that region but also elsewhere; in addition, it reduced exports and necessitated additional imports for reconstruction. These factors, plus depressed deliveries of ships, a major export item, and a virtual cessation of corn exports because of the disastrous 1978 harvest, meant that the current account deficit rose to US$ 3.7 billion, leading to a decline of US$ 1.3 billion in gross convertible international reserves of the banking system to US$ 2 billion at the end of the year, and substantial net foreign borrowing totaling around US$ 2.1 billion. The latter, combined with the rise in interest rates, increased the debt

service ratio on debt in convertible currencies (excluding purchases from the Fund) from 16.9 per cent in 1978 to 19.5 per cent in 1979.

4. Domestically, higher import prices were an important factor contributing to a rise in the rate of inflation from some 14 per cent in 1978 (year-on-year average for all domestic expenditure) to almost 21 per cent in 1979, although the rate of increase declined in the second half of the year. It was not possible to prevent the increase in prices being largely reflected in increases in personal income payments per employee, but we believe it is significant that these rose by only about 20 per cent compared with the previous year. In this respect, it appears that workers exercised considerable self-restraint in the self-management agreements on income payments.

5. Although many of the reasons for the adverse developments in 1979 were beyond our control, the Government has to face the fact that the deterioration that occurred in the balance of payments must be reversed in 1980. Yugoslavia has therefore decided that policies this year must bring about a substantial reduction in the current account deficit and thereby limit the growth of external debt. To achieve this and to aid in reducing the rate of inflation, a slower growth of domestic activity will be necessary. Therefore, a major stabilization effort has been introduced and will continue until the necessary corrections in the domestic and external sectors have been made. Given the size of the imbalance in 1979, it will not be possible to achieve all of the needed corrections in 1980 and we realize that the effort must continue in 1981. To support the stabilization program, which is described in detail below in respect of the 1980 period, Yugoslavia is requesting a new stand-by arrangement from the Fund for the period up to December 31, 1981 in a total amount equivalent to SDR 339.325 million, including the equivalent of SDR 200.825 million from the Supplementary Financing Facility.

6. Although the stabilization program will extend over both 1980 and 1981, we are convinced that substantial progress must be made in 1980 to reduce the current account deficit. We intend to do everything possible to reduce the deficit to US$ 2.0 billion this year and believe that there is a reasonable chance of achieving this. Such a large and rapid reduction might entail too great a disruption to real growth and employment but we are convinced that the current account deficit must not exceed US$ 2.5 billion this year with another large reduction in 1981. Thus in 1980, we aim to reduce the deficit by at least US$ 1.2 billion, which would be a reduction of at least one third. As a percentage of gross social product, the current deficit would decline as a minimum from 6.0 per cent in 1979 to below 4 per cent in 1980. A deficit of this size would entail an amount of foreign borrowing that we consider manageable (see below).

7. A major effort will be required to reduce the deficit to the extent sought, but we believe the needed improvement can be made. While part of it will come from larger net invisible receipts, the major adjustment will be on the trade account, where exports must increase strongly and the growth in imports must be sharply reduced. To achieve these results, the pattern of domestic production and expenditure must change so as to release more production for export and to reduce the import intensiveness of domestic output. Under the Yugoslav system of workers' self-management, all enterprises involved in foreign trade must agree among themselves within the Communities of Interest for Foreign Economic Relations on foreign trade plans that will lead to a viable balance of payments. In 1980, enterprises are making a major effort to produce more exportable goods and to substitute domestic products for imports wherever possible. They will be aided by the fact that a number of major development projects have recently been finished, which will reduce the demand for imported investment goods. Moreover, these projects will increase export supplies and permit greater import substitution.

Throughout the economy, investment proposals are being re-examined to shift the emphasis for the time being toward projects construction that require few imports and away from import-intensive projects, especially those not directly related to export production or import replacement. Intensified efforts are being made to increase domestic supplies of raw materials, for example, coal and iron ore, and of intermediate products. Inter alia, this should keep the volume of oil imports, excluding amounts needed to fill a new pipeline, at no more than the 1979 level and possibly less.

8. In addition, in 1980 some of the particular trade difficulties of 1979 should not recur. So far, there is every indication that corn exports will revive and imports of wheat should not be needed to the extent experienced in 1979. Because of past orders, deliveries of ships will increase sharply in 1980 and 1981. The planned growth of gross social product is 2 percentage points less than the outcome in 1979, which will slow down import demand. Although overall world export demand may be weak in 1980, the main Yugoslav export markets are expected to be relatively less affected, and demand in them is expected to be around 6 per cent. Moreover, in 1979 we depreciated the dinar in terms of effective exchange rates by about 8 per cent following a depreciation of 9 per cent in the preceding year. We intend to continue with an exchange rate policy that will maintain our competitive position and we expect to regain some of the market shares lost in recent years. Although its impact in 1980 will be limited, the recently concluded agreement with the European Economic Community should have an increasingly favorable effect on our economic relations with its member countries in the coming years, including 1981. Taking all these factors into account, export volume is forecast to increase by 8 per cent and value by 21 per cent. Import volume should decline by around 9 per cent and the value vould increase by some 9 per cent. The forecast turnaround in imports is not out of line with improvements made in previous periods when policies have been directed toward substantial improvement in the external sector.

Workers remittances should benefit from wage increases in Western Europe and tourism should show a recovery from 1979. Taking all the above into account, a current account deficit of US$ 2 billion in 1980 may be possible and it is our firm intention not to exceed a maximum level of US$ 2.5 billion.

9. The large deficit in the current account in 1979 necessitated a net increase of foreign borrowing in convertible currencies of US$ 2.0 billion and at the end of that year the outstanding level of such debt was US$ 13.5 billion, of which US$ 12.8 billion had an original maturity of more than one year. During 1979, there was a refinancing of debt totaling around US$ 0.8 billion and the conditions attached to the new credits generally provided for grace periods of three years and maturities of the order of 8-10 years. We intend to continue to pay careful attention to the terms of new foreign borrowing so as to avoid sharp peaks in servicing schedules, especially since, partly as a result of the rise in interest rates, the debt service ratio for convertible foreign debt, excluding purchases from the Fund, reached 19.5 per cent in 1979. To prevent a debt service problem from emerging and consistent with the maximum projected current account deficit for 1980, outstanding foreign debt in convertible currencies with original maturities of more than one year (excluding purchases from the Fund), which stood at US$ 12.3 billion at the end of 1979, will not exceed US$ 14.7 billion by the end of 1980 (based on exchange rates current on December 31, 1979 and excluding net exceptional financing during 1980). To ensure orderly borrowing during the year, quarterly limits on the outstanding amounts have been set as follows: no more than US$ 13.6 billion on June 30, 1980, US$ 14.2 billion on September 30, 1980, and US$ 14.7 billion on December 30, 1980.

10. As mentioned earlier, during 1979 the gross convertible international reserves of the banking system declined and in 1980 they will need to be built up again. It is our intention

to increase the gross convertible reserves of the National Bank of Yugoslavia by at least US$ 0.7 billion during 1980. This will necessitate a continuation of exceptional financing by the commercial banks, which has involved borrowing abroad in convertible currencies to maintain the level of the international reserves. In 1979, such borrowing totaled US$ 250 million. To ensure an adequate level of liquidity in convertible currencies, the net convertible foreign assets of the National Bank of Yugoslavia less exceptional financing in convertible currencies by the commercial banks, which declined by US$ 1.702 million in 1979 will show no further decline by the end of 1980. Consistent with this target for end 1980, and allowing for the expected pattern of net foreign borrowing and the seasonal movements in the current account deficit, targets have been established providing for a decline of no more than US$ 900 million by June 30, 1980 and no more than US$ 500 million by September 30, 1980.

11. If the various balance of payments targets are to be achieved, policies must ensure that domestic activity is not too expansionary. To ensure such consistency, it has been decided to reduce the planned increase in real gross social product to 5 per cent in 1980 and to aim for a reduction in the gross social product deflator to 17 per cent compared with 20 per cent in 1979. All categories of domestic demand are planned to show smaller increases in real terms-the growth of personal consumption will decelerete from 5.5 per cent to 3.8 per cent, public consumption from 5.9 per cent to 2.1 per cent, and fixed capital formation from about 8 per cent to 5.8 per cent.

12. The achievement of these targets will require an intensified restraint by all sectors of the econamy-the public and enterprise sectors in particular. In this regard, we would point out that self-management agreements covering such factors as prices and personal income payments were implemented in a responsible and effective manner in 1979 and, with increasing experience with

the new system, it is expected that it will operate even more effectively in 1980. The Government is convinced that a strong consensus exists in Yugoslavia that all decisions taken in the economic field should reflect the economic aims enunciated in the stabilization program.

13. In some recent years there has been a tendency for public sector consumption to grow more rapidly than social product, and in all years the Federal Government has borrowed from the National Bank of Yugoslavia. The ratio of public sector expenditure to gross social product rose from about 36 per cent in 1973 to about 43 per cent in 1978. In 1979, however,this ratio declined to about 41 per cent. For the federal budget, expenditure in 1979 rose by 25 per cent compared with increases of 29 per cent in revenue and 28 per cent in nominal gross social product. The deficit declined from Din 5.3 billion in 1978 to Din 3.8 billion in 1979. For the public sector as a whole, there was virtually no deficit in 1979. For 1980, the intention is that the public sector will continue to grow more slowly than social product, although budget expenditure by the Federation will increase by 29 per cent. The deficit of the federal budget will rise to Din 6.2 billion but this is equivalent to only 0.4 per cent of gross social product. Gross borrowing from the National Bank will rise only fractionally (from Din 8.5 billion in 1979 to Din 9.2 billion in 1980), which is much less than the increase in expenditure. Current expenditure by the public sector as a whole is to increase by no more than 16 per cent.

14. Monetary policy is an important part of the stabilization program, since an excess supply of financial assets could weaken the implementation of other elements in the program. In 1978 there was an excessive rate of increase of money supply, which rose by 28 per cent and in 1979 strong steps were taken to decelerate monetary expansion, the target for the increase in money supply in that year being set at 18 per cent. In the first months of the year the demand for credit continued strongly and the National Bank had to take special measures to limit the

expansion by imposing strict credit limits on the commercial banks and by reducing demand for consumer credits by raising downpayment provisions. These measures were effective, so much so that some relaxation was necessary in the second half of the year when the loss of liquidity of the commercial banks resulting from the continued external deficit threatened an abrupt decline in enterprise activity. At the end of 1979, money supply was only 17 per cent higher than a year earlier. Also, despite the need to counteract some of the liquidity loss caused by the external deficit, the rate of domestic credit creation was 27 per cent in 1979 compared with 30 per cent in the previous year.

15. For 1980, we consider that money supply should rise broadly in line with the reduced rate of growth of nominal social product. To that end, and given the planned balance of payments targets, the increase in money supply will be kept to 22 per cent and the increase in net domestic assets of the banking system to 22 per cent. To ensure that money supply does not increase excessively in the first half of the year, thereby prejudicing the whole year result, limits have been set within the year on net domestic assets of the banking system, which totaled Din 1.201 billion on December 31, 1979. They are not to exceed Din 1.321 billion on June 30, 1980, Din 1.381 billion on September 30, 1980, and Din 1.466 billion on December 31, 1980. To ensure that lending by the National Bank of Yugoslavia to the budget of the Federation does not compromise the overall credit program, such net lending in 1980 is not to exceed Din 9.2 billion. As with total domestic credit creation, sub-limits have been established within the year. Such credits to the federal budget, which totaled Din 68.7 billion on December 31, 1979, are not to exceed Din 76.4 billion on June 30, 1980, Din 77.4 billion on September 30, 1980, and Din 77.9 billion on December 31, 1980.

16. Detailed quantitative economic targets for 1981, including targets for increases in domestic credit, foreign borrowing and the net foreign assets of the National Bank of Yugoslavia cannot

be established at this stage. However, as mentioned above, the Government is determined to continue with the stabilization program next year. Also, it intends to continue to give first priority to a further improvement in the balance of payments. Domestic policies in all fields will be formulated to maintain and if necessary strengthen the current measures of restraint. On the basis of a preliminary examination of the possible 1981 Plan, domestic activity would grow no faster and perhaps somewhat more slowly than is planned for 1980. Externally, the planned current account deficit of the balance of payments will decline further, perhaps to around US$ 1.8 billion.

17. The Government of Yugoslavia does not intend to introduce any multiple currency practices or introduce new or intensify existing restrictions on payments and transfers for current international transactions or enter into any bilateral payments arrangements with Fund members; furthermore, the Government of Yugoslavia does not intend to introduce new restrictions or intensify existing restrictions on imports for balance of payments reasons.

18. The Government believes that the policies set forth in this letter are adequate to achieve the objectives of its program, but will take any further measures that may become appropriate for this purpose. The Government of Yugoslavia will consult with the Fund on the adoption of any measures that may become appropriate, in accordance with the policies of the Fund on such consultations. Moreover, the Yugoslav authorities will consult with the Fund and reach understandings on the quantitative aspects of the program relating to the period of the Stand-by arrangement subsequent to December 31, 1980.

Sincerely yours,

P. Kostić

DR KSENTE BOGOEV
Governor
National Bank of Yugoslavia
For the Government of the
Socialist Federal Republic
of Yugoslavia

ING PETAR KOSTIĆ
Federal Secretary for Finance

For the Government of the
Socialist Federal Republic
of Yugoslavia

International Telex

Western Union International, Inc.

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1980 APR 10 PM 12:54

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CABLE
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H18.33

ORIG:MR. WHITTOME
CC:MR. TYLER

INTERFUND WASHINGTONDC

FOR MR. WHITTOME, DIRECTOR. EUROPEAN DEPARTMENT
I WISH TO INFORM YOU THAT THE NATINALBANK OF YUGOSLAVIA IS NOW AUTHORIZED TO DISCUSS WITH THE FUND FURTHER DRWEEE DRAWINGS BY YUGOSLVIA. WOULD BE VERY GRATEFUL FOR YOUR SUGGESTINS WHEN DISCUSSINS WITH FUND REPRESENTATIVES COULD START. BEST REGARDS, BOGOEV

NARODNABANKA JUGOSLAVIJE BEOGRAD

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INTERFUND WSH

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INTERFUND WASHINGTONDC

ORIG: MR. TYLER
CC: MR. WHITTOME

FOR MR. TYLER, ASSISTANT DIRECTOR, EUROPEAN DEPARTMENT.
GLAD TO INFORM YOU THAT WE COULD START DISCUSSIONS CONCERNING FURTHER DRAWINGS BY YUGOSLVIA AT YOUR EARLIEST CONVENIENCE. BEST REGARDS, MARJANOVIC

NARODNABANKA JUGOSLAVIJE BEOGRAD

INTERFUND WSH

VIA ITT

cc: EED

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11868 YU NARBAN 4.4.1980 NR 8122 H15.17

INTERFUND WASHNGTONDC

FOR MR.RUDING, EXECUTIVE DIRECTOR.

1. THANK YOUFOR YOUR CABLE OF MARCH 31,1980. I APPRECIATE VERY MUCH YOUR INTEREST AND SUGGESTIONS CONCERNING POSSIBILITY OF FURTHER DRAWING BY YUGOSLAVIA. I EXPECT AND HOPE TO BE IN A POSITION TO INFORM YOU DURING THE FORTHCOMING WEEK OF THE POSITIVE DECISION OF THE FEDEXECUTIVE COUNCIL.

2. ALSO, WISH TO INFORM YOU THAT THE MEETING OF THE INTERIM COMMITTEE WILL BE ATTTENDED BY MR. KOSTIC AND MYSELF.

BEST REGARDS, BOGOEV

NARODNABANKA JUGOSLAVIJE BEOGRAD

INTERFUND WSH

VIA ITT

CC: EED

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INTERFUND WSH

11868 YU NARBAN 10.4.1980 NR 8506 H18.31

INTERFUND WASHINGTONDC

FOR MR. RUDING, EXECUTIVE DIRECTOR.
REFERRING TO MY CABLE OF APRIL 4,1980 WISH TO INFORM YOU THAT THE NATIONALBANK OF YUGOSLAVIA IS NOW AUTHORIZED TO DISCUSS WITH TBE FUND THE QUESTION OF DRWEEE DRAWING BY YUGOSLAVIA. WOLEEE WOULD APPRECIATE VERY MUCH YOUR FURTHER SUPPORT IN THIS MATTER
BEST REGARDS, BOGOEV

NARODNABANKA JUGOSLAVIJE BEOGRAD

⊕
INTERFUND WSH

⊕
INTERFUND WSH

CONFIDENTIAL

MEMORANDUM FOR THE FILES

Subject: Yugoslavia

January 22, 1980

At his request, I had lunch today with Mr. Stojiljkovic, Yugoslav Alternate at the World Bank. His main purpose was to discuss the forthcoming mission to Yugoslavia, especially whether it would be possible to negotiate use of the upper credit tranches. The conversation ran along expected lines, since neither of us was in a position to or wanted to be very specific in terms of what Yugoslavia might be able to offer or the Fund to ask. However, the tone of the conversation implied that Stojiljkovic himself was much in favor of Yugoslavia using Fund resources provided that the conditionality was bearable. By this I do not think he meant virtual unconditionality, and indeed I think that he and presumably some of his colleagues in Belgrade might welcome the Fund as a whipping boy when proposing tougher policies inside the country. He said, inter alia, that there were two schools of thought inside official circles. One was that Yugoslavia should stand on its own feet and not rely on outside help, including the Fund. The other believes that it would be quite appropriate to present a program acceptable both to Yugoslavia and the Fund and ask for credits. Mr. Stojiljkovic implied quite strongly that in his view many would argue that it was only worth going to the trouble of getting Fund money if large amounts were available. He was well aware of Mr. Ruding's advice to the Yugoslav authorities regarding how much a second and third credit tranche stand-by arrangement plus corresponding SFF amounts were worth.

GT

Geoffrey Tyler

cc: Front Office

1. YUGOSLAVIA - WAIVER OF PERFORMANCE CRITERIA AND MODIFICATION OF STAND-BY ARRANGEMENT

The Executive Directors considered a staff paper on a request from Yugoslavia for a waiver of performance criteria and a modification of the stand-by arrangement, together with a draft decision (EBS/80/250, 11/19/80; and Sup. 1, 11/26/80).

The staff representative from the European Department explained that the Yugoslav authorities had requested a waiver of the performance criteria relating to the September 30, 1980 ceilings on net domestic assets of the banking system, net credit of the National Bank, and the cumulative change in net convertible foreign assets of the National Bank. They had not requested any modification of the ceiling on outstanding convertible currency debt.

Mr. Ruding recommended acceptance of Yugoslavia's request. The country had already achieved significant adjustment, and a substantial program for further adjustment was under way. In spite of the adverse effects of increased oil prices, the authorities had succeeded in reducing the deficit in the current account of the balance of payments from $3.7 billion to $2.3 billion, and it was expected to fall further. The reasons for the nonfulfillment of the performance criteria mentioned by the staff representative were clearly explained in the staff paper. Perhaps the most important contributory cause had been the devaluation of the dinar by more than 20 per cent in June 1980. Also important, however, was the centralization of external borrowing in the central bank. The shift away from borrowing by enterprises and other banks had not been entirely foreseen and had inevitably affected the performance criteria. The shift had made it necessary for the ceilings relating to the external situation of the National Bank to be raised, but had also permitted a simultaneous lowering of the ceilings relating to the external situation of other sectors of the economy.

The depreciation of the currency and the exchange rate policy that had contributed to the need for the waiver of the performance criteria had been strongly advocated by the Fund earlier in the year, Mr. Ruding recalled. Not knowing whether the authorities would follow the Fund's advice, the performance criteria in the stand-by program had not assumed a major currency depreciation. During the second year of the stand-by program, the present strict and ambitious adjustment measures would be continued. A staff mission was at present in Yugoslavia discussing with the authorities the measures to be taken during 1981.

The reduction of the current account deficit had been made possible by the implementation of some very strong measures, Mr. Ruding commented. Real income had fallen quite substantially; monetary policy had been tightened more than in previous years; and the growth rate of the gross social product had fallen from 7.1 per cent in 1979 to an estimated 2.5 per cent for the current year. The present economic situation in Yugoslavia demonstrated the necessity of financing and adjustment going hand in hand. Finally, he had in the past expressed reservations of principle about modifications of stand-by programs. He continued to believe, however, that all judgments on such matters should be based on the individual circumstances of the country concerned. In the case of Yugoslavia, some of the modifications had been made necessary by factors beyond the control of the authorities; moreover, the country was obviously on the right track with its adjustment efforts. Because of the country's satisfactory overall performance, the Fund should show flexibility in adapting its performance criteria to changed circumstances.

Mr. Aulagnon considered that there was a convincing case for approving the Yugoslav request. He had strongly supported the original stand-by program as a means of overcoming certain difficulties endangering the future success of development efforts in that country. The most important of those difficulties had been the serious disequilibrium in the balance of payments; the program had already been successful in that the current account deficit, which had amounted to almost $4 billion in 1979, would be reduced to, at the most, $2.3 billion in 1980, which was better than the target of $2.5 billion. There was no doubt that the main thrust of the financial program for 1980 was, therefore, firmly on track and that the modifications requested should be seen as the consequence of the sharp depreciation of the exchange rate that had been advocated by the Executive Board.

He agreed with the staff that the acceleration in the inflation rate, which would probably reach about 30 per cent in terms of the social product deflator in 1980, was worrying, Mr. Aulagnon continued. It was true that the rise in inflation resulted more from the large depreciation of the dinar than from other domestic pressures, but the fact that the rise was accompanied by a 28 per cent increase in domestic credit clearly indicated the need for a close monitoring of all the related variables over the coming months. Incidentally, the staff had calculated that the depreciation of the dinar between December 1979 and the end of October 1980 amounted to 30 per cent. The authorities, on the other hand, in their letter to the Managing Director, indicated a depreciation of 42 per cent over a similar period; could the staff clarify that discrepancy?

Even under the assumption that external factors accounted for most of the internal imbalances, Mr. Aulagnon commented, the restrictive stance on domestic consumption, adopted for the first part of the stand-by program, should be maintained in 1981. Commendable results had been achieved through that policy so far, as real public expenditures might decline by about 8-10 per cent during 1980, while the increase in private consumption would be limited to 1 per cent in real terms. Finally, he hoped that commercial banks would take into account the positive results of Yugoslavia's financial program, and particularly the improvement of the balance of payments position.

Mr. Price recalled that when Yugoslavia's stand-by program had originally been discussed, he had had considerable doubts about the feasibility of the targets relating to external financing. He had also commented on the need to coordinate better the borrowing from commercial banks. In view of the comments that he had made at the time, he now welcomed the Yugoslav authorities' more realistic approach to their borrowing program. The centralization of commercial borrowing could well increase the overall amount available to the economy from abroad. He supported the proposed waiver of the performance criteria, particularly as the major objectives of the stand-by program were being met.

The fact that the current account deficit had been cut more extensively than planned seemed to reflect a welcome caution on the authorities' part, Mr. Price noted. He hoped that the authorities' present approach to the difficult task of securing external finance would continue; in that context, he was glad that they had not requested a modification of the December 1980 performance criterion on credit to the federal budget. He welcomed the fact that credit policy was not fully accommodating inflation. It was probably disquieting to the authorities that the improvements in the current account had been, to some extent, offset by withdrawals from foreign exchange accounts held by Yugoslav nationals working abroad; he wondered whether that trend was likely to be reversed.

Mr. Buira noted that Yugoslavia had made substantial progress in reducing its current account deficit, despite a deterioration in its terms of trade that had been larger than projected. During the first ten months of 1980, exports had been rising at some 30 per cent a year, while imports had decelerated in volume terms by about 12 per cent. The trade deficit was expected to be about $1 billion less than originally envisaged by the program, largely because of the substantial decrease in domestic expenditure, which had led to a lower growth of domestic output and to a substantial depreciation of the effective exchange rate. The higher price increases resulting from the depreciation had meant that the performance criteria relating to net domestic assets of the banking system and to the budget had not been observed by the end of September 1980. Furthermore, the political transition toward collective leadership together with the smaller than expected access of enterprises to external credit had meant that the performance criteria relating to the increase in the net foreign assets of the National Bank had not been met, and international reserves had declined.

The acceleration of the inflation rate gave grounds for concern, Mr. Buira said. However, since it reflected more the deterioration in the terms of trade and the depreciation of the exchange rate than domestic demand pressures, it could reasonably be expected to decline of its own accord. In consequence, he concurred with the staff view that a modest increase in the growth of the money supply, from 22 per cent to 24 per cent, was necessary to permit some growth in the gross social product and to avoid excessive deflationary pressures. It was noteworthy that real incomes were expected to decline, that fixed investment was expected to be negative, and that the authorities had indicated their intention of complying with the overall annual credit allocation to the federal budget and had, therefore, requested a waiver for the September ceiling only. In conclusion, the program remained on track and the authorities' request for a waiver of some performance criteria and a modification of the stand-by agreement was justified.

Mr. Winkelmann expressed his support for the requested waiver. It was astonishing to see how quickly the authorities had been able to correct the overheating of the economy that had been apparent in the discussions connected with the 1979 Article IV consultation. Unfortunately, the inflation rate had risen to a worrying level, and since most of the depreciation of the dinar had taken place in the summer of 1980 some price increases from the external side were no doubt still in the pipeline. It would take some months before inflationary pressures from abroad decreased.

Could the staff indicate how the velocity of money had changed over the past months, Mr. Winkelman inquired. Generally a slowing down of an economy was accompanied by a reduction in the velocity of money. If that were the case for Yugoslavia, where the velocity of money had been high, the expansion of the monetary base could still be quite considerable. An excessive slowdown in the velocity of money would indicate a loss of some dynamism in the economy.

In the medium and long terms, Mr. Winkelmann considered, there were grounds for optimism about Yugoslavia's access to the banking community. Quite recently some German banks had concluded agreements worth more than DM 500 million with the Yugoslav authorities, and it seemed that the banking community had a fairly optimistic view of Yugoslavia's future. He hoped that the country would be able to bring down its high rate of inflation, which had originated, to a large extent, from the necessary depreciation of the currency.

Mr. Janjua expressed his support for Yugoslavia's request for a waiver of performance criteria and a modification of the stand-by arrangement. The nonobservance of some of the performance criteria in September 1980, which had resulted largely from unforeseen developments beyond the control of the authorities, was in no way a reflection on the basic soundness of the program. The progress made over the past year clearly indicated the authorities' firm intention to implement the stand-by program. Strong domestic policies had effectively reduced domestic expenditure and, in combination with the gradual devaluation of the exchange rate, had been instrumental in improving the current balance--the major objective of the program. The devaluation of the dinar and the adjustment in administered prices, though addding to price increases initially, were steps in the right direction, and in due course would contribute to relative price stability, more efficient resource allocation, and greater competitiveness.

The proposed new ceilings represented only modest changes when compared with the size and impact of the factors causing price increases, Mr. Janjua considered. The authorities were aware of the need for more corrective measures. Their policies in the recent past had provided a basis for the successful implementation of the medium-term stabilization program.

Finally, Mr. Janjua inquired, could the staff indicate what would have been the optimum level of devaluation, and what effects the greater than expected devaluation had had on prices? In addition, like Mr. Aulagnon, he would like some explanation of the discrepancy between the rate of depreciation over the past year as measured by the staff and the rate as measured by the Yugoslav authorities.

Mr. Cross observed that the Yugoslav authorities had already taken important adjustment measures--changes in the exchange rate; the restriction of the growth of money to a level below the growth in national product; the adjustment of administered prices in energy and agriculture--and, in consequence, the improvement in the current account had been greater than envisaged. Nevertheless, the continued acceleration of inflation stemming from the depreciation had proved to be a major factor in the overshooting of the spending targets; and the need to finance the budget deficit had led to a breach in the credit targets. In that connection, he had been puzzled by the fact that the inflationary forces that had pushed up the budget expenditures had not also led to a corresponding increase in budget revenues. He would be grateful if the staff could clarify that situation and also estimate the amount of medium- and long-term financing necessary to repay short-term credits and reverse the present decline in reserves. He also would appreciate some explanation of the perplexing difference in exchange rate movements as measured by the staff and as measured by the Yugoslav authorities. In conclusion, he supported the request for a waiver of performance criteria and a modification of the stand-by arrangement.

Mr. Caranicas expressed his approval for the proposed modification of the stand-by arrangement. He agreed with Mr. Ruding that the requested waiver was well justified by factors that were beyond the control of the authorities. It was also justified by the fact that the Yugoslav authorities had made great progress in achieving their targets with regard to the balance of payments, and that they were ready to take additional measures as necessary to achieve all the objectives of their stabilization program.

Mr. Zhang expressed his support for the Yugoslav request. Could the staff or Mr. Ruding give more information on the relationship between the depreciation of the currency and the increase in prices?

The staff representative from the European Department, in explaining the discrepancy between the figures for the trade-weighted exchange rate depreciation, remarked that the methods of calculation used by the staff and by the Yugoslav authorities were different. Unlike the staff, the Yugoslav authorities made their calculations on the basis of one dinar per U.S. dollar. Furthermore, again unlike the staff, the authorities might have included data from East European countries in their exchange rate model. Both of those differences could explain why the rate of depreciation appeared higher in the Yugoslav figures than in those of the staff. The staff had not envisaged as large a devaluation as had taken place during 1980 and, in consequence, had underestimated the level of price increases. Prices were continuing to increase as the full effects of the devaluation and the changes in certain administered prices became felt. The figures for October that had just been received showed that in October 1980 prices had been 36 per cent higher than a year previously.

Foreign exchange deposits had recovered somewhat during the second half of the year, the staff representative stated. During the political uncertainty in Yugoslavia following Marshall Tito's death, the Central Bank had become the main borrower. With regard to the velocity of money, GNP had increased faster than the increase in money supply; staff calculations showed that the velocity of money had increased by about 10 per cent. In answer to another question, according to latest estimates the National Bank had borrowed about $1.3 billion over the past year. The shortfall in government revenue could be attributed in part to the low rate of growth of imports and, in addition, to the surcharge on imports that had been reduced in line with the devaluation in June 1980.

Mr. Ruding explained that the substantial depreciation of the currency had contributed to inflation because of the importance of imports in the Yugoslav economy. There was a high import component in investment expenditure, and, although declining, it nevertheless remained a significant element in the overall gross social product. The depreciation had also meant that the effects of the oil price increases had been felt strongly in the economy; Yugoslavia imported about 70 per cent of its oil, much of which was purchased at spot market prices. The price of gasoline had been raised substantially and had noticeably affected the index of prices. Furthermore, the rate of inflation had also increased following the rise in a number of administered prices. He agreed with the staff representative that the difference in the rate of depreciation as measured by the staff and by the Yugoslav authorities could be explained by differences in methodology. Making calculations based on the dinar could well give results different from calculations based on the dollar and could lead to sharp differences in results. Differences could also arise from the weight given to trade and to currency exchanges in the calculations.

The Yugoslav authorities had not pursued an active interest rate policy in the past, Mr. Ruding remarked. He had stressed to them the importance of adopting such a policy, particularly in view of the present highly negative interest rates that affected investment, savings, and external accounts. With such negative rates, there was little incentive for Yugoslavs living abroad to remit foreign exchange. The authorities had stated their intention of modifying their policy in the coming period. External financing had not been obtained for substantial amounts over the past year, but the picture had changed in the latter part of 1980 when the political situation had become clearer and external borrowing had been centralized. Successful approaches had been made to a number of countries in both Europe and the Middle East to obtain additional credit on a bilateral basis. A large syndicated Euroloan from commercial banks was still under negotiation. Progress was being made but, because of the necessarily slow nature of the negotiations, not as much money as anticipated had been disbursed recently.

Although the Yugoslav authorities had achieved great success in many areas, inflation had become a more serious problem, Mr. Ruding commented. The reduction of inflation would have to be the core of the stand-by program over the coming year. In addition to inflation, the authorities were worried about the growth rate, which was lower in 1980 than it had been over many previous years. They hoped to achieve some degree of acceptable growth over the coming year. Deficits in the balance of payments had been cut, but had by no means been eliminated. The authorities planned to seek external financing from a number of different sources; they did not wish to rely entirely on the markets and hoped to receive more credits from the Fund. Because of the active and ambitious adjustment measures that the authorities were continuing to take, Yugoslavia deserved more assistance from the Fund. The case for approving the proposed decision was quite convincing.

Finally, in response to the Acting Chairman, Mr. Ruding explained that it was difficult to say whether the Yugoslav authorities had obtained better terms by borrowing on a centralized basis, because it was not clear what terms would have been imposed had that policy change not been adopted. In view of the fact that access to the market by non-oil developing countries had deteriorated somewhat, he believed that the centralization of borrowing in Yugoslavia had enabled the country to raise larger amounts and, perhaps, on slightly better terms.

The Executive Board then approved the following decision:

> The letter of November 26, 1980 from the Governor of the National Bank of Yugoslavia and the Federal Secretary for Finance (EBS/80/250, Sup. 1, 11/26/80) shall be annexed to the stand-by arrangement with Yugoslavia (EBS/80/114, 5/22/80) and the letter of May 16, 1980 from the Governor of the National Bank of Yugoslavia and the Federal Secretary for Finance attached to it shall be read as modified by the letter of November 26, 1980.

Decision No. 6685-(80/175), adopted
December 3, 1980

FOR
AGENDA

EBS/80/250
Supplement 1

CONFIDENTIAL

November 26, 1980

To: Members of the Executive Board

From: The Acting Secretary

Subject: Yugoslavia - Request for Waiver of Performance Criteria and Modification of Stand-By Arrangement

Attached is the text of the letter referred to in the second paragraph of page 2 of EBS/80/250 (11/19/80), signed on November 26, 1980 by the Governor of the National Bank of Yugoslavia and the Federal Secretary of Finance requesting a waiver of performance criteria and modification of stand-by arrangement.

Att: (1)

Belgrade, Yugoslavia

November 26, 1980

Dear Mr. de Larosière,

1. In our letter of May 16, 1980 addressed to you, we described the economic and financial program adopted by the Government of the Socialist Federal Republic of Yugoslavia as a major stabilization effort to achieve, inter alia, a substantial reduction in the current account deficit of the balance of payments. In support of the program the Fund approved on June 6, 1980 a stand-by arrangement that included as quantified performance criteria, quarterly limits on (1) net domestic assets of the banking system, (2) net credit of the National Bank of Yugoslavia to the budget of the Federation, (3) outstanding foreign debt in convertible currency with original maturities of more than one year (excluding purchases from the Fund), and (4) the cumulative decline in net convertible foreign assets of the National Bank less exceptional financing in convertible currencies by commercial banks.

2. On September 30, 1980 the performance criteria relating to net domestic assets of the banking system, net credit of the National Bank to the budget of the Federation, and the cumulative change in net convertible foreign assets of the National Bank were not observed for reasons that are described below, which were not foreseen when the program was established. However, we believe that the most important objective of the program, namely a substantial improvement in the current account of the balance of payments, is being achieved and that the inability to meet some of the performance criteria on September 30, 1980 does not indicate that the basic program is not being firmly implemented.

3. During the first nine months of 1980, substantial progress has been made in reducing the current account deficit of the balance of payments. Export volume increased by 11 per cent with respect to the same period of 1979 and export value by 32 per cent. The value of imports over the same period rose by 8.5 per cent but the volume of imports declined by 10 per cent. Thus, developments in the trade account have been more favorable so far in 1980 than was projected at the time of the formulation of the program, when we expected export volume for the whole year to rise by 8 per cent and import volume to decline by 9 per cent. On services account there have been both favorable and unfavorable developments. On balance, higher service payments, especially for interest, are likely to lead to a somewhat smaller surplus on services than we originally expected. However, we expect that the current account deficit will be about US$2.2-2.3 billion (equivalent to about 3 per cent of GSP), compared with the target of US$2.5 billion described in our letter of May 22, 1980, and appreciably below the deficit of US$3.7 billion recorded in 1979.

4. The improvement in the current account of the balance of payments was achieved in part by an active exchange rate policy designed to restore the competitiveness of the Yugoslav economy. Over the first months of 1980 the effective exchange rate of the dinar continued to be depreciated. Moreover, on June 6, 1980 the dinar was depreciated from Din 21 to Din 27.3 per U.S. dollar to reinforce the efforts being made to improve the current account of

the balance of payments. By end-September 1980 the effective trade-weighted exchange rate had depreciated by 42 per cent per unit of foreign currency with respect to December 1979.

5. While there were favorable developments in the current account of the balance of payments, developments in the capital account have been different from our original expectations. In particular, during the first nine months of the year, difficulties were encountered in obtaining the desired amount of medium-term and long-term foreign loans from commercial banks to the nonbank sector. Disbursements fell short of the levels planned when we formulated our economic program for 1980, and outstanding medium-term and long-term convertible debt, which amounted to US$12.3 billion at the end of 1979, amounted to US$13.3 billion in September 1980, considerably below the level of US$14.2 billion originally envisaged. We expect that gross medium-term and long-term borrowing in convertible currencies will accelerate sharply in the current quarter but the level of such debt outstanding at the end of 1980 is unlikely to exceed US$13.1 billion.

6. The shortfall in foreign medium-term and long-term borrowing required us to make extensive use of short-term foreign borrowing and to run down gross international reserves. As a result, net international reserves of the National Bank declined by more than the amounts envisaged in the stand-by program. By September 30, 1980 the cumulative decline from December 31, 1979 in net convertible foreign assets of the National Bank of Yugoslavia, less exceptional financing by commercial banks, which had been targeted at US$500 million, amounted to US$937 million. In view of the favorable developments in the current account, and the expected acceleration of medium-term and long-term convertible foreign borrowing in the remainder of 1980, we estimate that the deterioration described above will be partly reversed. Accordingly, we expect that the cumulative decline in net convertible foreign assets of the National Bank, less exceptional financing by commercial banks, should not exceed US$1,600 million between December 31, 1979 and December 31, 1980.

7. Domestically, an important aspect of our policies had been to reduce demand pressures. Our success can be judged by the fact that, based on results for the first eight or nine months of the year, real fixed investment is expected to decline by about 2 per cent in 1980 compared with 1979, real private consumption may rise by only about 1 per cent, and real public sector expenditure may decline by about 8-10 per cent. Real social product in 1980 is expected to be only about 2.5 per cent greater than in 1979, when the increase was 7 per cent.

8. By itself, the above reduction in domestic demand pressures should have helped bring about a reduction in inflation. Unfortunately, the combination of the high rate of increase of the foreign exchange price of imports, including oil and other raw materials, the depreciation of the effective exchange rate of the dinar, and necessary adjustments in some administered prices led to an acceleration of the rate of inflation and currently retail prices were 30 per cent higher than a year earlier.

9. With nominal social product expected to rise by about 32 per cent in 1980 compared with our original expectation of a rise of only 22 per cent, some increase in monetary expansion above originally planned rates has become necessary. When we originally formulated the monetary program, the increase in the money supply between December 31, 1979 and December 31, 1980 was to be 22 per cent. We have now increased this target to 24 per cent. Consistent with this target and the fact that the net foreign assets of the banking system have declined by more than we originally estimated because of lower foreign borrowing by the nonbank sector, we have found it necessary to permit the net domestic assets of the banking system to increase by somewhat more than originally planned. Thus, the level of net domestic assets of the banking system on September 30, 1980 was Din 1,449.6 billion compared with the original target of Din 1,381 billion and we have raised the limit for December 31, 1980 to Din 1,538 billion from the original target of Din 1,466 billion.

10. We originally set limits of Din 77.4 billion for September 30, 1980 and Din 77.9 billion for December 31, 1980 on net credit of the National Bank to the budget of the Federation, which stood at Din 68.7 billion on December 31, 1979. Principally because revenues of the Federal budget did not increase by as much as anticipated, partly because of the slow growth of imports, the Federal Government had borrowed Din 77.9 billion net on September 30, 1980, which is the amount programmed for the year as a whole. However, we do not intend to raise the latter limit so that for the year as a whole the Federal budget will not add to liquidity by more than the planned amount.

11. The Government of the Socialist Federal Republic of Yugoslavia believes that significant economic progress has been made so far in 1980 and it intends to continue with the stabilization effort in 1981. We believe that the changes in the performance criteria for September 30 and December 31, 1980 described in paragraphs 6, 9, and 10 above are consistent with the implementation of the stabilization program and request the necessary waiver with respect to the above-mentioned performance criteria for September 30, 1980 and the necessary modification of those for December 31, 1980. The Socialist Federal Republic of Yugoslavia intends to take any further measures that may become necessary to achieve the aims of the stabilization program.

Yours sincerely,

/s/

Ksente Bogoev
Governor, National Bank of Yugoslavia

/s/

Ing. Petar Kostic
Federal Secretary for Finance

DOCUMENT OF INTERNATIONAL MONETARY FUND
AND NOT FOR PUBLIC USE

FOR AGENDA

EBS/80/250

CONFIDENTIAL

November 19, 1980

To: Members of the Executive Board

From: The Secretary

Subject: Yugoslavia - Request for Waiver of Performance Criteria and Modification of Stand-By Arrangement

Attached for consideration by the Executive Directors is a paper on a request expected to be received shortly from Yugoslavia for a waiver of performance criteria and modification of stand-by arrangement. A draft decision appears on pages 6 and 7.

This subject has been tentatively scheduled for discussion on ~~Monday~~ Wed., December 3, 1980.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

YUGOSLAVIA

Request for Waiver of Performance Criteria and Modification of Stand-By Arrangement 1/

Prepared by the European Department

(In consultation with the Exchange and Trade Relations, Legal, and Treasurer's Departments)

Approved by L.A. Whittome and Subimal Mookerjee

November 19, 1980

## I. Introduction

On June 6, 1980, the Executive Board approved a stand-by arrangement up to end-1981 for Yugoslavia (EBS/80/114, Sup. 1, 6/9/80), in an amount equivalent to SDR 339.325 million to be financed from the Fund's general resources (41 per cent) and from the supplementary financing facility (59 per cent). One purchase equivalent to SDR 150 million has been made so far under the arrangement. The program included, as performance criteria, phased limits on: (a) net domestic assets of the banking system; (b) net credit of the National Bank to the Budget of the Federation; (c) outstanding foreign debt in convertible currency with original maturities of more than one year (excluding purchases from the Fund); (d) the cumulative change in net convertible foreign assets of the National Bank; together with (e) the standard clauses relating to multiple currency practices, bilateral payments agreements, and to restrictions on payments and transfers for current international transactions and on imports for balance of payments reasons. Performance criteria were set for June 30, 1980, September 30, 1980, and December 31, 1980. Quantitative performance criteria for 1981 are to be established once detailed economic targets for that year are prepared. The performance criteria for the limits on net domestic assets of the banking system, net credit by the National Bank to the budget of the Federation and the cumulative change in net foreign assets of the National Bank were not observed on September 30, 1980. Therefore, Yugoslavia was unable to make the purchase equivalent to SDR 50 million, available on November 15, 1980. The nonobservance of the performance criteria has resulted in large part from the greater-than-expected devaluation of the dinar in June 1980 and the associated sharp rise in domestic prices and from the shortfall in receipts of medium- and long-term foreign loans to the enterprise sector. It is noteworthy, however, that the reduction in the current

1/ A staff mission consisting of Messrs Tyler (EUR), Manison (EUR), Loser (ETR), Buyse (EUR), Bery (World Bank), and as secretary Mrs. Padmore (EUR), were in Belgrade from October 29 to November 7, 1980 to discuss developments under the stand-by arrangement.

account deficit of the balance of payments in 1980, which is a major aim of the stabilization program, is being achieved. The deficit is now estimated to decline to around US$2.3 billion compared with US$3.7 billion in 1979; the program called for a reduction to US$2.5 billion.

In the letter to the Managing Director which is to be signed later this week, and which will be circulated shortly as a supplement to this paper, the Governor of the National Bank of Yugoslavia and the Federal Secretary for Finance request a waiver on the limits described in the previous paragraph for September 30, 1980 and a modification of two of these limits for December 31, 1980. The proposed new limits are set out in Annex Table 4.

Yugoslavia's use of Fund resources is summarized in Table 1. As of November 10, 1980, the Fund's holdings of dinars amounted to the equivalent of SDR 871.0 million, or 314.4 per cent of quota. Two purchases of SDR 138.5 million, each equivalent to 50 per cent of quota, were made under the CFF in May 1979 and February 1980, respectively. Outstanding purchases under the oil facility amount to SDR 96.2 million, or 34.7 per cent of quota. Yugoslavia's holdings of SDRs on November 10, 1980 amounted to SDR 60.1 million, or 47.3 per cent of net cumulative allocation.

Table 1. Yugoslavia's Position in the Fund as of November 10, 1980

| | In Millions of SDRs | As Per Cent of Quota |
|---|---|---|
| Quota | 277.0 | |
| General resources account | | |
| Fund's holdings of dinars | 871.0 | 314.4 |
| Oil facilities | 96.2 | 34.7 |
| CFF | 277.0 | 100.0 |
| SFF | 97.6 | 35.2 |
| Ordinary net credit tranches | 121.6 | 43.9 |
| Distribution of gold | 1.7 | 0.5 |
| Special drawing rights account | | |
| Net cumulative allocation | 126.9 | |
| Holdings | 60.1 | |

## II. Developments and Performance Under Stand-By Arrangement

Recent economic developments and the policies to be followed in 1980 were discussed by the Executive Board on June 6, 1980 when Executive Directors considered the Staff Report on the 1980 Article IV consultation with Yugoslavia, (SM/80/119, 5/20/1980; and Sup. 1, 6/10/80), the related paper on Recent Economic Developments (SM/80/120, 5/27/80) and approved the current stand-by arrangement (EBS/80/114, 5/22/80; and Sup. 1, 6/9/80).

The main objective of the stabilization program was to reduce the current account deficit of the balance of payments to at least US$2.5 billion in 1980. Toward this end, it was the aim to reduce the growth rate of real gross social product to 5 per cent compared with 7.1 per cent in 1979. The program called for a decrease in the annual rate of inflation to 17 per cent (in terms of the gross social product deflator), about 3 percentage points less than in 1979. In addition, it was planned that foreign borrowing in conjunction with exceptional financing 1/ by the commercial banks and the use of Fund resources be sufficient in 1980 to permit an increase in gross official reserves of about US$0.7 billion. The authorities indicated that the reduction in the current account deficit would receive priority and that additional measures would be taken, if necessary, to achieve the external target. Subsequently, the planned domestic growth rate was reduced and latest estimates indicate that real domestic expenditures will decline by 2.6 per cent and the growth of real GSP will be only 2.5 per cent in 1980. Whereas at the beginning of the year, real private consumption and real fixed investment were planned to rise by 3.8 per cent and 5.8 per cent, respectively, they are now expected to rise by 1 per cent and decline by 2 per cent, respectively.

Despite the easing of domestic demand pressures the rise in prices has been considerably higher than previously foreseen. By September 1980 the retail price index was 31 per cent above that of a year earlier; it is now expected that the GSP deflator will rise by around 30 per cent in 1980. The strong immediate effects on costs and prices of the depreciation of 22 per cent of the Yugoslav dinar in June 1980, following smaller depreciations earlier in the year, together with administered price adjustments to correct distortions, particularly in prices of energy and agricultural products, have been mainly responsible for the recent upsurge in domestic prices. The acceleration in the cost of living combined with recent successful efforts to restrain the growth of personal incomes has resulted in a substantial decline in real personal incomes during 1980. The average level of real personal incomes in the socialized sector in the first nine months of the year was 8-9 per cent below that in the corresponding period of 1979.

With domestic prices rising more rapidly than originally foreseen, the growth of nominal GSP exceeded sharply the planned growth of the money supply, which was to grow at the same rate as nominal GSP, i.e., 22 per cent. The authorities have decided that it would be inappropriate to permit an expansion of money supply equal to the now anticipated increase of about 33 per cent in

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1/ Financial credits obtained by the commercial banks at the request of the National Bank and used to support gross official foreign exchange holdings.

nominal GSP. However, they believe that a slight increase is necessary to prevent a further reduction in the growth rate of real GSP. Hence, they are adjusting credit creation so as to provide an increase in money supply during the whole of 1980 of 24 per cent. Consistent with this growth and the fact that net foreign assets of the banking system have fallen by more than originally planned (see below), the new target for net domestic assets of the banking system at the end of 1980 is Din 1,538 billion, an increase of 28 per cent compared with end-1979. Of this planned increase during 1980 of Din 337 billion, Din 31 billion arises because of the depreciation of the dinar in June 1980 since some dinar credits are linked to the exchange rate of the dinar. If this increase is excluded, the planned effective increase in net domestic assets in 1980 would be 25 per cent.

Partly because of the faster than expected increase in domestic prices and partly because of the higher dinar prices of imports, expenditure of the Federal budget has risen above the levels originally projected and for the year as a whole will be 3-4 per cent higher. In addition, receipts in the first half of the year increased more slowly than forecast. This has meant that credit from the National Bank to the Federal budget was used more rapidly than had been planned and it was in fact fully utilized by end-June 1980. As a result, the limit of such credit for September 30, 1980 was exceeded by Din 0.5 billion. However, the decision has been made not to raise the limit for the whole year and thus no modification is requested for the relevant performance criterion for December 31, 1980. As a result, expenditure will need to be reduced or other sources of finance found. Any borrowing from the commercial banks would be within the above limit on total bank lending. For the public sector as a whole, total expenditures are forecast to decline in real terms compared with 1979 and there may be a small overall surplus.

As indicated above, the current account of the balance of payments is expected to recover markedly in 1980. The current account deficit, which amounted to US$3.7 billion (6 per cent of GSP) in 1979, is projected to decline to US$2.3 billion (equivalent of about 3 per cent of GSP), about US$0.2 billion less than originally envisaged. The dollar value of exports increased at a rate of 30 per cent over the first ten months of 1980 compared with the same period in 1979, and their volume rose by an estimated 10 per cent. The increase in the value of imports decelerated sharply to a rate of 8.5 per cent over the same period, with their volume declining by about 12 per cent. For the year as a whole, the trade deficit is expected to be around US$1 billion less than originally forecast. On services account, tourist receipts were buoyant but interest payments rose by more than forecast, because a greater proportion of borrowing was in the form of more expensive short-term credits, and in the first half of the year there were substantial withdrawals from foreign exchange accounts of Yugoslavs working abroad. The latest full year estimate is for net services receipts to be about US$0.8 billion less than the earlier estimate. The improvement in the current account stemmed in part from the measures of financial restraint and the related easing of domestic demand pressures and also from the impact of the devaluation of 22 per cent for the dinar vis-à-vis the U.S. dollar that occurred on June 6, which followed frequent small adjustments over the first part of the year. By end-October 1980, the effective trade-weighted exchange rate had declined by 30 per cent compared with December 1979.

Until recently, the outcome in the external capital account has been somewhat disappointing. Originally it had been hoped that virtually all the current account deficit would be covered by medium- and long-term borrowing by the enterprise sector. This would have permitted an increase in gross convertible international reserves equal to exceptional borrowing by the banking system plus net purchases from the Fund. However, in the main, enterprises were able to obtain only the normal flow of suppliers' credits and could not obtain the additional financial credits needed to cover the current account deficit. Partly this was due to various noneconomic factors, but no doubt the deterioration of the balance of payments in 1979 made foreign banks cautious until a recovery could be clearly seen.

In the short run, this forced a major increase in the use of lines of short-term foreign credit and a decline in gross official reserves. Moreover, foreign banks indicated that they would wish to extend financial credits to the National Bank rather than to the enterprise sector. On this basis, the National Bank has concluded and is currently negotiating a large volume of financial credit from abroad, which will be used to repay part of the buildup of short-term credits and which it is hoped should reverse the decline in gross official reserves. However, the above developments have meant that the net foreign asset position of the National Bank was worse at end-September 1980 than originally forecast and this will also be the case at the end of December 1980. On the former date the cumulative decrease in the net foreign asset position was US$937 million compared with an expected US$500 million and at end-year the decline is forecast to reach US$1,600 million rather than return to zero. The corollary is, of course, that outstanding debt of the enterprise sector will not rise as forecast and as a consequence, the limit for December 31, 1980 has been reduced by US$1.6 billion to US$13.1 billion.

As mentioned, the official international reserves declined during the first three quarters and at end-September 1980 totaled US$957 million compared with US$1,315 million at the end of 1979. In October 1980 they rose to US$1,294 million and the present forecast for end-December 1980 is US$1,600 million.

## III. Staff Appraisal

In most respects, the Yugoslav economy has made important progress in 1980. Strong domestic policies, including a very effective incomes policy and tight monetary policies, have sharply reduced real domestic expenditures so that, despite the slower growth of domestic output, resources have been released to contribute to a substantial reduction in the current account deficit. The reduction in the current account deficit of the balance of payments is greater than planned despite the fact that the terms of trade deteriorated more in 1980 than had been forecast. The improved current account position has been supported by the policy of gradual depreciation of the effective exchange rate in the first five months of the year and by the sharp depreciation of 22 per cent on June 6, 1980.

The greater-than-expected deterioration in the terms of trade combined with the depreciation of the effective exchange rate by around 30 per cent since the beginning of the year has put more pressure on prices than originally anticipated and it is now likely that the rise in the social product deflator will be 30 per cent for 1980. The original estimate, on which planned monetary expansion was based, was only 17 per cent. The staff agrees with the authorities' view that this acceleration in the inflation rate is worrying and must be reversed. However, there is no evidence that it results to any marked extent from domestic pressures. In the circumstances the staff considers that the modest increase in the planned growth of the money supply from 22 per cent to 24 per cent is warranted and should not endanger the stabilization program. The growth in 1980 of domestic credit needed to achieve this growth in money supply is 28 per cent, of which about 2.5 per cent results from an increase in dinar credit linked to foreign exchange following the June depreciation. The new ceilings for domestic credit at end-September and end-December 1980 shown in Annex Table 4 are therefore considered reasonable.

The fact that the Federal budget needed access to its whole year credit allocation should not have any significance on the financial program since the total credit limit is not to be increased. The staff therefore considers that a waiver should be granted in respect of the breach of the ceiling on September 30, 1980.

Borrowing by Yugoslavia on foreign capital markets was adversely affected in the first half of the year by a number of noneconomic factors and probably by the slowness with which the improvement in the balance of payments was generally recognized. In the current quarter, medium- and long-term borrowing prospects have improved but for the year as a whole, short-term foreign debt will rise by more than planned and the gross official international reserves will increase by less than intended. However, the staff considers that the somewhat weaker structure of foreign borrowing is much less significant than the sharp improvement in the current account of the balance of payments. Moreover, the fact that more medium- and long-term foreign borrrowing has been done by the National Bank does not affect the overall foreign debt position or its servicing. The staff therefore considers that the requested waiver and modifications of the performance criteria relating to foreign borrowing for September 30 and December 31, 1980 are justified.

Accordingly, the following draft decision is submitted for consideration by the Executive Directors:

1. The letter of November ..., 1980 from the Governor of the National Bank of Yugoslavia and the Federal Secretary for Finance (EBS/80/250, Sup. 1, 11/ /80) shall be annexed to the stand-by arrangement with Yugoslavia (EBS/80/114, 5/22/80) and the letter of

May 16, 1980 from the Governor of the National Bank of Yugoslavia and the Federal Secretary for Finance attached to it shall be read as modified by the letter of November..., 1980.

Table 1. Yugoslavia: National Accounts, 1/ 1977-80

(Percentage change at constant prices)

| | 1977 | 1978 | 1979 | 1980 Plan | 1980 Latest forecast |
|---|---|---|---|---|---|
| Private consumption | 7.0 | 7.0 | 6.0 | 3.8 | 1.0 |
| Public consumption 2/ | 7.4 | 5.3 | 7.9 | 2.1 | 0.8 |
| Gross fixed capital formation | 11.7 | 13.4 | 4.6 | 5.8 | -1.9 |
| Gross domestic expenditure | 11.7 | 4.8 | 9.5 | 3.7 | -2.6 |
| Exports: goods and services | -4.4 | -1.9 | 3.4 | 6.0 | 8.5 |
| Imports: goods and services | 12.5 | -1.3 | 9.8 | --3/ | -10.5 |
| Gross social product | 8.0 | 6.8 | 6.8 | 5.0 | 2.5 |
| Memorandum item: | | | | | |
| Gross social product deflator | 14.7 | 15.0 | 20.7 | 17.0 | 30.0 |

Sources: Resolutions on Realization of Social Plan 1976-80 for 1979 and 1980; and data supplied by the Yugoslav authorities.

1/ Based on material product national income accounting according to Yugoslav methodology, which excludes services rendered to individuals from the gross material product. Gross domestic product is estimated to be about 15 per cent higher than gross social product.
2/ Includes material costs of general and collective consumption only.
3/ The Yugoslav authorities intend to keep growth of imports in line with balance of payments capabilities.

Table 2. Yugoslavia: Balance of Payments, 1977-80 1/

(In millions of U.S. dollars)

| | 1977 | 1978 | 1979 | Latest Forecast 1980 |
|---|---|---|---|---|
| A. Goods and services and unrequited transfers | -1,346 | -1,283 | -3,661 | -2,300 |
| Exports f.o.b. | 5,191 | 5,809 | 6,794 | 8,850 |
| Imports c.i.f. | -9,789 | -10,439 | -14,019 | -14,850 |
| Trade balance | -4,598 | -4,630 | -7,225 | -6,000 |
| Services and unrequited transfers | | | | |
| Credits: | | | | |
| Workers and emigrants remittances | 2,505 | 2,950 | 3,393 | 3,850 |
| Travel | 915 | 1,130 | 1,183 | 1,600 |
| Transportation | 1,100 | 1,200 | 1,405 | 1,650 |
| Interest | 135 | 170 | 188 | 165 |
| Other | 740 | 810 | 1,313 | 1,500 |
| Total | 5,395 | 6,260 | 7,482 | 8,765 |
| Debits: | | | | |
| Workers and emigrants remittances | -725 | -1,280 | -1,683 | -2,200 |
| Travel | -98 | -128 | -155 | -120 |
| Transportation | -505 | -590 | -674 | -770 |
| Interest | -410 | -495 | -821 | -1,200 |
| Other | -405 | -420 | -585 | -775 |
| Total | -2,143 | -2,913 | -3,918 | -5,065 |
| Services and unrequited transfers (net) | 3,252 | 3,347 | 3,564 | 3,700 |
| B. Long-term capital | 1,402 | 1,350 | 1,173 | 407 |
| C. Total (A through B) | 56 | 67 | -2,488 | -1,893 |
| D. Short-term capital incl. bilateral balances, errors and omissions | 40 | 12 | 778 | 262 |
| E. Total (A through D) | 96 | 79 | -1,710 | -1,631 |
| F. Allocation of SDRs | -- | -- | 37 | 38 |
| G. Exceptional financing | 75 | 350 | 250 | 250 |
| H. Total (A through G) | 171 | 429 | -1,423 | -1,343 |
| I. Reserve movements | | | | |
| Use of Fund credit | -112 | -74 | 286 | 343 |
| SDRs | -3 | -7 | -- | -- |
| Reserve position in the Fund | -- | -81 | -- | -- |
| Gold | -5 | -10 | -- | -- |
| Official foreign exchange (increase -) | -51 | -257 | 1,138 | -300 |
| Liabilities of National Bank (increase +) | -- | -- | -- | 1,300 |
| Total | -171 | -429 | 1,423 | 1,343 |

Sources: National Bank of Yugoslavia; and staff estimates.

1/ Data on capital account converted on statistical exchange rate basis.

Table 3. Yugoslavia: Monetary Survey 1/

(In billions of dinars)

| | 1977 | 1978 | 1979 | 1980 I | 1980 II | 1980 III | 1980 IV Forecast |
|---|---|---|---|---|---|---|---|
| | Level at end of period | | | | | | |
| Net foreign assets | -14.0 | -33.4 | -112.0 | -143.0 | -209.8 | -213.6 | -194.0 |
| Domestic credit | 731.9 | 948.0 | 1,201.3 | 1,261.4 | 1,368.4 | 1,449.6 | 1,538.0 |
| Short-term | 155.5 | 193.0 | 246.6 | 259.9 | 269.7 | 298.6 | ... |
| Long-term | 514.5 | 637.8 | 787.4 | 817.6 | 863.3 | 907.5 | ... |
| Other 2/ | 61.9 | 117.2 | 167.3 | 183.9 | 235.4 | 243.5 | ... |
| Money supply 3/ | 251.1 | 315.3 | 375.2 | 386.2 | 399.3 | 430.8 | 465.0 |
| Quasi-money 4/ | 326.7 | 436.1 | 560.2 | 573.8 | 674.9 | 728.5) | |
| Of which: | | | | | | ) | |
| Foreign exchange deposits | 99.5 | 155.3 | 200.2 | 195.3 | 276.0 | 300.1) | 879.0 |
| Other, net | 140.1 | 163.2 | 153.9 | 158.4 | 84.4 | 76.7) | |

Source: Social Accounting Service of Yugoslavia, Statistical Bulletin, various issues.

1/ Derived from the balance sheet for all banks.
2/ Includes foreign exchange claims on domestic clients, and investments in short-term and long-term securities.
3/ National Bank definition of money supply.
4/ Comprises foreign exchange deposits of residents, other sight deposits, time deposits, restricted deposits, securities issued by banks, and claims on banks in respect of pooled resources.

Table 4. Yugoslavia: Quantitative Performance Criteria for 1980 in Stand-By Arrangement

| | 1979 December 31 Actual | 1980 June 30 Actual | 1980 Sept. 30 Actual | 1980 Dec. 31 Fore-cast | 1980 Ceiling Under Program June 30 | 1980 Ceiling Under Program September 30 | 1980 Ceiling Under Program December 31 |
|---|---|---|---|---|---|---|---|
| | | | | | (Proposed new ceilings in brackets) | | |
| Net domestic assets of the banking system; in billions of dinars | 1,201 | 1,368 | 1,450 | 1,538 | 1,321 | 1,381 (1,450) | 1,466 (1,538) |
| Net credit of the National Bank to the Budget of the Federation; in billions of dinars | 68.7 | 77.9 | 77.9 | 77.9 | 76.4 | 77.4 (77.9) | 77.9 |
| Cumulative change in net convertible foreign assets of the National Bank; in millions of U.S. dollars 1/ | ... | -972 | -937 | -1,600 | -900 | -500 (-937) | -- (-1,600) |
| Convertible currency debt outstanding; in billions of U.S. dollars 2/ | 12.3 | 13.1 | 13.3 | 13.1 | 13.6 | 14.2 (14.2) | 14.7 (13.1) |

Source: Data supplied by the Yugoslav authorities.

1/ Net of exceptional borrowing by commercial banks.

2/ Debt outstanding in convertible currency with original maturities of more than one year. Excluding outstanding purchases from the Fund and increases in exceptional borrowings by the commercial banks in 1980. Valued at exchange rates prevailing on December 31, 1979.

# INTERNATIONAL MONETARY FUND
## Washington, D.C. 20431

Mr. Brian Rose

Room 9-120
#8

PRESS RELEASE NO. 80/44

FOR IMMEDIATE RELEASE
June 6, 1980

The International Monetary Fund has approved a stand-by arrangement for the Government of Yugoslavia authorizing purchases up to the equivalent of SDR 339.325 million. The purchases may be made over the period until December 31, 1981 in support of the Government's stabilization program for 1980 and 1981. The arrangement will be financed in part from the Fund's ordinary resources (SDR 138.5 million), and in part from resources borrowed by the Fund under the supplementary financing facility (SDR 200.825 million).

Yugoslavia faced a number of economic difficulties in 1979. The weakness of the world economy combined with the large increase in commodity prices, including oil, put pressure on the balance of payments. Domestic difficulties like the devastating earthquake in Montenegro and bad weather affected overall performance. While there was some deceleration in real growth during the course of the year, it was less than expected largely because of the underlying strength of economic expansion at the end of 1978. The internal pressures that existed in the first half of the year together with rising import prices led to an acceleration of inflation to around 22 per cent annually. These pressures together with the external difficulties were responsible for the sharp deterioration in the current account of the balance of payments to a deficit of $3.7 billion in 1979 compared with one of $1.3 billion in 1978.

In response to these developments, the authorities have introduced a stabilization program for 1980, in order to dampen domestic demand pressures, bring inflation under better control, and reduce the current account deficit. These objectives are to be achieved through a combination of fiscal and monetary measures as well as policies in the incomes, prices, and external fields. The stabilization effort will continue in 1981 because the size of the imbalance precludes making all the necessary correction during 1980.

Yugoslavia's quota in the Fund is SDR 277 million. Its financial obligations to the Fund resulting from past operations and transactions currently total the equivalent of SDR 469.2 million.

EBS/80/114
Supplement 1

CONFIDENTIAL

June 9, 1980

To: Members of the Executive Board

From: The Secretary

Subject: Yugoslavia - Stand-By Arrangement

Attached for the records of the Executive Directors is the text of the stand-by arrangement for Yugoslavia agreed at Executive Board Meeting 80/86, June 6, 1980.

Att: (1)

<u>Stand-By Arrangement--Yugoslavia</u>

1. Annexed hereto is a letter dated May 16, 1980 from the Minister of Finance of Yugoslavia setting forth the objectives and policies which the authorities of Yugoslavia will pursue.

2. The International Monetary Fund grants this stand-by arrangement to support these objectives and policies.

3. Yugoslavia will remain in close consultation with the Fund during the period of the stand-by arrangement. These consultations may include correspondence and visits of officials of the Fund to Yugoslavia or of representatives of Yugoslavia to the Fund. For the purpose of these consultations, Yugoslavia will provide the Fund through reports at intervals or dates requested by the Fund, with such information as the Fund requests in connection with the objectives and policies set forth in the annexed letter. In particular, Yugoslavia will consult with the Fund on the adoption of any measures that may be appropriate at the initiative of Yugoslavia or whenever the Managing Director requests consultation because any of the criteria referred to in paragraph 5 below are not being observed or because he considers that consultation on the program is desirable. In addition, after the period of the stand-by arrangement and while Yugoslavia has outstanding purchases in the upper credit tranches, the Government will consult with the Fund, from time to time, at the initiative of the Government or at the request of the Managing Director, concerning Yugoslavia's balance of payments policies.

4. During the period from June 6, 1980 to December 31, 1981, Yugoslavia will have the right, after making full use of any reserve tranche that it may have at the time of making a request for a purchase under the stand-by arrangement, to make purchases from the Fund in an amount equivalent to SDR 339.325 million, provided that:

(a) (i) purchases under the stand-by arrangement shall not, without the consent of the Fund exceed the equivalent of SDR 150 million until November 15, 1980, SDR 200 million until February 15, 1981, SDR 250 million until May 15, 1981, SDR 300 million until August 15, 1981, and SDR 339.325 million until November 15, 1981; and

(ii) the right of Yugoslavia to make purchases under this stand-by arrangement shall be subject to paragraph 5 below to the extent that such purchases would increase the Fund's holdings of dinars beyond the first credit tranche plus 12.5 per cent of quota.

(b) If at any time, any limit in (a)(i) above would prevent a purchase under the stand-by arrangement that would not increase the Fund's holdings of Yugoslavia's currency beyond the first credit tranche plus 12.5 per cent of quota, the limit will not apply to that purchase.

(c) Purchases under this arrangement shall be made with supplementary financing until purchases under the arrangement reach the equivalent of SDR 34.625 million, and then each purchase shall be made from ordinary resources and with supplementary financing in the ratio of 25 to 30.

5. (a) During any period before December 31, 1980 in which:

(i) the limits on the increase in outstanding foreign debt in convertible currencies referred to in paragraph 9 of the annexed letter are exceeded; or

(ii) the targets for the net convertible foreign assets of the National Bank of Yugoslavia, referred to in paragraph 10 of the annexed letter have not been met; or

(iii) the limits on net domestic assets of the banking system referred to in paragraph 15 of the annexed letter have been exceeded; or

(iv) the limits on the net lending of the National Bank of Yugoslavia to the Budget of the Federation referred to in paragraph 15 of the annexed letter have been exceeded; or

(v) the intentions stated in paragraph 17 of the annexed letter are not carried out, the Government of Yugoslavia will not request any purchase under this arrangement except after consulting the Fund and reaching understandings with the Fund regarding the circumstances in which such purchases may be made.

(b) Moreover, during the period of the stand-by arrangement after December 31, 1980, Yugoslavia will not request purchases under the stand-by arrangement unless Yugoslavia has reached understandings with the Fund on its policy intentions and performance criteria in accordance with the last sentence of paragraph 18 of the annexed letter or while the understandings thus reached are not being observed.

6. Purchases under the stand-by arrangement shall be made in the currencies of other members selected in accordance with the policies and procedures of the Fund, and may be made in special drawing rights if, upon the request of Yugoslavia, the Fund agrees to provide them at the time of the purchase. Purchases shall be made in exchange for the currency of Yugoslavia.

7. Yugoslavia will pay a charge for this stand-by arrangement in accordance with the decisions of the Fund.

8. Subject to paragraph 4 above, Yugoslavia will have the right to engage in the transactions covered by this stand-by arrangement without further review by the Fund. This right can be suspended only with respect to requests received by the Fund after (a) a formal ineligibility; or (b)

a decision of the Executive Board to suspend transactions, either generally or in order to consider a proposal, made by an Executive Director or the Managing Director, formally to suppress or to limit the eligibility of Yugoslavia. When notice of a decision of formal ineligibility or of a decision to consider a proposal is given pursuant to this paragraph 8, purchases under this stand-by arrangement will be resumed only after consultation has taken place between the Fund and Yugoslavia and understandings have been reached regarding the circumstances in which such purchases can be resumed.

9. (a) Repurchase of the outstanding amount of Yugoslavia's currency that results from a purchase under this arrangement and is subject to charges under Article V, Section 8(b):

(i) may be made at any time;

(ii) will be expected normally as the balance of payments and reserve position of Yugoslavia improves;

(iii) shall be made in accordance with the representation of the Fund if, after consultation with Yugoslavia, the Fund represents that under its policies at the time of the repurchase Yugoslavia should repurchase because of an improvement in its balance of payments and reserve position;

(iv) with respect to purchases from ordinary resources, shall be completed five years after the date of the purchase, provided that the repurchase shall be made in equal quarterly installments during the period beginning three years and ending five years after the date of the purchase unless the Fund approves a different schedule; and

(v) with respect to purchases with supplementary financing, shall be completed seven years after the purchase, provided that the repurchase shall be made in equal semiannual installments during the period beginning three and one half years and ending seven years after the purchase.

(b) Any reductions in Yugoslavia's currency held by the Fund shall reduce the amounts subject to repurchase under (a) above in accordance with the principles applied by the Fund for this purpose at the time of reduction provided, however, that a repurchase attributed to a purchase with supplementary financing in advance of the schedule in (a)(v) above shall be accompanied by a repurchase in respect of the purchase from ordinary resources made at the same time if any part of the latter purchase is still outstanding. The amounts of the two repurchases shall be in the same proportions in which ordinary resources and supplementary financing were used in the purchases, provided, however, that the repurchase in respect of the purchase from ordinary resources shall not exceed the amount of the purchase still outstanding.

(c) Repurchase shall be made with special drawing rights, or with the currencies specified by the Fund at the time of the repurchase in accordance with the policies and procedures of the Fund at the time of the repurchase.

Annex to Stand-By Arrangement

Belgrade, Yugoslavia
May 16, 1980

Dear Mr. de Larosière:

1. The Yugoslav economy is passing through a particularly difficult period. The current account of the balance of payments was in deficit by US$1.3 billion in both 1977 and 1978 and domestic prices were increasing at rates well in excess of 10 per cent. Domestic activity was buoyant, with real gross social product increasing by 7.9 per cent in 1977 and 6.6 per cent in 1978. A relatively rapid rate of growth was considered necessary to prevent a serious problem of unemployment. However, it added to the existing domestic and external pressures. Moreover, as the growth of world economic activity decelerated, various restrictions were placed against important Yugoslav exports in some markets.

2. The Government decided in 1979 that a stabilization effort was required to moderate domestic pressures and to contain the deficit in the current account of the balance of payments to a level that would not require excessive foreign borrowing. Accordingly, the target for the increase in real gross social product was reduced to 6 per cent and the aim was to reduce the general rate of price increase from 15 per cent in 1978 to around 13 per cent in 1979. With regard to the balance of payments, the current account deficit was to be kept to US$1 billion, which would have implied that the debt service ratio for foreign debt in convertible currencies would remain below 20 per cent. These targets were to be achieved by the implementation of an integrated set of domestic and external policies, which included, inter alia, more restrictive credit policies and an exchange rate policy designed to maintain the external competitiveness of our economy. The stabilization program was supported by a stand-by arrangement with the Fund equivalent to SDR 69.125 million agreed to on May 23, 1979, covering the first credit tranche.

3. For several reasons, the course of events in 1979 deviated from the original plan. We probably had underestimated the underlying pressures on the economy that existed at the end of 1978 and which continued in the first part of 1979. As a result, domestic activity in the first half of the year was higher than we intended. Although additional measures were taken that reduced rates of growth in the second half of the year, the increase in real gross social product in 1979 as a whole is estimated to have been 7.1 per cent, some one percentage point above the target. However, there were important factors, all beyond our control, that prevented us from achieving our other goals. Above all, there was the unexpected and large increase in oil prices. Oil prices for Yugoslavia rose on average from US$101 per metric ton in 1978 to US$143 per metric ton in 1979. In addition, natural gas imports increased sharply in 1979, principally in order to fill a newly completed pipeline, while cereal imports increased because of a particularly

poor corn harvest in 1978 and a bad wheat crop in 1979. The value of imports of these three commodity groups was almost US$1 billion higher than in 1978. Another major exogenous factor was the earthquake in Montenegro in April 1979, which adversely affected tourism not only in that region but also elsewhere; in addition, it reduced exports and necessitated additional imports for reconstruction. These factors, plus depressed deliveries of ships, a major export item, and a virtual cessation of corn exports because of the disastrous 1978 harvest, meant that the current account deficit rose to US$3.7 billion, leading to a decline of US$1.3 billion in gross convertible international reserves of the banking system to US$2 billion at the end of the year, and substantial net foreign borrowing totaling around US$2.1 billion. The latter, combined with the rise in interest rates, increased the debt service ratio on debt in convertible currencies (excluding purchases from the Fund) from 16.9 per cent in 1978 to 19.5 per cent in 1979.

4. Domestically, higher import prices were an important factor contributing to a rise in the rate of inflation from some 14 per cent in 1978 (year-on-year average for all domestic expenditure) to almost 21 per cent in 1979, although the rate of increase declined in the second half of the year. It was not possible to prevent the increase in prices being largely reflected in increases in personal income payments per employee, but we believe it is significant that these rose by only about 20 per cent compared with the previous year. In this respect, it appears that workers exercised considerable self-restraint in the self-management agreements on income payments.

5. Although many of the reasons for the adverse developments in 1979 were beyond our control, the Government has to face the fact that the deterioration that occurred in the balance of payments must be reversed in 1980. Yugoslavia has therefore decided that policies this year must bring about a substantial reduction in the current account deficit and thereby limit the growth of external debt. To achieve this and to aid in reducing the rate of inflation, a slower growth of domestic activity will be necessary. Therefore, a major stabilization effort has been introduced and will continue until the necessary corrections in the domestic and external sectors have been made. Given the size of the imbalance in 1979, it will not be possible to achieve all of the needed corrections in 1980 and we realize that the effort must continue in 1981. To support the stabilization program, which is described in detail below in respect of the 1980 period, Yugoslavia is requesting a new stand-by arrangement from the Fund for the period up to December 31, 1981 in a total amount equivalent to SDR 339.325 million, including the equivalent of SDR 200.825 million from the supplementary financing facility.

6. Although the stabilization program will extend over both 1980 and 1981, we are convinced that substantial progress must be made in 1980 to reduce the current account deficit. We intend to do everything possible to reduce the deficit to US$2.0 billion this year and believe that there is a reasonable chance of achieving this. Such a large and rapid reduction might entail too great a disruption to real growth and employment but we are convinced that the current account deficit must not exceed US$2.5 billion this year with another large reduction in 1981. Thus in 1980, we aim to reduce the

deficit by at least US$1.2 billion which would be a reduction of at least one third. As a percentage of gross social product, the current deficit would decline as a minimum from 6 per cent in 1979 to below 4 per cent in 1980. A deficit of this size would entail an amount of foreign borrowing that we consider manageable (see below).

7. A major effort will be required to reduce the deficit to the extent sought, but we believe the needed improvement can be made. While part of it will come from larger net invisible receipts, the major adjustment will be on the trade account, where exports must increase strongly and the growth in imports must be sharply reduced. To achieve these results, the pattern of domestic production and expenditure must change so as to release more production for export and to reduce the import intensiveness of domestic output. Under the Yugoslav system of workers' self-management, all enterprises involved in foreign trade must agree among themselves within the Communities of Interest for Foreign Economic Relations on foreign trade plans that will lead to a viable balance of payments. In 1980, enterprises are making a major effort to produce more exportable goods and to substitute domestic products for imports wherever possible. They will be aided by the fact that a number of major development projects have recently been finished, which will reduce the demand for imported investment goods. Moreover, these projects will increase export supplies and permit greater import substitution. Throughout the economy, investment proposals are being re-examined to shift the emphasis for the time being toward projects that require few imports and away from import-intensive projects, especially those not directly related to export production or import replacement. Intensified efforts are being made to increase domestic supplies of raw materials, for example, coal and iron ore, and of intermediate products. Inter alia, this should keep the volume of oil imports, excluding amounts needed to fill a new pipeline, at no more than the 1979 level and possibly less.

8. In addition, in 1980 some of the particular trade difficulties of 1979 should not recur. So far, there is every indication that corn exports will revive and imports of wheat should not be needed to the extent experienced in 1979. Because of past orders, deliveries of ships will increase sharply in 1980 and 1981. The planned growth of gross social product is 2 percentage points less than the outcome in 1979, which will slow down import demand. Although overall world export demand may be weak in 1980, the main Yugoslav export markets are expected to be relatively less affected, and demand in them is expected to be around 6 per cent. Moreover, in 1979 we depreciated the dinar in terms of effective exchange rates by about 8 per cent following a depreciation of 9 per cent in the preceding year. We intend to continue with an exchange rate policy that will maintain our competitive position and we expect to regain some of the market shares lost in recent years. Although its impact in 1980 will be limited, the recently concluded agreement with the European Community should have an increasingly favorable effect on our economic relations with its member countries in the coming years, including 1981. Taking all these factors into account, export volume is forecast to increase by 8 per cent and value by 21 per cent. Import volume should decline by around 9 per cent and the value would increase by some 9 per cent. The forecast turnaround in imports is not out of line with improvements made in previous periods when policies have been directed

toward substantial improvement in the external sector. Workers' remittances should benefit from wage increases in Western Europe and tourism should show a recovery from 1979. Taking all the above into account, a current account deficit of US$2 billion in 1980 may be possible and it is our firm intention not to exceed a maximum level of US$2.5 billion.

9. The large deficit in the current account in 1979 necessitated a net increase of foreign borrowing in convertible currencies of US$2 billion and at the end of that year the outstanding level of such debt was US$13.5 billion, of which US$12.8 billion had an original maturity of more than one year. During 1979, there was a refinancing of debt totaling around US$0.8 billion and the conditions attached to the new credits generally provided for grace periods of three years and maturities of the order of 8-10 years. We intend to continue to pay careful attention to the terms of new foreign borrowing so as to avoid sharp peaks in servicing schedules, especially since, partly as a result of the rise in interest rates, the debt service ratio for convertible foreign debt, excluding purchase from the Fund, reached 19.5 per cent in 1979. To prevent a debt service problem from emerging and consistent with the maximum projected current account deficit for 1980, outstanding foreign debt in convertible currencies with original maturities of more than one year, (excluding purchases from the Fund) which stood at US$12.3 billion at the end of 1979, will not exceed US$14.7 billion by the end of 1980 (based on exchange rates current on December 31, 1979 and excluding net exceptional financing during 1980). To ensure orderly borrowing during the year, quarterly limits on the outstanding amounts have been set as follows: no more than US$13.6 billion on June 30, 1980, US$14.2 billion on September 30, 1980, and US$14.7 billion on December 30, 1980.

10. As mentioned earlier, during 1979 the gross convertible international reserves of the banking system declined and in 1980 they will need to be built up again. It is our intention to increase the gross convertible reserves of the National Bank of Yugoslavia by at least US$0.7 billion during 1980. This will necessitate a continuation of exceptional financing by the commercial banks, which has involved borrowing abroad in convertible currencies to maintain the level of the international reserves. In 1979, such borrowing totaled US$250 million. To ensure an adequate level of liquidity in convertible currencies, the net convertible foreign assets of the National Bank of Yugoslavia less exceptional financing in convertible currencies by the commercial banks, which declined by US$1,702 million in 1979 will show no further decline by the end of 1980. Consistent with this target for end-1980, and allowing for the expected pattern of net foreign borrowing and for the seasonal movements in the current account deficit, targets have been established providing for a decline of no more than US$900 million by June 30, 1980 and no more than US$500 million by September 30, 1980.

11. If the various balance of payments targets are to be achieved, policies must ensure that domestic activity is not too expansionary. To ensure such consistency, it has been decided to reduce the planned increase in real gross social product to 5 per cent in 1980 and to aim for a reduction in the gross social product deflator to 17 per cent compared with 20 per cent in 1979. All categories of domestic demand are planned to show smaller increases in real terms--the growth of personal consumption will decelerate from 5.5 per cent to 3.8 per cent, public consumption from 5.9 per cent to 2.1 per cent, and fixed capital formation from about 8 per cent to 5.8 per cent.

12. The achievement of these targets will require an intensified restraint by all sectors of the economy--the public and enterprise sectors in particular. In this regard, we would point out that self-management agreements covering such factors as prices and personal income payments were implemented in a responsible and effective manner in 1979 and, with increasing experience with the new system, it is expected that it will operate even more effectively in 1980. The Government is convinced that a strong consensus exists in Yugoslavia that all decisions taken in the economic field should reflect the economic aims enunciated in the stabilization program.

13. In some recent years there has been the tendency for public sector consumption to grow more rapidly than social product, and in all years the Federal Government has borrowed from the National Bank of Yugoslavia. The ratio of public sector expenditure to gross social product rose from about 36 per cent in 1973 to about 43 per cent in 1978. In 1979, however, this ratio declined to about 41 per cent. For the federal budget, expenditure in 1979 rose by 25 per cent compared with increases of 29 per cent in revenue and 28 per cent in nominal gross social product. The deficit declined from Din 5.3 billion in 1978 to Din 3.8 billion in 1979. For the public sector as a whole, there was virtually no deficit in 1979. For 1980, the intention is that the public sector will continue to grow more slowly than social product, although budget expenditure by the Federation will increase by 29 per cent. The deficit of the federal budget will rise to Din 6.2 billion but this is equivalent to only 0.4 per cent of gross social product. Gross borrowing from the National Bank will rise only fractionally (from Din 8.5 billion in 1979 to Din 9.2 billion in 1980), which is much less than the increase in expenditure. Current expenditure by the public sector as a whole is to increase by no more than 16 per cent.

14. Monetary policy is an important part of the stabilization program, since an excess supply of financial assets could weaken the implementation of other elements in the program. In 1978 there was an excessive rate of increase of money supply, which rose by 28 per cent and in 1979 strong steps were taken to decelerate monetary expansion, the target for the increase in money supply in that year being set at 18 per cent. In the first months of the year the demand for credit continued strongly and the National Bank had to take special measures to limit the expansion by imposing strict credit limits on the commercial banks and by reducing demand for consumer credits by raising downpayment provisions. These measures were effective, so much so that some relaxation was necessary in the second half of the year when the loss of liquidity of the commercial banks resulting from the continued external deficit threatened an abrupt decline in enterprise activity. At the end of 1979, money supply was only 17 per cent higher than a year earlier. Also, despite the need to counteract some of the liquidity loss caused by the external deficit, the rate of domestic credit creation was 27 per cent in 1979 compared with 30 per cent in the previous year.

15. For 1980, we consider that money supply should rise broadly in line with the reduced rate of growth of nominal social product. To that end, and given the planned balance of payments targets, the increase in money supply will be kept to 22 per cent and the increase in net domestic assets of the banking system to 22 per cent. To ensure that money supply does not increase excessively in the first half of the year, thereby prejudicing the whole year result, limits have been set within the year on net domestic assets of the

banking system, which totaled Din 1,201 billion on December 31, 1979. They are not to exceed Din 1,321 billion on June 30, 1980, Din 1,381 billion on September 30, 1980, and Din 1,466 billion on December 31, 1980. To ensure that lending by the National Bank of Yugoslavia to the budget of the Federation does not compromise the overall credit program, such net lending in 1980 is not to exceed Din 9.2 billion. As with total domestic credit creation, sublimits have been established within the year. Such credits to the federal budget, which totaled Din 68.7 billion on December 31, 1979, are not to exceed Din 76.4 billion on June 30, 1980, Din 77.4 billion on September 30, 1980, and Din 77.9 billion on December 31, 1980.

16. Detailed quantitative economic targets for 1981, including targets for increases in domestic credit, foreign borrowing and the net foreign assets of the National Bank of Yugoslavia cannot be established at this stage. However, as mentioned above, the Government is determined to continue with the stabilization program next year. Also, it intends to continue to give first priority to a further improvement in the balance of payments. Domestic policies in all fields will be formulated to maintain and if necessary strengthen the current measures of restraint. On the basis of a preliminary examination of the possible 1981 Plan, domestic activity would grow no faster and perhaps somewhat more slowly than is planned for 1980. Externally, the planned current account deficit of the balance of payments will decline further, perhaps to around US$1.8 billion.

17. The Government of Yugoslavia does not intend to introduce any multiple currency practices or introduce new or intensify existing restrictions on payments and transfers for current international transactions or enter into any bilateral payments arrangements with Fund members; furthermore, the Government of Yugoslavia does not intend to introduce new restrictions or intensify existing restrictions on imports for balance of payments reasons.

18. The Government believes that the policies set forth in this letter are adequate to achieve the objectives of its program, but will take any further measures that may become appropriate for this purpose. The Government of Yugoslavia will consult with the Fund on the adoption of any measures that may become appropriate, in accordance with the policies of the Fund on consultations. Moreover, the Yugoslav authorities will consult with the Fund and reach understanding on the quantitative aspects of the program relating to the period of the stand-by arrangement subsequent to December 31, 1980.

Yours sincerely,

(Ksente Bogoev)
Governor, National Bank of Yugoslavia

(Ing. Petar Kostic)
Federal Secretary for Finance

Mr. J. de Larosière
Managing Director
International Monetary Fund
WASHINGTON, D. C. 20431

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FOR AGENDA

EBS/80/114

CONFIDENTIAL

May 22, 1980

To: Members of the Executive Board

From: The Secretary

Subject: Yugoslavia - Request for Stand-By Arrangement

Attached for consideration by the Executive Directors is a request from Yugoslavia for a stand-by arrangement equivalent to SDR 339.325 million. A draft decision appears on page 11.

This subject, together with the staff report for the 1980 Article IV consultation with Yugoslavia (SM/80/119, 5/20/80), has been tentatively scheduled for discussion on Friday, June 6, 1980.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

YUGOSLAVIA

# Request for Stand-by Arrangement with Supplementary Financing

Prepared by the European Department and the Exchange and Trade Relations Department 1/

(In consultation with the Legal Department and the Treasurer's Department)

Approved by L.A. Whittome and S. Kanesa-Thasan

May 21, 1980

## I. Introduction

In a letter dated May 16, 1980 (annexed), Yugoslavia requests a stand-by arrangement, with associated use of supplementary financing for the period up to December 31, 1981, in an amount equivalent to SDR 339.325 million, which is equivalent to the second and third credit tranches (SDR 138.5 million) plus the associated amounts 2/ available under the supplementary financing facility. The letter describes the policies and intentions of the Yugoslav authorities.

Yugoslavia is an original Fund member. Its quota in the Fund is SDR 277 million. Yugoslavia has used Fund resources on a number of occasions. The last stand-by arrangement with Yugoslavia for SDR 69.25 million, covering the first credit tranche, was granted in May 1979 and was used in full. In February 1980, Yugoslavia drew SDR 138.5 million under the compensatory financing facility, bringing the outstanding drawings by Yugoslavia under the facility to the equivalent of 100 per cent of quota.

On April 30, 1980, Fund holdings of dinars were equivalent to 269.8 per cent of quota, or 125 per cent of quota excluding outstanding purchases under the oil facilities and compensatory financing facility, and holdings resulting from gold sales to Yugoslavia. Yugoslavia is a participant in the Special Drawing Rights Department. At the end of April 1980, holdings were SDR 55.1 million, or 43.4 per cent of net cumulative allocation of SDR 126.9 million. Yugoslavia has acquired 177,144 ounces of fine gold in the gold distribution program, and received US$19.4 million in the direct distribution of profits from gold sales. Yugoslavia has transferred one third of the latter amount to the Trust Fund.

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1/ A mission consisting of Messrs. Tyler (EUR), Mountford (EUR), and Loser (ETR) with Mrs. Pabst (EUR) as secretary was in Belgrade from May 4-7, 1980 to finalize discussions which began in February-March 1980 during the 1980 Article IV consultation discussions.

2/ Including an amount equivalent to 12.5 per cent of quota related to the first credit tranche; the first credit tranche was drawn in May 1979.

## II. The Economic and Financial Program

The background to the current problems of the Yugoslav economy and the policies to be followed in 1980 are described in the Staff Report for the 1980 Article IV consultation with Yugoslavia (SM/80/119, 5/20/80) and in Recent Economic Developments (SM/80/120, 5/27/80). In response to the sharp increase in the deficit in the current account of the balance of payments in 1979, which was financed in part by a sizable reduction in reserves, and the further acceleration in the rate of inflation, the authorities have introduced a stabilization program for calendar year 1980, in order to dampen domestic demand pressures, bring inflation under better control, and reduce the current account deficit. It is the firm intention of the authorities to continue with the stabilization effort in 1981. Under the Yugoslav constitutional system, final numerical targets for 1981 cannot be established until the end of 1980. The attached Letter of Intent therefore describes the financial program for 1980 in detail and the broad path that will be followed in 1981. The stand-by arrangement makes provision for a consultation with the Fund to reach understandings on quantitative aspects of the program for the period of the stand-by arrangement subsequent to December 31, 1980. The establishment of such undertakings is a performance criterion.

The main macroeconomic targets of the program for 1980 are a reduction in the growth rate of real social product to 5 per cent compared with 7.1 per cent in 1979, and a decrease in the rate of inflation to 17 per cent (in terms of the GSP deflator) about 3 percentage points less than in 1979. For the balance of payments, the current account deficit is to be reduced to a maximum of US$2.5 billion in 1979. 1/ In combination with exceptional financing by the commercial banks and the use of Fund resources, foreign borrowing is planned to be sufficient in 1980 to permit an increase in gross official reserves of about US$0.7 billion.

The stabilization effort will continue in 1981. Final quantitative targets cannot be established at this time, but present thinking is that the current account deficit of the balance of payments should be reduced to about US$1.8 billion in that year. To achieve this, real growth of GSP will probably need to be kept at around the level planned for 1980 or perhaps somewhat lower.

### 1. Fiscal policy

On the basis of available information, the financial position of the public sector as a whole appears to have improved in 1979. The growth rate of consolidated public sector expenditures and revenues was apparently lower than that of nominal GSP, and the overall deficit was probably reduced to negligible proportions. More precise and reliable data are available

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1/ The authorities hope that a firm implementation of the program could lead to a smaller deficit of about US$2 billion but in the opinion of the staff it is more appropriate to base the financial program for the purpose of the stand-by arrangement on the somewhat more pessimistic assumption of a deficit of US$2.5 billion.

Table 1. Yugoslavia: Summary Balance of Payments, 1977-80 1/

(In billions of U.S. dollars)

| | | 1977 | 1978 | 1979 Prel. | 1980 Forecast |
|---|---|---|---|---|---|
| A. | Exports, f.o.b. | 5.2 | 5.8 | 6.8 | 8.2 |
| | Imports, c.i.f. | -9.8 | -10.4 | -14.0 | 15.3 |
| | Trace balance | -4.6 | -4.6 | -7.2 | -7.0 |
| B. | Services and transfers, net | 3.3 | 3.3 | 3.5 | 4.5 |
| | Current account balance | -1.3 | -1.3 | -3.7 | -2.5 |
| C. | Long-term capital, net | 1.4 | 1.4 | 1.4 | 2.5 |
| D. | Short-term capital, including bilateral balances, and errors and omissions; excluding G | -- | -- | 0.6 | -- |
| E. | Total (A through D) | 0.1 | 0.1 | -1.7 | -- |
| F. | Allocation of SDRs | -- | -- | -- | -- |
| G. | Exceptional financing | 0.1 | 0.3 | 0.2 | 0.4 |
| H. | Total (A through G) | 0.2 | 0.4 | -1.5 | 0.4 |
| I. | Reserve movements (increase -) | -0.2 | -0.4 | 1.5 | -0.4 |

Sources: Data supplied by the Yugoslav authorities; and staff estimates.

1/ Totals may not add due to rounding.

Table 2. Yugoslavia: Budget of the Federation

(In billions of dinars) 1/

| | 1976 | 1977 | 1978 | 1979 Preliminary outturn | 1980 Plan |
|---|---|---|---|---|---|
| Expenditure | 75.5 | 89.0 | 77.9 | 97.4 | 125.3 |
| Revenue | 64.9 | 80.0 | 72.6 | 93.6 | 119.1 |
| Deficit | -10.7 | -9.0 | -5.3 | -3.8 | -6.2 |
| Financed by: | | | | | |
| Borrowing from National Bank | 7.9 | 11.2 | 9.5 | 8.5 | 9.2 |
| Other (net) | 2.8 | -2.2 | -4.2 | -4.7 | -3.0 |

Source: Data supplied by the Yugoslav authorities.

1/ Totals may not add because of rounding.

only for the budget of the Federation (the central government) which accounts for only about one fifth of total consolidated public sector transactions, but has in recent years been the source of virtually all of the public sector deficit. In 1979, expenditures by the Federation rose 25 per cent, or less than the rate of increase in nominal GSP, and buoyant revenues led to a reduction in the deficit to Din 3.8 billion, equivalent to 0.3 per cent of GSP, compared to a deficit equivalent to 0.6 per cent of GSP in 1978. This decrease in the deficit enabled the authorities to keep borrowing from the National Bank to Din 8.5 billion.

For 1980, total expenditures by the Federation are budgeted to increase by 28.6 per cent, with the bulk of the increase due to a rise in defense expenditures. As a result the deficit will increase to Din 6.2 billion, equivalent to 0.4 per cent of nominal social product. Gross borrowing from the National Bank, however, is only expected to amount to Din 9.2 billion, or less in real terms than in 1978 or 1979. The Economic Resolution for 1980, which embodies the main policies that the various sectors of the economy must follow, specifies that current expenditures of the public sector as a whole must not rise by more than 16 per cent, which would be substantially less than the growth of total expenditures in the economy.

2. Monetary policy

Following a large expansion of money supply in 1978, the authorities sought in 1979 to follow more restrictive policies, as described in the Article IV consultation paper. In practice the conduct of monetary policy was complicated by the fact that the decline in net foreign assets of the banking system was considerably larger than forecast, due to the sharp deterioration of the balance of payments situation. To avoid an excessive squeeze on domestic liquidity, the authorities allowed an increase in domestic bank credit of 26.7 per cent (compared with an original target of 19 per cent), which was about 2 percentage points lower than the increase in GSP. The increase in narrow money supply, on the other hand, was only 17.3 per cent, considerably less than the nominal GSP increase, and slightly less than the planned increase of 18 per cent. Against this, it is obvious that the large increase in domestic credit accommodated the balance of payments deficit and the acceleration in the rate of inflation.

For 1980 the authorities intend to maintain tight monetary and credit conditions, with annual increases in both domestic credit and money supply 22 per cent, the forecast increase in nominal GSP. Moreover, in order to ensure the observance of the credit target for 1980, the authorities have established quarterly ceilings on bank credit, which are set out in Table 3, and are incorporated for the period of the proposed stand-by arrangement as performance criteria. With minor exceptions, which the authorities have acted to correct, the targets were broadly met in the first quarter of 1980. The authorities do not intend to increase these targets in the event that price increases exceed the planned level of 17 per cent on which the financial program is based. It is implicit in the monetary program that the economy was not excessively liquid at the end of 1979 and that the velocity

Table 3 . Yugoslavia: Monetary Survey

(Change in billions of dinars)

| | 1979 | | | | 1980 | | | |
|---|---|---|---|---|---|---|---|---|
| | I | II | III | IV | I | II | III | IV |
| | | | | | Projected | | | |
| Net foreign assets | -17.0 | -16.5 | -11.4 | -33.7 | -20.0 | -5.0 | 4.0 | -4.0 |
| Domestic credit | 56.6 | 38.9 | 63.0 | 94.8 | 60.0 | 60.0 | 60.0 | 85.0 |
| Of which: | | | | | | | | |
| National Bank credit to the Federation | (3.0) | (2.0) | (0.5) | (3.0) | (4.7) | (3.0) | (1.0) | (0.5) |
| Money supply 1/ | 7.0 | -2.2 | 28.0 | 24.2 | 15.0 | 17.0 | 25.0 | 27.0 |
| Quasi-money 2/ | 20.9 | 30.4 | 36.7 | 34.3 | 25.0 | 38.0 | 39.0 | 53.0 |
| Other items, net | 11.7 | -5.8 | -13.1 | 2.6 | | | | |

Source: Data supplied by the Yugoslav authorities.

1/ Definition of National Bank of Yugoslavia, which includes government demand deposit.
2/ Includes foreign exchange deposits.

of circulation will not increase in 1980. Obviously, either of these assumptions could be questioned. Against that, the authorities have emphasized their determination to adjust domestic targets and policies if the external targets during 1980 are not being realized.

Consistent with these ceilings and with the Federal Budget for 1980, the authorities have established sublimits on lending from the National Bank of Yugoslavia to the budget of the Federation. These sublimits are set out in Table 4, and are incorporated as performance criteria in the proposed stand-by arrangement.

Although it is not possible under the Yugoslav system to establish at this time quantitative monetary targets for 1981, the authorities have stated their firm intention to have a financial program for next year that will be consistent with a further improvement in the current account of the balance of payments.

3. Incomes and prices policies

In most recent years wages in Yugoslavia have risen quite strongly in real terms (5 per cent in 1977 and 6 per cent in 1978). In the period up to 1979 the unique system of wage determination by self-management agreements resulted in real wage increases that exceeded the increase in productivity and contributed to the development of excess domestic demand pressures, and had adverse repercussions on the Yugoslav competitive position. In 1979, however, the system of incomes determination in Yugoslavia worked in a more satisfactory fashion. As a result, the average increase in nominal personal incomes per employee was limited to 20 per cent in 1979, implying a small real decrease. For 1980, guidelines or principles have been established, in the framework of social compacts at the republican and Federal levels, that would require the increases in nominal personal incomes to be between 5-9 percentage points less than the nominal increase in GSP. The differential guidelines for various sectors would result in a real decrease in personal incomes in some sectors (e.g., banks, the public sector, and services). Individual work units completed their self-management agreements in March 1980 in line with these guidelines. Accordingly it is forecast that real wages per employee will again show a small decrease in 1980 on average.

The system for the determination of prices in Yugoslavia is complex. (Details are given in SM/80/120, pp. 24-27). A new and not yet fully established mechanism is to operate in the second half of 1980. In the meantime Federal and republican governments have agreed on national policies concerning 11 important commodities, previously subject to direct control. Also, the new guidelines provide that in general prices that were increased in the second half of 1979 cannot be changed until the second half of 1980. At the beginning of 1980 prices in general were rising at a rate in excess of that planned for the year as a whole but the authorities are convinced that the rate of inflation will moderate as the year progresses and the new policies take effect.

Table 4 . Yugoslavia: Quantitative Performance Criteria in Proposed Stand-By Arrangement

| | 1979 December 31 Actual | 1980 Proposed Ceilings Under Program 1/ June 30 | September 30 | December 31 |
|---|---|---|---|---|
| Net domestic assets of the banking system (In billions of dinars) | 1,201 | 1,321 | 1,381 | 1,466 |
| Net credit of the National Bank to the Budget of the Federation (In billions of dinars) | 68.7 | 76.4 | 77.4 | 77.9 |
| Cumulative change in net convertible foreign assets of the National Bank 2/ (In millions of U.S. dollars) | ... | -900 | -500 | -- |
| Convertible currency debt outstanding 3/ (In billions of U.S. dollars) | 12.3 | 13.6 | 14.2 | 14.7 |

Source: Data supplied by the Yugoslav authorities.

1/ Quantitative performance criteria for 1981 to be determined at the time of the mid-term review.
2/ Net of exceptional borrowing by commercial banks.
3/ Debt outstanding in convertible currency with original maturities of more than one year. Excluding outstanding purchases from the Fund and increases in exceptional borrowings by the commercial banks in 1980. Valued at exchange rates prevailing on December 31, 1979.

4. Exchange rate, foreign borrowing, and reserve policies

During 1978 and 1979 the authorities followed a more active exchange rate policy than before, and the effective exchange rate depreciated by about 17 per cent over the two-year period, which was sufficient to produce a real effective depreciation of about 9 per cent (adjusted for relative movements in producer prices in Yugoslavia and in the major convertible trade partners in the convertible area). The effective depreciation obviously regained at least part of the competitiveness lost during the period prior to 1978. In the view of the authorities, which the staff shares, the continued disappointing export performance in 1979 was to a considerable extent the result of a combination of domestic demand pressures and a number of special factors affecting exports (see SM/80/119, p. 3). The authorities are convinced that the exchange rate policy followed in 1978 and 1979 was appropriate and are committed to continuing with an exchange rate policy in 1980 that is consistent with maintaining competitiveness and bringing about the planned improvement in the current account of the balance of payments. The average effective depreciation from the last quarter of 1979 to the first quarter of 1980 was 3.4 per cent.

In 1979 the large current account deficit was only partially covered by capital inflows, and the gross convertible reserves of the banking system declined by US$1.2 billion to US$2.0 billion, equivalent to 1.5 months of estimated convertible currency imports of goods and services in 1980. The official reserves held by the National Bank of Yugoslavia fell to US$1.3 billion at the end of 1979. For 1980, the authorities wish to reverse last year's trend and are therefore planning for some increase in gross official reserves. Accordingly, they intend to increase gross long-term capital borrowing in 1980 to US$4.3 billion, producing a net long-term capital inflow of US$2.5 billion. In combination with the forecast current account deficit of US$2.5 billion, such an inflow, plus the envisaged recourse to exceptional financing by the commercial banks of US$0.4 billion, and the planned net use of Fund resources amounting to US$0.3 billion, would allow a moderate increase in the gross international reserves of the National Bank of US$0.7 million. Consistent with these plans, the authorities have established, for the purposes of the requested stand-by arrangement, quarterly targets for the net convertible foreign assets of the National Bank less exceptional financing in convertible currencies by the commercial banks, which are shown in Table 4 and which are incorporated for the period of the proposed stand-by arrangement as performance criteria.

The planned increase in foreign borrowing in 1980 is considered manageable and prudent by the authorities in the context of the level of Yugoslavia's external debt and the debt service situation foreseen for the next several years. An important factor in keeping the debt service position manageable is that most recent and projected financial credits incorporate grace periods of up to three years. At the end of 1979, outstanding debt repayable in convertible currency amounted to US$13.5 billion (of which US$12.8 billion had an original maturity of more than one year), and the debt service ratio on the latter debt, excluding purchases from the Fund, was 19.5 per cent. In order to avoid the emergence of a major debt service problem, and consistent with the projected current account deficit, the authorities have established limits on the increase in outstanding foreign debt in convertible currencies with original maturities of more than one year. 1/ These limits are shown in Table 4 and are incorporated for the period of the proposed stand-by arrangement as performance criteria.

In order to improve the current account of the balance of payments, enterprises have been very strict in establishing the targets for exports, imports and services receipts that are incorporated in their individual and joint self-management agreements and the republican agreements within the Communities of Interest for External Economic Relations. (For details of the system see SM/79/111, 4/30/79, and also SM/78/246, 10/5/78). The authorities emphasize that all enterprises concerned are determined to monitor progress and so ensure that their individual and joint targets are met. A factor of some importance for the trade account in the second half of 1980 and more so in 1981, will be the operation of the new agreement with the EC, which should expand opportunities for Yugoslav exports to the member countries and prevent unexpected disruptions to exports, such as have sometimes occurred in the past.

In the attached letter, there is the standard clause that Yugoslavia will not introduce any multiple currency practices or introduce new or intensify existing restrictions on payments and transfers for current international transactions or enter into bilateral payments arrangements with Fund members; furthermore, the Government of Yugoslavia does not intend to introduce new or intensify existing restrictions on imports for balance of payments reasons.

## III. Staff Appraisal and Proposed Decision

The severe deterioration in Yugoslavia's balance of payments position on current account in 1979 was partly due to the failure of the stabilization measures to bring about the intended dampening of domestic demand pressures, but also was caused by a combination of adverse special factors. Some of these factors also contributed to the acceleration of inflation. Although monetary, fiscal and incomes policies were tightened considerably in 1979, these policies did not begin to produce significant results until the second half of the year when there were signs of a gradual deceleration in the pace of domestic expansion. In view of the persistence of high rates of inflation, and the seriousness of the external imbalance, the authorities have decided to pursue firmer stabilization policies in 1980 and 1981.

The staff agrees with the need for a strong stabilization effort, and believes that the program announced for 1980 should result in the desired changes in trends. The planned reduction in the growth rate of real GSP to 5 per cent, in inflation to 17 per cent and in the current account deficit to US$2.5 billion will constitute a major step in the direction of correcting the internal and external imbalances. In the staff's view the combination

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1/ Excluding outstanding purchases from the Fund and excluding exceptional financing by the commercial banks.

of fiscal and monetary restraint, a firm incomes policy designed to reduce average wages per employee slightly in real terms, and continuation of an exchange rate policy designed to ensure external competitiveness, should be sufficient to produce the planned improvement in the external sector in 1980. It will, however, be important that the intended policies are implemented firmly and adjusted if necessary and the staff therefore welcomes the authorities' intention to take further measures in the course of the year if the program does not appear to be accomplishing its objectives. In particular, it is important that the monetary authorities do not intend to raise the credit targets in the event that price increases are greater than currently anticipated, especially since achieving the planned reduction in the rate of inflation may be difficult. The staff agrees with the Yugoslav authorities that a firm stabilization program will need to be continued in 1981.

Because of the size of the economic problems and the special institutional features of the Yugoslav economy, a strong effort will be required from the enterprise sector and from the republican and communal authorities as well as from the Federal Government. The evidence of 1979 and actions taken by all parties so far in 1980 suggest an understanding by all that some sacrifices must be made and that policies must be firmly implemented. In the staff's view, there is a full realization in Yugoslavia that the external targets must be achieved and that for the moment they have priority over domestic objectives. The planned improvement in the current account in 1980 is substantial but the authorities rightly recognize that a continued reduction in the deficit must occur in 1981. The staff feels confident therefore that when details of targets and policies for 1981 are determined at the end of the year, they will be such as to continue the priority that is currently being given to the external sector. In this context the consultation with the Fund regarding the 1981 program and the establishment of quantitative performance criteria for that year will have special significance.

In the opinion of the staff, the program described in the annexed letter can be expected to lead to the necessary easing of domestic demand pressures and a marked improvement in the balance of payments situation. In view of the substantial efforts being undertaken by the Yugoslav authorities, the staff feels that Yugoslavia deserves the support of the Fund. Accordingly the following draft decision is proposed for adoption by the Executive Board:

1. The Government of Yugoslavia has requested a stand-by arrangement with supplementary financing for the period from June 6, 1980 to December 31, 1981, for an amount equivalent to SDR 339.325 million.

2. The Fund approves the stand-by arrangement attached to EBS/80/114 and waives the limitation in Article V, Section 3(b)(iii).

Stand-By Arrangement--Yugoslavia

1. Annexed hereto is a letter dated May 16, 1980 from the Minister of Finance of Yugoslavia setting forth the objectives and policies which the authorities of Yugoslavia will pursue.

2. The International Monetary Fund grants this stand-by arrangement to support these objectives and policies.

3. Yugoslavia will remain in close consultation with the Fund during the period of the stand-by arrangement. These consultations may include correspondence and visits of officials of the Fund to Yugoslavia or of representatives of Yugoslavia to the Fund. For the purpose of these consultations, Yugoslavia will provide the Fund through reports at intervals or dates requested by the Fund, with such information as the Fund requests in connection with the objectives and policies set forth in the annexed letter. In particular, Yugoslavia will consult with the Fund on the adoption of any measures that may be appropriate at the initiative of Yugoslavia or whenever the Managing Director requests consultation because any of the criteria referred to in paragraph 5 below are not being observed or because he considers that consultation on the program is desirable. In addition, after the period of the stand-by arrangement and while Yugoslavia has outstanding purchases in the upper credit tranches, the Government will consult with the Fund, from time to time, at the initiative of the Government or at the request of the Managing Director, concerning Yugoslavia's balance of payments policies.

4. During the period from                    to December 31, 1981, Yugoslavia will have the right, after making full use of any reserve tranche that it may have at the time of making a request for a purchase under the stand-by arrangement, to make purchases from the Fund in an amount equivalent to SDR 339.325 million, provided that:

(a) (i) purchases under the stand-by arrangement shall not, without the consent of the Fund exceed the equivalent of SDR 150 million until November 15, 1980, SDR 200 million until February 15, 1981, SDR 250 million until May 15, 1981, SDR 300 million until August 15, 1981, and SDR 339.325 million until November 15, 1981; and

(ii) the right of Yugoslavia to make purchases under this stand-by arrangement shall be subject to paragraph 5 below to the extent that such purchases would increase the Fund's holdings of dinars beyond the first credit tranche plus 12.5 per cent of quota.

(b) If at any time, any limit in (a)(i) above would prevent a purchase under the stand-by arrangement that would not increase the Fund's holdings of Yugoslavia's currency beyond the first credit tranche plus 12.5 per cent of quota, the limit will not apply to that purchase.

(c) Purchases under this arrangement shall be made with supplementary financing until purchases under the arrangement reach the equivalent of SDR 34.625 million, and then each purchase shall be made from ordinary resources and with supplementary financing in the ratio of 25 to 30.

5. (a) During any period before December 31, 1980 in which:

(i) the limits on the increase in outstanding foreign debt in convertible currencies referred to in paragraph 9 of the annexed letter are exceeded; or

(ii) the targets for the net convertible foreign assets of the National Bank of Yugoslavia, referred to in paragraph 10 of the annexed letter have not been met; or

(iii) the limits on net domestic assets of the banking system referred to in paragraph 15 of the annexed letter have been exceeded; or

(iv) the limits on the net lending of the National Bank of Yugoslavia to the Budget of the Federation referred to in paragraph 15 of the annexed letter have been exceeded; or

(v) the intentions stated in paragraph 17 of the annexed letter are not carried out, the Government of Yugoslavia will not request any purchase under this arrangement except after consulting the Fund and reaching understandings with the Fund regarding the circumstances in which such purchases may be made.

(b) Moreover, during the period of the stand-by arrangement after December 31, 1980, Yugoslavia will not request purchases under the stand-by arrangement unless Yugoslavia has reached understandings with the Fund on its policy intentions and performance criteria in accordance with the last sentence of paragraph 18 of the annexed letter or while the understandings thus reached are not being observed.

6. Purchases under the stand-by arrangement shall be made in the currencies of other members selected in accordance with the policies and procedures of the Fund, and may be made in special drawing rights if, upon the request of Yugoslavia, the Fund agrees to provide them at the time of the purchase. Purchases shall be made in exchange for the currency of Yugoslavia.

7. Yugoslavia will pay a charge for this stand-by arrangement in accordance with the decisions of the Fund.

8. Subject to paragraph 4 above, Yugoslavia will have the right to engage in the transactions covered by this stand-by arrangement without further review by the Fund. This right can be suspended only with respect to requests received by the Fund after (a) a formal ineligibility; or (b)

a decision of the Executive Board to suspend transactions, either generally or in order to consider a proposal, made by an Executive Director or the Managing Director, formally to suppress or to limit the eligibility of Yugoslavia. When notice of a decision of formal ineligibility or of a decision to consider a proposal is given pursuant to this paragraph 8, purchases under this stand-by arrangement will be resumed only after consultation has taken place between the Fund and Yugoslavia and understandings have been reached regarding the circumstances in which such purchases can be resumed.

9. (a) Repurchase of the outstanding amount of Yugoslavia's currency that results from a purchase under this arrangement and is subject to charges under Article V, Section 8(b):

(i) may be made at any time;

(ii) will be expected normally as the balance of payments and reserve position of Yugoslavia improves;

(iii) shall be made in accordance with the representation of the Fund if, after consultation with Yugoslavia, the Fund represents that under its policies at the time of the repurchase Yugoslavia should repurchase because of an improvement in its balance of payments and reserve position;

(iv) with respect to purchases from ordinary resources, shall be completed five years after the date of the purchase, provided that the repurchase shall be made in equal quarterly installments during the period beginning three years and ending five years after the date of the purchase unless the Fund approves a different schedule; and

(v) with respect to purchases with supplementary financing, shall be completed seven years after the purchase, provided that the repurchase shall be made in equal semiannual installments during the period beginning three and one half years and ending seven years after the purchase.

(b) Any reductions in Yugoslavia's currency held by the Fund shall reduce the amounts subject to repurchase under (a) above in accordance with the principles applied by the Fund for this purpose at the time of reduction provided, however, that a repurchase attributed to a purchase with supplementary financing in advance of the schedule in (a)(v) above shall be accompanied by a repurchase in respect of the purchase from ordinary resources made at the same time if any part of the latter purchase is still outstanding. The amounts of the two repurchases shall be in the same proportions in which ordinary resources and supplementary financing were used in the purchases, provided, however, that the repurchase in respect of the purchase from ordinary resources shall not exceed the amount of the purchase still outstanding.

(c) Repurchase shall be made with special drawing rights, or with the currencies specified by the Fund at the time of the repurchase in accordance with the policies and procedures of the Fund at the time of the repurchase.

Annex to Stand-By Arrangement

Belgrade, Yugoslavia
May 16, 1980

Dear Mr. de Larosière:

1. The Yugoslav economy is passing through a particularly difficult period. The current account of the balance of payments was in deficit by US$1.3 billion in both 1977 and 1978 and domestic prices were increasing at rates well in excess of 10 per cent. Domestic activity was buoyant, with real gross social product increasing by 7.9 per cent in 1977 and 6.6 per cent in 1978. A relatively rapid rate of growth was considered necessary to prevent a serious problem of unemployment. However, it added to the existing domestic and external pressures. Moreover, as the growth of world economic activity decelerated, various restrictions were placed against important Yugoslav exports in some markets.

2. The Government decided in 1979 that a stabilization effort was required to moderate domestic pressures and to contain the deficit in the current account of the balance of payments to a level that would not require excessive foreign borrowing. Accordingly, the target for the increase in real gross social product was reduced to 6 per cent and the aim was to reduce the general rate of price increase from 15 per cent in 1978 to around 13 per cent in 1979. With regard to the balance of payments, the current account deficit was to be kept to US$1 billion, which would have implied that the debt service ratio for foreign debt in convertible currencies would remain below 20 per cent. These targets were to be achieved by the implementation of an integrated set of domestic and external policies, which included, inter alia, more restrictive credit policies and an exchange rate policy designed to maintain the external competitiveness of our economy. The stabilization program was supported by a stand-by arrangement with the Fund equivalent to SDR 69.125 million agreed to on May 23, 1979, covering the first credit tranche.

3. For several reasons, the course of events in 1979 deviated from the original plan. We probably had underestimated the underlying pressures on the economy that existed at the end of 1978 and which continued in the first part of 1979. As a result, domestic activity in the first half of the year was higher than we intended. Although additional measures were taken that reduced rates of growth in the second half of the year, the increase in real gross social product in 1979 as a whole is estimated to have been 7.1 per cent, some one percentage point above the target. However, there were important factors, all beyond our control, that prevented us from achieving our other goals. Above all, there was the unexpected and large increase in oil prices. Oil prices for Yugoslavia rose on average from US$101 per metric ton in 1978 to US$143 per metric ton in 1979. In addition, natural gas imports increased sharply in 1979, principally in order to fill a newly completed pipeline, while cereal imports increased because of a particularly

poor corn harvest in 1978 and a bad wheat crop in 1979. The value of imports of these three commodity groups was almost US$1 billion higher than in 1978. Another major exogenous factor was the earthquake in Montenegro in April 1979, which adversely affected tourism not only in that region but also elsewhere; in addition, it reduced exports and necessitated additional imports for reconstruction. These factors, plus depressed deliveries of ships, a major export item, and a virtual cessation of corn exports because of the disastrous 1978 harvest, meant that the current account deficit rose to US$3.7 billion, leading to a decline of US$1.3 billion in gross convertible international reserves of the banking system to US$2 billion at the end of the year, and substantial net foreign borrowing totaling around US$2.1 billion. The latter, combined with the rise in interest rates, increased the debt service ratio on debt in convertible currencies (excluding purchases from the Fund) from 16.9 per cent in 1978 to 19.5 per cent in 1979.

4. Domestically, higher import prices were an important factor contributing to a rise in the rate of inflation from some 14 per cent in 1978 (year-on-year average for all domestic expenditure) to almost 21 per cent in 1979, although the rate of increase declined in the second half of the year. It was not possible to prevent the increase in prices being largely reflected in increases in personal income payments per employee, but we believe it is significant that these rose by only about 20 per cent compared with the previous year. In this respect, it appears that workers exercised considerable self-restraint in the self-management agreements on income payments.

5. Although many of the reasons for the adverse developments in 1979 were beyond our control, the Government has to face the fact that the deterioration that occurred in the balance of payments must be reversed in 1980. Yugoslavia has therefore decided that policies this year must bring about a substantial reduction in the current account deficit and thereby limit the growth of external debt. To achieve this and to aid in reducing the rate of inflation, a slower growth of domestic activity will be necessary. Therefore, a major stabilization effort has been introduced and will continue until the necessary corrections in the domestic and external sectors have been made. Given the size of the imbalance in 1979, it will not be possible to achieve all of the needed corrections in 1980 and we realize that the effort must continue in 1981. To support the stabilization program, which is described in detail below in respect of the 1980 period, Yugoslavia is requesting a new stand-by arrangement from the Fund for the period up to December 31, 1981 in a total amount equivalent to SDR 339.325 million, including the equivalent of SDR 200.825 million from the supplementary financing facility.

6. Although the stabilization program will extend over both 1980 and 1981, we are convinced that substantial progress must be made in 1980 to reduce the current account deficit. We intend to do everything possible to reduce the deficit to US$2.0 billion this year and believe that there is a reasonable chance of achieving this. Such a large and rapid reduction might entail too great a disruption to real growth and employment but we are convinced that the current account deficit must not exceed US$2.5 billion this year with another large reduction in 1981. Thus in 1980, we aim to reduce the

deficit by at least US$1.2 billion which would be a reduction of at least one third. As a percentage of gross social product, the current deficit would decline as a minimum from 6 per cent in 1979 to below 4 per cent in 1980. A deficit of this size would entail an amount of foreign borrowing that we consider manageable (see below).

7. A major effort will be required to reduce the deficit to the extent sought, but we believe the needed improvement can be made. While part of it will come from larger net invisible receipts, the major adjustment will be on the trade account, where exports must increase strongly and the growth in imports must be sharply reduced. To achieve these results, the pattern of domestic production and expenditure must change so as to release more production for export and to reduce the import intensiveness of domestic output. Under the Yugoslav system of workers' self-management, all enterprises involved in foreign trade must agree among themselves within the Communities of Interest for Foreign Economic Relations on foreign trade plans that will lead to a viable balance of payments. In 1980, enterprises are making a major effort to produce more exportable goods and to substitute domestic products for imports wherever possible. They will be aided by the fact that a number of major development projects have recently been finished, which will reduce the demand for imported investment goods. Moreover, these projects will increase export supplies and permit greater import substitution. Throughout the economy, investment proposals are being re-examined to shift the emphasis for the time being toward projects that require few imports and away from import-intensive projects, especially those not directly related to export production or import replacement. Intensified efforts are being made to increase domestic supplies of raw materials, for example, coal and iron ore, and of intermediate products. Inter alia, this should keep the volume of oil imports, excluding amounts needed to fill a new pipeline, at no more than the 1979 level and possibly less.

8. In addition, in 1980 some of the particular trade difficulties of 1979 should not recur. So far, there is every indication that corn exports will revive and imports of wheat should not be needed to the extent experienced in 1979. Because of past orders, deliveries of ships will increase sharply in 1980 and 1981. The planned growth of gross social product is 2 percentage points less than the outcome in 1979, which will slow down import demand. Although overall world export demand may be weak in 1980, the main Yugoslav export markets are expected to be relatively less affected, and demand in them is expected to be around 6 per cent. Moreover, in 1979 we depreciated the dinar in terms of effective exchange rates by about 8 per cent following a depreciation of 9 per cent in the preceding year. We intend to continue with an exchange rate policy that will maintain our competitive position and we expect to regain some of the market shares lost in recent years. Although its impact in 1980 will be limited, the recently concluded agreement with the European Community should have an increasingly favorable effect on our economic relations with its member countries in the coming years, including 1981. Taking all these factors into account, export volume is forecast to increase by 8 per cent and value by 21 per cent. Import volume should decline by around 9 per cent and the value would increase by some 9 per cent. The forecast turnaround in imports is not out of line with improvements made in previous periods when policies have been directed

toward substantial improvement in the external sector. Workers' remittances should benefit from wage increases in Western Europe and tourism should show a recovery from 1979. Taking all the above into account, a current account deficit of US$2 billion in 1980 may be possible and it is our firm intention not to exceed a maximum level of US$2.5 billion.

9. The large deficit in the current account in 1979 necessitated a net increase of foreign borrowing in convertible currencies of US$2 billion and at the end of that year the outstanding level of such debt was US$13.5 billion, of which US$12.8 billion had an original maturity of more than one year. During 1979, there was a refinancing of debt totaling around US$0.8 billion and the conditions attached to the new credits generally provided for grace periods of three years and maturities of the order of 8-10 years. We intend to continue to pay careful attention to the terms of new foreign borrowing so as to avoid sharp peaks in servicing schedules, especially since, partly as a result of the rise in interest rates, the debt service ratio for convertible foreign debt, excluding purchase from the Fund, reached 19.5 per cent in 1979. To prevent a debt service problem from emerging and consistent with the maximum projected current account deficit for 1980, outstanding foreign debt in convertible currencies with original maturities of more than one year, (excluding purchases from the Fund) which stood at US$12.3 billion at the end of 1979, will not exceed US$14.7 billion by the end of 1980 (based on exchange rates current on December 31, 1979 and excluding net exceptional financing during 1980). To ensure orderly borrowing during the year, quarterly limits on the outstanding amounts have been set as follows: no more than US$13.6 billion on June 30, 1980, US$14.2 billion on September 30, 1980, and US$14.7 billion on December 30, 1980.

10. As mentioned earlier, during 1979 the gross convertible international reserves of the banking system declined and in 1980 they will need to be built up again. It is our intention to increase the gross convertible reserves of the National Bank of Yugoslavia by at least US$0.7 billion during 1980. This will necessitate a continuation of exceptional financing by the commercial banks, which has involved borrowing abroad in convertible currencies to maintain the level of the international reserves. In 1979, such borrowing totaled US$250 million. To ensure an adequate level of liquidity in convertible currencies, the net convertible foreign assets of the National Bank of Yugoslavia less exceptional financing in convertible currencies by the commercial banks, which declined by US$1,702 million in 1979 will show no further decline by the end of 1980. Consistent with this target for end-1980, and allowing for the expected pattern of net foreign borrowing and for the seasonal movements in the current account deficit, targets have been established providing for a decline of no more than US$900 million by June 30, 1980 and no more than US$500 million by September 30, 1980.

11. If the various balance of payments targets are to be achieved, policies must ensure that domestic activity is not too expansionary. To ensure such consistency, it has been decided to reduce the planned increase in real gross social product to 5 per cent in 1980 and to aim for a reduction in the gross social product deflator to 17 per cent compared with 20 per cent in 1979. All categories of domestic demand are planned to show smaller increases in real terms--the growth of personal consumption will decelerate from 5.5 per cent to 3.8 per cent, public consumption from 5.9 per cent to 2.1 per cent, and fixed capital formation from about 8 per cent to 5.8 per cent.

12. The achievement of these targets will require an intensified restraint by all sectors of the economy--the public and enterprise sectors in particular. In this regard, we would point out that self-management agreements covering such factors as prices and personal income payments were implemented in a responsible and effective manner in 1979 and, with increasing experience with the new system, it is expected that it will operate even more effectively in 1980. The Government is convinced that a strong consensus exists in Yugoslavia that all decisions taken in the economic field should reflect the economic aims enunciated in the stabilization program.

13. In some recent years there has been the tendency for public sector consumption to grow more rapidly than social product, and in all years the Federal Government has borrowed from the National Bank of Yugoslavia. The ratio of public sector expenditure to gross social product rose from about 36 per cent in 1973 to about 43 per cent in 1978. In 1979, however, this ratio declined to about 41 per cent. For the federal budget, expenditure in 1979 rose by 25 per cent compared with increases of 29 per cent in revenue and 28 per cent in nominal gross social product. The deficit declined from Din 5.3 billion in 1978 to Din 3.8 billion in 1979. For the public sector as a whole, there was virtually no deficit in 1979. For 1980, the intention is that the public sector will continue to grow more slowly than social product, although budget expenditure by the Federation will increase by 29 per cent. The deficit of the federal budget will rise to Din 6.2 billion but this is equivalent to only 0.4 per cent of gross social product. Gross borrowing from the National Bank will rise only fractionally (from Din 8.5 billion in 1979 to Din 9.2 billion in 1980), which is much less than the increase in expenditure. Current expenditure by the public sector as a whole is to increase by no more than 16 per cent.

14. Monetary policy is an important part of the stabilization program, since an excess supply of financial assets could weaken the implementation of other elements in the program. In 1978 there was an excessive rate of increase of money supply, which rose by 28 per cent and in 1979 strong steps were taken to decelerate monetary expansion, the target for the increase in money supply in that year being set at 18 per cent. In the first months of the year the demand for credit continued strongly and the National Bank had to take special measures to limit the expansion by imposing strict credit limits on the commercial banks and by reducing demand for consumer credits by raising downpayment provisions. These measures were effective, so much so that some relaxation was necessary in the second half of the year when the loss of liquidity of the commercial banks resulting from the continued external deficit threatened an abrupt decline in enterprise activity. At the end of 1979, money supply was only 17 per cent higher than a year earlier. Also, despite the need to counteract some of the liquidity loss caused by the external deficit, the rate of domestic credit creation was 27 per cent in 1979 compared with 30 per cent in the previous year.

15. For 1980, we consider that money supply should rise broadly in line with the reduced rate of growth of nominal social product. To that end, and given the planned balance of payments targets, the increase in money supply will be kept to 22 per cent and the increase in net domestic assets of the banking system to 22 per cent. To ensure that money supply does not increase excessively in the first half of the year, thereby prejudicing the whole year result, limits have been set within the year on net domestic assets of the

banking system, which totaled Din 1,201 billion on December 31, 1979. They are not to exceed Din 1,321 billion on June 30, 1980, Din 1,381 billion on September 30, 1980, and Din 1,466 billion on December 31, 1980. To ensure that lending by the National Bank of Yugoslavia to the budget of the Federation does not compromise the overall credit program, such net lending in 1980 is not to exceed Din 9.2 billion. As with total domestic credit creation, sublimits have been established within the year. Such credits to the federal budget, which totaled Din 68.7 billion on December 31, 1979, are not to exceed Din 76.4 billion on June 30, 1980, Din 77.4 billion on September 30, 1980, and Din 77.9 billion on December 31, 1980.

16. Detailed quantitative economic targets for 1981, including targets for increases in domestic credit, foreign borrowing and the net foreign assets of the National Bank of Yugoslavia cannot be established at this stage. However, as mentioned above, the Government is determined to continue with the stabilization program next year. Also, it intends to continue to give first priority to a further improvement in the balance of payments. Domestic policies in all fields will be formulated to maintain and if necessary strengthen the current measures of restraint. On the basis of a preliminary examination of the possible 1981 Plan, domestic activity would grow no faster and perhaps somewhat more slowly than is planned for 1980. Externally, the planned current account deficit of the balance of payments will decline further, perhaps to around US$1.8 billion.

17. The Government of Yugoslavia does not intend to introduce any multiple currency practices or introduce new or intensify existing restrictions on payments and transfers for current international transactions or enter into any bilateral payments arrangements with Fund members; furthermore, the Government of Yugoslavia does not intend to introduce new restrictions or intensify existing restrictions on imports for balance of payments reasons.

18. The Government believes that the policies set forth in this letter are adequate to achieve the objectives of its program, but will take any further measures that may become appropriate for this purpose. The Government of Yugoslavia will consult with the Fund on the adoption of any measures that may become appropriate, in accordance with the policies of the Fund on consultations. Moreover, the Yugoslav authorities will consult with the Fund and reach understanding on the quantitative aspects of the program relating to the period of the stand-by arrangement subsequent to December 31, 1980.

Yours sincerely,

(Ksente Bogoev)
Governor, National Bank of Yugoslavia

(Ing. Petar Kostic)
Federal Secretary for Finance

Mr. J. de Larosière
Managing Director
International Monetary Fund
WASHINGTON, D. C. 20431

# Office Memorandum

cc: ET The five year at all target seems to me to be an error of judgment on their part unless they assume a drastic fall in the real price of oil

TO : The Managing Director
The Deputy Managing Director

DATE: December 22, 1980

FROM : Geoffrey Tyler GT

SUBJECT: Yugoslavia--Stand-By Arrangement

A mission consisting of Messrs. Tyler (EUR), Manison (EUR), Loser (ETR), Buyse (EUR), and, as secretary, Mrs. Bailey (EUR), had discussions in Belgrade from December 5 to December 19, 1980 regarding the replacement of the existing stand-by arrangement by a larger and longer one. Without cancellation, the current stand-by arrangement (second and third credit tranches plus the supplementary financing facility, SDR 339.325 million) would last until December 31, 1981; SDR 139.325 million remains for purchase in 1981. The visit followed a preliminary one of some ten days in October-November 1980, on which occasion Mr. Bery of the World Bank also participated. In addition to meetings with senior officials, the mission had a number of meetings with the Governor of the National Bank, Mr. Bogoev, and the Federal Secretary of Finance, Mr. Kostic.

At the outset, we were told that the Government had authorized the negotiation of a stand-by arrangement for a period of three years in annual amounts equal to 200 per cent of the previous quota (i.e., SDR 554 million per annum).

## Developments in 1980

### a. The domestic economy

Originally, real social product was planned to increase by 5 per cent, compared with 7 per cent per annum in 1977-79. In mid-year, this target was reduced to 4 per cent. Currently, it is estimated that the growth will be around 3 per cent. Total real domestic expenditure was unchanged, with real investment declining by 1.5 per cent. Private consumption increased by around 1 per cent. Wage restraint was well maintained and real personal income payments per capita declined by around 7 per cent.

The main weakness domestically was in prices, which rose by almost 40 per cent between end-December 1979 and end-December 1980 compared with a target of less than 20 per cent. This is disappointing, but is explained to a considerable extent by the large effective depreciation of the dinar, a larger-than-anticipated increase in foreign prices of imports, and decisions to increase prices of certain basic goods and services for internal structural reasons. There is no evidence that excess domestic demand was a factor. One estimate given to us was that the foreign sector factors brought about some 20 percentage points of the increase and the structural price changes perhaps another 10 percentage points.

Public sector expenditure declined in real terms because of the sharp fall in real wage rates and a major cutback in nonessential investment. Unfortunately, the federal budget revenues declined because of lower receipts of customs duties and a relatively large deficit--up to about 1.3 per cent of social product--may occur unless last-minute compensations can be made in other revenues or expenditure. The decline in customs duty revenue followed the termination of the 10 per cent import surcharge and a shift of imports away from items having high rates of duty. Any increase in borrowing requirements is expected to come from the commercial banks within their credit ceilings, at the expense of enterprise sector borrowing.

b. The balance of payments

The target set by the Government for 1980 was a current account deficit of US$2.0 billion, while the stand-by arrangement permitted a deficit of up to US$2.5 billion. It seems the likely outcome will be a deficit of about US$2.2 billion (about 3.5 per cent of GDP). The volume of exports rose by 10-11 per cent and unit values by 19 per cent. For imports the volume declined by 11 per cent and unit values increased by 19 per cent. As a result, the trade deficit declined by US$1.2 billion to US$6.0 billion. Net invisibles improved by about US$0.3 billion as receipts from tourism and workers' remittances more than offset higher interest payments.

On capital account, net medium- and long-term borrowings are expected to total US$1.4 billion and net short-term capital inflow, including net errors and omissions, about US$0.4 billion. Net medium- and long-term inflow includes US$850 million of gross financial credits obtained by the National Bank. The exact figure could increase depending on the timing of the receipt of some large borrowings that could be realized in either the final days of this year or in January 1981. The short-term inflow includes the net use of bilateral credit facilities equal to some US$350 million in 1980 (following a net use of US$665 million in 1979). The commercial banks made compensatory borrowings of US$250 million but increased their gross foreign exchange holdings by about US$700 million. After net use of Fund resources equal to about US$300 million, the gross official convertible reserves are forecast to increase by about US$0.2 billion to reach about US$1.5 billion at end-December 1980. This is equal to six weeks of imports of goods from the convertible area forecast for 1981.

c. Performance under the current stand-by arrangement

There is not much more to be said than was described in the paper requesting the waiver and modification approved by the Executive Board on December 3, 1980 (EBS/80/250, 11/19/80). The domestic credit targets were exceeded but only marginally in view of the unanticipated acceleration in the rate of inflation, and the fact that part of the credit increase replaced foreign borrowing by the enterprise sector which in the event was undertaken by the National Bank. The end-year target for borrowing by the federal budget from the National Bank will not be exceeded. The fact that a sizable amount of foreign borrowing was done by the National Bank in place of enterprises meant that the net foreign asset position of the National Bank deteriorated by more than originally forecast. If it had been known at the time the stand-by arrangement was negotiated that the law would be changed to permit the National Bank to obtain foreign financial credits, the relevant ceilings would have been defined differently and they would not have been broken.

In broader economic terms, in the mission's view the results of the stabilization program have been quite successful. The external target for the current account deficit was achieved, and this was the most pressing need. The sharp reduction in the growth of real domestic expenditure assisted the improvement in the external sector. Price performance was a weakness, but explainable, and with the prospect of improvement in 1981. Similarly, performance under the federal budget was a disappointment, but in 1981 a turnaround is forecast.

Forecasts for 1981

The target current account deficit for 1981 has been set at US$1.8 billion (2.3 per cent of GSP), or US$0.4 billion less than the expected 1980 outcome. It is predicted upon an increase in the value of exports of 19 per cent (+7-8 per cent in volume) and in the value of imports of 11 per cent (-3 per cent in volume). On this assumption, the authorities believe that GSP can increase in real terms by about 3 per cent, the same as in 1980. Real domestic expenditure is to remain at the 1980 level, an increase of 2.5 per cent in private consumption being offset by a decline of 5 per cent in fixed investment. Real public sector consumption should continue to decline. The authorities are hesitant to put an official forecast on price increases, but for necessary working purposes they are implicitly predicting an increase during the year of around 20-25 per cent. The higher end of the range seems the more probable outcome. However, it would represent a substantial slowdown from the 1980 experience. Real personal income payments per employee are to rise by 1.0-1.5 per cent, in line with productivity.

The question marks are mostly with the import forecast. For the second consecutive year, real output is to increase and the volume of imports to fall (although by much less than in 1980). Officials explain the assumption by pointing to the sharp change in the pattern of domestic expenditure from import-intensive capital goods and certain consumer goods (e.g., automobiles) to less import-intensive raw materials and intermediate goods. They believe also that there is still a large amount of unused domestic capacity and that additions to inventories will be small. Past statistical relations between imports and production are highly variable. Moreover, the underlying relationship is undoubtedly changing as a result of current policies. On balance, the mission accepts the Yugoslav forecast, although it will not be easy to achieve. As in 1980, considerable weight must be given to the authorities' statement that the external target is paramount and that other targets, including that of domestic growth, will be adjusted, if necessary, to achieve it.

Financing the current account deficit will involve a similar mixture of sources as in 1980, including the further use of bilateral balances (US$0.3 billion), compensatory borrowings by the commercial banks (US$0.4 billion), and financial borrowing by the National Bank (US$0.8 billion). Assuming the net use of Fund credit of US$0.65 billion, the gross official convertible reserves would rise by US$0.3 billion; those of commercial banks would not change. It is possible that the National Bank will obtain more than the above amount of financial credits. Any additional amount would be used to repay short-term debt and/or increase gross official reserves.

Monetary policy in 1981 is again being based on a slower increase of money supply than nominal GSP. Money supply and credit are to increase during the year by 22 per cent compared with an increase of about 26 per cent in GSP. In our view, these targets are conservative, especially since the price assumption may be exceeded. In the public sector, expenditure is again to grow more slowly than nominal GSP and noneconomic investment should again decline in real terms. The deficit of the proposed federal budget is reduced from a possible Din 21 billion in 1980 to Din 1 billion in 1981. The improvement will probably come from increasing some sales tax rates. After allowing for bond amortization payments, National Bank lending to the budget would fall from Din 9.2 billion in 1980 to Din 4.6 billion.

Medium-term policies

The 1981-85 Plan is currently in its final three months of elaboration. The broad aims have been decided, but between now and March 1981 more detailed projections, including, for example, sectoral investment targets, will be made. The Plan assumes that the stabilization effort will continue throughout the period, with special emphasis on the external sector. The cumulative current account deficit has been set at about US$6.0 billion with the aim of reducing the 1985 deficit to some US$700-800 million, which would be less than 1 per cent of GNP. Real social product is to increase at about 4.0-4.5 per cent per annum. Private consumption is to grow at an annual rate of about 3 per cent. Investment is to grow more slowly (averaging about 1.5 per cent per annum) and is to be directed principally to the productive sector; investment in noneconomic sectors will be low. Total domestic expenditure is to increase by about 1.0-1.5 percentage points less per annum than social product, thus releasing resources to the external sector. As indicated, activity in the first year of the Plan period will increase relatively slowly. It is hoped that an acceleration can occur during the course of 1982-85.

Within the production sector, priority areas have been established which will improve export supply and permit import replacement. They include agriculture, energy, basic raw materials, export-oriented industries generally, and domestic and external transport. Forecasts of output and consumption trends until 1985 imply that the economy will become less import-intensive during the next five years. An important feature is a greater degree of pooling of resources between enterprises and republics to avoid wasteful duplication of investment.

In mid-1981 the World Bank will be conducting a detailed study of the 1981-85 Plan and its investment strategy. The current thinking in the World Bank is that the program is appropriate, although it is clear that it will necessitate a considerable effort and a large degree of cooperation between enterprises and between republics.

Interest rate policy is currently being studied with a view to making it a more effective influence on the level of expenditure and resource resource allocation. Proposals for presentation to the Government are being prepared by the Bankers' Association and other interested parties. It is proposed to increase both lending and borrowing rates with preferential rates being given to the priority sectors. The basic assumption that real interest rates should be positive has been accepted by most concerned. However, the possible initial average increase in interest rates (perhaps 50 per cent) would still leave them highly negative until the inflation rates decline substantially. We gained the impression that the banks and the less-developed republics are not as attached to the proposals as are the federal authorities and the National Bank. The proposals are to be presented to the Government around March 1981. We emphasized the opinion strongly expressed by the Fund Board that a major interest rate reform was desirable.

Details of the proposed stand-by arrangement

The attached draft letter describing the aims and policies of the stabilization program has been agreed with the Governor of the National Bank and the Federal Secretary for Finance. They will present it to the Federal Government for approval. It includes as performance criteria:

(i) quarterly ceilings on net domestic assets of the banking system;

(ii) quarterly subceilings on National Bank lending to the federal budget;

(iii) quarterly limits on medium- and long-term foreign borrowing in convertible currencies, including that by the National Bank;

(iv) quarterly targets for the net foreign assets of the National Bank, excluding changes due to medium- and long-term borrowing included in (iii) above and less compensatory borrowing by the commercial banks; and

(v) the usual clause on trade and payments restrictions.

The quantitative ceilings are set out in the attached table. Provision is made in the stand-by arrangement for consultations with the Fund to agree on the programs for 1982 and 1983 and quantified performance criteria for those years before the first purchase can be made in each of these years.

The mission believes the program warrants support of the Yugoslav request. Targets and policies for 1981 represent a continuation of the basically good 1980 outcome and the authorities were convincing when stressing their determination to have policies implemented effectively. More detail on 1982-85 targets will become available in 1981, but we believe the quantification we have, combined with the explicit undertaking in the letter of intent to describe the 1981-85 Plan in more detail later in 1981, is adequate at this stage. The structural changes that the 1981-85 Plan embodies are in our view achievable and of a character that should lead to a significant improvement in the balance of payments by increasing exports and reducing the relative demand for imports.

The total amount of SDR 1,662 million is divided into three equal annual amounts of SDR 554 million. Within this, there is a first purchase of SDR 176 million (32 per cent of the total) and three subsequent purchases of SDR 126 million each in the first year.

Conclusion and recommendation

We recommend that you approve the Yugoslav request for a new stand-by arrangement, as described above, based on the attached letter of intent. If you accept this recommendation, we shall so inform the Yugoslav authorities. Any changes requested in the draft letter after consultation with other departments will be forwarded to Belgrade.

If you approve the request, we would expect to have a draft Board paper for your approval in the first half of January.

Attachment

cc: Mr. Habermeier
Mr. Hood
Mr. Whittome
Mr. Finch
Mr. Goode
Mr. Mohammed
Mr. Nicoletopoulos
Mr. Van Houtven
Mr. Ungerer
Mr. Watson
Paris Office

Mr. Whittome

December 3, 1980

MEMORANDUM

To: Treasurer
Internal Auditor
Director, European Department
Director, Exchange and Trade Relations Department
Director, Legal Department

From: The Acting Secretary

Subject: Yugoslavia - Waiver of Performance Criteria and Modification of Stand-By Arrangement

At EBM/80/175 (12/3/80) the Executive Board approved the decision set forth in EBS/80/250 (11/19/80), with the date November 26 inserted in lines 1, 3, and 7.

# Office Memorandum cc: PL

Circulate to all DCS

TO : Mr. Tyler

DATE: December 2, 1980

FROM : Claudio Loser

SUBJECT : Yugoslavia: Precedents on Six-Monthly Quantitative Performance Criteria

The use of six-monthly performance criteria has been very infrequent in recent upper credit tranche stand-by and extended arrangements, and was usually applied in special circumstances. Among all stand-by arrangements concluded since 1976, only those with Italy (1977) and Equatorial Guinea (1980) envisaged six-monthly phasing, and in the latter case mostly due to difficulties in obtaining the relevant statistical information. In several other instances the first phased purchase was scheduled for a period of about six months after approval, but mostly reflected the lag between the specified date for the first ceilings and the reporting of the information. The only extended arrangement that envisaged six-monthly performance criteria was concluded with Kenya in 1976. Thereafter all arrangements included quarterly performance criteria after the first ceiling.

With regard to external debt ceilings, the common practice has been to set limitations on an annual basis, with subceilings on shorter-term maturities. Ceilings applied most frequently to commitments. In several stand-by and extended arrangements limitations applied to net debt outstanding but on a quarterly basis. Among recent arrangements with that feature, the following can be mentioned: Costa Rica 1980, Egypt 1977, Honduras 1979, Mexico 1977, Romania short term 1977, and Yugoslavia 1980. In principle there would be no problem to apply longer term ceilings to net disbursements as has been the common practice with ceilings on external debt commitments. With regard to balance of payments tests, whenever they were present in recent arrangements they were applied on a quarterly basis. The only recent instances where longer periods were incorporated were the six-monthly net foreign assets target in the extended arrangement with the Philippines (1976) and the equivalent target on convertible currencies for Romania (1977), where the ceilings were established for nine months after the approval of the stand-by.

The issue of the phasing of net foreign assets performance criteria should be viewed not only with respect to prior practice but in the light of the frequency of use of this particular objective. In a number of the recent arrangements no balance of payment test was incorporated, as its effectiveness for monitoring exchange rate policies is somewhat controversial. However, for Yugoslavia with its very low level of external reserves and its somewhat precarious external competitive position, given the recent sharp increase in domestic prices, there is an argument for continuing with the close monitoring of the net foreign assets position.

In sum, while there would be no problems with performance criteria for external debt on a six-monthly basis there does not seem to be strong reasons for changing the quarterly basis for other performance criteria, particularly with respect to domestic credit.

cc: Mr. Mookerjee
Mr. Manison
Mr. Buyse

# Office Memorandum

TO : Mr. Rose

DATE: November 26, 1980

FROM : Geoffrey Tyler GT

SUBJECT : Yugoslavia--Frequency of Performance Criteria

Mr. Loser is continuing to look at the precedents with respect to half-yearly as against quarterly performance criteria. It is possible that the results will show that we have been particularly strict on Yugoslavia with respect to the ceilings on foreign debt and net foreign assets of the National Bank. If this appears to be so, I have asked him to speak to Mr. Mookerjee and to obtain his view about whether we should have second thoughts on how we treat Yugoslavia. If he thinks there is a case for semi-annual criteria in the external sector, I have asked him to discuss the matter with you, so that Mr. Manison and Mr. Loser can bring the departmental view with them.

cc: Mr. Loser
Mr. Manison

November 26, 1980

MEMORANDUM FOR FILES

Subject: Yugoslavia

Mr. Ruding outlined to me his discussions with the Yugoslav authorities. In the main they parallelled those of the recent mission. However, there were several points regarding the proposed new stand-by arrangement that should be recorded.

1. The Yugoslavs have apparently fully decided to ask for the maximum amount per year, i.e., 200 per cent of existing quota.

2. They would like the stand-by arrangement to be finalized as soon as possible. I told Mr. Ruding that, quite apart from the Yugoslavs' wish, we had internal reasons for wanting to finish our report at the earliest possible date.

3. The Yugoslavs would like front loading. I said that, while a modest amount would be normal, it was unlikely that we would agree to a major degree of front loading. (Our brief authorizes SDR 150 million out of a total of SDR 554 million for 1981, which is 27 per cent.)

4. The Yugoslavs would prefer to have performance criteria operative at six-month intervals and would accept corresponding phasing of the money. I told Mr. Ruding that my own view was that we would be unable to accept such an innovation. (As a practical matter, it would mean only one check point in a year, June 30, since December 31 is overtaken by the following year's program.) The Yugoslav desire arises from their belief that they find it difficult to adjust their planning and administration to quarterly intervals. I cannot see why their problems are greater than those of anyone else.

GT

Geoffrey Tyler

cc: Mr. Rose ✓
Mr. Manison

November 26, 1980

MEMORANDUM FOR FILES

Subject: Yugoslavia

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Geoffrey Tyler

cc: Mr. Rose
Mr. Manison

# *Office Memorandum*

TO : Mr. Rose

DATE: November 26, 1980

FROM : Geoffrey Tyler GT

SUBJECT : Yugoslavia--Frequency of Performance Criteria

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cc: Mr. Loser
Mr. Manison

# *Office Memorandum*

TO : The Managing Director
The Deputy Managing Director

DATE: November 21, 1980

FROM : L.A. Whittome

SUBJECT : Yugoslavia--Briefing Paper for Staff Visit to Discuss Possible Use of Fund Resources

A mission is to visit Belgrade from December 5, 1980 for about two weeks to discuss possible use of Fund resources. A draft briefing paper is attached for your approval. It has been cleared with Mr. Mookerjee (ETR), Mr. Rhomberg (RES), Ms. Lachman (LEG), Mr. Wittich (TRE), and Mr. Conrad (FAD).

The paper should be returned to the European Department.

Attachment

cc: Mr. Watson

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

YUGOSLAVIA

Briefing Paper - Use of Fund Resources

Prepared by the European and Exchange and Trade Relations Departments

Approved by L.A. Whittome and S. Mookerjee

November 21, 1980

## I. Introduction

A staff mission comprising Messrs. Tyler (EUR), Manison (EUR), Loser (ETR), Buyse (EUR), and, as secretary, Mrs. Bailey (EUR) will visit Belgrade from December 5 to 19 for discussions relating either to the setting of performance criteria under the existing stand-by arrangement or, as is assumed to be more likely, for the negotiation of a new enlarged stand-by arrangement for two or three years.

The current stand-by arrangement, which covered the second and third credit tranches plus SFF, was approved on June 6, 1980 for the period up to December 31, 1981 in an amount equivalent to SDR 339.325 million to be financed from the Fund general resources (41 per cent) and from the supplementary financing facility (59 per cent). One purchase equivalent to SDR 150 million has been made to date under the arrangement. If performance criteria for September 30, 1980 had been observed further purchases up to the equivalent of SDR 50 million could have been made from November 15, 1980 until the end of the year. Thereafter, no further purchases could be made until policy intentions and quantitative performance criteria for the year 1981 were agreed with the Fund.

In the event, three of the four performance criteria set for September 30, 1980 were not observed, namely those on net domestic assets of the banking system, net credit of the National Bank to the Budget of the Federation and the cumulative change in net convertible foreign assets of the National Bank. The authorities, in a letter dated November ___, 1980, have requested a waiver on the aforementioned performance criteria and a modification on the limits set for December 31, 1980 on net domestic assets of the banking system and on the target for the cumulative decline in net foreign assets of the National Bank. The staff paper to which this letter is annexed is to be discussed by the Board of Executive Directors on December 3, 1980.

Yugoslavia's use of Fund resources is summarized in Appendix I. As of November 14, 1980, the Fund's holdings of Yugoslav dinar amounted to the equivalent of SDR 866.4 million, or 312.8 per cent of quota. Two purchases of SDR 138.5 million, each equivalent to 50 per cent of quota were made under the CFF in May 1979 and February 1980, respectively. Outstanding purchases under the oil facility amount to SDR 91.7 million, or 33.1 per cent of quota. Yugoslavia's holdings of SDRs on November 14, 1980 amounted to SDR 60.1 million, or 47.3 per cent of net cumulative allocation.

## II. Economic Developments and Prospects

Section II covers the same ground as that in the recent 48-hour report to Management. It would suffice to read the last two paragraphs of this section.

Following a substantial deterioration in the balance of payments and external reserves position and the emergence of increased inflationary pressures in 1979, the authorities embarked on a stabilization program in 1980. This gave top priority to reducing the current account deficit of the balance of payments from US$3.7 billion in 1979 to US$2.5 billion in 1980. The authorities have achieved a number of favorable results so far. The current account deficit of the balance of payments is expected to be around US$2.3 billion in 1980 (3 per cent of GSP, compared with 6 per cent in 1979). Policies of financial restraint and the related easing of domestic demand pressures together with the sharp depreciation in the Yugoslav dinar on June 7, 1981 following frequent small adjustments in the exchange rate over the first part of the year, contributed to the improvement in the current account of the balance of payments.

The most unwelcome aspect of the recent economic performance has been the acceleration in domestic price increases. The retail price index was 31 per cent higher in September 1980 than a year earlier, compared with an increase of 22 per cent during 1979. The sharp upsurge in prices during 1980 is attributed to the effects of the exchange rate changes during the year and of higher import costs in foreign currency terms, together with the impact of an array of administered price adjustments to correct distortions, particularly in the energy, agricultural, and transportation sectors.

The authorities have been very successful in restraining the growth of domestic demand in 1980. Real domestic expenditure, which rose by 9.5 per cent in 1979, is now expected to fall by 2.6 per cent in part because of additional measures of demand restraint that were applied during the year to ensure achievement of the balance of payments objective; real domestic expenditure had originally been projected to rise by 3.7 per cent. The latest forecasts indicate that real private consumption will rise by only 1.0 per cent in 1980, after increasing by 6.0 per cent in 1979, while real fixed investment is expected to fall by 1.9 per cent following an increase of

4.6 per cent in 1979. The substantial moderation of domestic demand pressures permitted a shift of resources into the external sector and helped to offset partly the negative impact of the decline in real domestic expenditures on the growth of domestic production. As a result, real GSP is now forecast to rise by 2.5 per cent in 1980 compared with the original forecast of 5 per cent and of a recorded outturn of 7 per cent in 1979.

Incomes, fiscal and monetary policies have all made significant contributions to alleviating domestic demand pressures in 1980. The growth of nominal personal incomes in the socialized sector has been kept well within prescribed limits. This development in conjunction with the acceleration in cost of living increases has led to an estimated fall of 8-9 per cent in real personal incomes in the first nine months of 1980 compared with the corresponding period of 1979. The growth of public expenditures has been substantially curtailed in 1980. Real public consumption expenditures are forecast to rise by only 0.8 per cent compared with an increase of 7.9 per cent in 1979, while a considerable reduction has been effected in nonproductive investments. For 1980 as a whole, the public sector is expected to be in surplus. The relatively effective implementation of incomes and fiscal policies in 1980 has arisen largely from the strict observance of the quantitative guidelines that were agreed in social compacts concluded between the republics, autonomous provinces, socio-political bodies, and enterprises at the beginning of 1980.

The financial program for 1980 called for the growth of the money supply and domestic bank credit to rise by 22 per cent over the 12 months to December 1980, which was the same rate as that of projected nominal GSP. Although it was not sufficient to offset the contractionary impact of the greater-than-expected fall in net foreign assets of the banking system. As a consequence, the money supply rose at an annual rate of around 20 per cent in the first three quarters of 1980. Given these developments and the revised projected growth rate for nominal GSP of 33 to 34 per cent, the Yugoslav authorities in October revised upward their targets for the growth of domestic bank credit and the money supply for 1980. The increase in domestic bank credit is now expected to be limited to 28 per cent, with 2.5 percentage points of the increase being attributable to the effects of the June 1980 depreciation on the outstanding value of dinar credits to residents linked to the exchange rate. The money supply is now forecast to rise by 24 per cent in the 12 months to December 1980, which would imply a considerable rise in the income velocity of circulation of money.

The improvement in the current account of the balance of payments has been due solely to the large reduction in the trade deficit, the fall in which was US$1 billion greater than originally foreseen. The dollar value and volume of exports rose by 30 per cent and 10 per cent, respectively, in the first 10 months of 1980 compared with the same period of 1979. In contrast, the value of imports increased by only 8.5 per cent over the same period, with their volume declining by about 12 per cent. For the full year, the volume of exports had originally been projected to rise by 8 per cent, while import volume was projected to fall by 9 per cent. Although receipts from tourism have risen at a faster rate than planned during 1980, substantial withdrawals from foreign exchange deposits by Yugoslavs working abroad in the first part of the year and the higher than forecast rise in interest payments, are expected to result in net service receipts being US$0.8 billion less than originally forecast.

Developments in the external capital account were disappointing in the first part of 1980. Originally it had been expected that the greater part of the current account deficit and the amortization of loans would be covered by medium and long-term borrowing by the enterprise sector. This would have permitted an increase in gross convertible external reserves equal to exceptional borrowing by the banking system 1/ plus net purchases from the Fund. However, while enterprises were able to obtain the normal flow of suppliers' credits they could not secure the additional financial credits. The shortfall was attributable in part to noneconomic factors, especially the illness and death of President Tito, but was due also to the substantial deterioration in the balance of payments in 1979, which made foreign banks cautious about committing loans to Yugoslavia until a recovery could be clearly discerned.

As a consequence, the authorities were forced to increase their utilization of lines of short-term foreign credits and to draw upon their low level of gross official reserves. Moreover, foreign banks indicated their preference to extend financial credits directly to the National Bank rather than to the enterprise sector. On this basis, the National Bank is currently negotiating a large amount of financial credits from abroad, which will be used to repay short-term credits and hopefully bolster gross official reserves. At the end of October 1980 official international reserves amounted to US$1,294 million, which was equivalent to less than one month's imports of goods and services. The present forecast is that these reserves will be increased to US$1,600 million by end-1980.

1/ This is borrowing by the commercial banks at the request of the National Bank for the purpose of supplying official international reserves.

Reflecting the shortfall in external borrowing by the enterprise sector, the increase on level of convertible currency external debt outstanding (original maturities of one year or more and excluding outstanding purchases from the Fund) has been well within the limits specified as performance criteria under the current stand-by arrangement.

During the recent staff mission to Yugoslavia the authorities stressed repeatedly their need to continue with restrictive demand management policies in 1981 in order to reduce further the deficit in the current account of the balance of payments and to reverse the acceleration of price increases. At the same time, 1981 marks the beginning of the next Five Year Plan and the authorities will be effecting policy measures designed to restructure the economy in accordance with the medium-term strategy. While economic policies and quantitative targets for 1981 have yet to be finalized, the following forecasts represent the preliminary thinking of the authorities.

The growth rate of real GSP is expected to rise slightly to 3 per cent in 1981. Real consumption expenditures are expected to increase at a slightly faster rate of about 1-2 per cent, while the volume of fixed investments is forecast to decline by over 5 per cent. The fall in the rate of capital formation is expected to reflect substantial cut backs in noneconomic investments; the flow of funds for priority projects in the domestic energy, agricultural, export oriented manufacturing and the internal transport sectors will be enhanced. The main impetus to growth is expected to come from the foreign sector with the volume of exports of goods and services being forecast to rise by 8 per cent. Imports of goods and services are forecast to fall by 2 per cent due mainly to an expected sharp fall in imports of capital goods.

Preliminary forecasts for 1981 are based on a deceleration in the rate of increase in the GSP deflator from 30 per cent in 1980 to 20 per cent in 1981. While domestic price increases remain a major area of uncertainty the authorities argue that the expected substantial slowdown in the rate of increase of import prices and the absence of large adjustments in the exchange rate and in administered prices in 1981 will combine with continued domestic demand restraint to produce a lessening of inflationary pressures.

## III. The Program for the Stand-By Arrangement

In theory, the mission might be requested only to discuss a continuation of the existing stand-by arrangement, in which case it would need to agree, ad referendum, on the quantified performance criteria for 1981. It is expected, however, that the discussion will concern a new enlarged stand-by arrangement for two to three years. On this assumption, the mission will be discussing a stand-by arrangement of up to a maximum amount of SDR 554 million (200 per cent of existing quota) per annum for two or three years. What follows relates to an ad referendum negotiation of a new stand-by arrangement.

In examining the program that the authorities present, the mission will be guided by the following main principles:

(a) although the improvement in the current account will not continue in 1981 at the same pace as achieved in 1980, a further reduction in the deficit in 1981 by around US$0.5 billion to a level of not more than US$1.8 billion (about 2.5 per cent of projected GSP) is a necessary condition for continued access to Fund resources;

(b) the current account deficit in 1981 should be covered to the maximum extent possible by medium- and long-term borrowing, not by an increase in short-term debt. If possible, at least part of the increase in the latter debt in 1981 should be repaid;

(c) net purchases from the Fund under a stand-by arrangement should be used as much as possible to add to the official gross international reserves;

(d) exchange rate policy should ensure the continued competitiveness of Yugoslav exports of goods and services;

(e) while relatively restrictive demand policies will need to continue in 1981, the authorities should act to promote a pattern of production and investment that will assist the balance of payments in the medium-term. In particular, the planned structure of investment should be consistent with a lessening of the relative importance of imported energy and an increased supply of competitive exports. Interest rate policy should be such as to support investment aims; and

(f) incomes policy should continue to aim at keeping the growth of incomes at less than the increase in output per worker. It is realized, however, that a reduction in real incomes on the scale that occurred in 1980 is probably not possible.

The targets for domestic growth and expenditure described in the previous section would represent an adequate basis for demand management in 1981. The main target that looks difficult--indeed impossible to achieve--is the reduction in the social product deflator to 20 per cent for 1981, since this implies that during the course of the year prices would rise only some 12-15 per cent, compared with an increase of 30 per cent during 1981.

The policy instruments to be used to achieve the targets will continue to be those utilized in 1980, namely a variety of social compacts among the various bodies involved in policymaking (enterprises and all levels of government), dealing with public sector budget policies, incomes and prices policies, and external policy, and the main centralized macro-instrument, monetary policy. The mission will stress the need to continue with the relative effectiveness achieved in 1980 in arriving at consensus in the fields of incomes and fiscal policies.

For monetary policy, the intention currently is to have money supply and domestic credit increase at a lower rate than that of nominal social product. On the basis of a social product deflator of 20 per cent, the target would be an increase of about 22 per cent from December 1980 to December 1981. If prices rise faster than implied by the above deflator, the pressure to expand monetary aggregates by more than 22 per cent would become strong, since there is evidence that at present, liquidity pressures on enterprises is strong. It is easy to envisage a modification of targets based on the above rate of increase being justifiable during the course of 1981. Given the uncertainties involved, it would be reasonable to set credit targets only for the first six months of the year with those for the second half being determined at a mid-term review. However, for domestic reasons, the authorities may wish to establish them from the beginning. If this is so, the mission would be willing either to agree to them on the basis described at the beginning of the paragraph or on a slightly more pessimistic assumption regarding price performance.

Given that the federal budget is a small part of the public sector and that borrowing from the National Bank of Yugoslavia has not been excessive in recent years, there is an argument for not continuing with a subceiling on credit to the federal budget from the National Bank. Against this, discipline in the federal budget may help the federal authorities to gain similar discipline in the rest of the public sector. The mission will aim at retaining this feature.

The credit program should be accompanied by a more active interest rate policy. The authorities intend to increase the average level of both lending and borrowing interest rates, although they will still remain negative in real terms until the inflation rate declines significantly. It is not yet known whether the new system will operate from January 1, 1981. The letter of intent should describe the new system and should indicate that it will be introduced at an early date. Also, the letter should indicate the authorities' intention to adapt and, if necessary, strengthen the system in the light of experience.

Since the medium-term strategy is to redirect investment into priority areas and to discourage inefficient investment in general, and investment in the nonproductive sectors in particular, the letter of intent should include a quantified description of the investment program and its structure in the 1981-85 Plan. It should also include as much information as possible on the expected impact of the program on the balance of payments and the policies that will be used to realize the aims of the Plan.

In the external sector, the letter of intent should indicate the authorities' intention to maintain competitiveness by appropriate exchange rate policy. The mission should explain that this would imply following the policy in effect prior to the large 1980 depreciation, of relatively frequent depreciations, depending on relative cost developments in Yugoslavia.

The performance criteria relating to the balance of payments should be altered slightly in light of the new development in 1980 whereby the National Bank has become, in effect, an intermediary for Yugoslav enterprises in medium- and long-term borrowing. Ceilings on medium- and long-term borrowing should therefore include such borrowings by the National Bank. As a corollary, the balance of payments test, the second performance criteria in the external sector, should exclude changes in National Bank foreign liabilities resulting from medium- and long-term loans.

The letter of intent, in addition to establishing a mid-term review for the 1981 period, will also provide for a review which will establish in more concrete terms the policies and targets for the second and third calendar years of the stand-by program. The authorities will be told that no purchases in a calendar year subsequent to 1981 will be possible until the detailed program and the quantified performance criteria for that year have been agreed with the Fund.

With respect to phasing of purchases within 1981, there seems no reason for significant front loading. The mission will propose that SDR 150 million be available at the commencement and the remaining amount be available in equal amounts in the middle of May, August, and November 1981.

## Fund Relations with Yugoslavia

(As of November 14, 1980)

| | |
|---|---|
| Quota | SDR 277 million. |
| Funds holdings of currency | SDR 866.4 million or 312.8 per cent of quota, including holdings under the compensatory financing facility amounting to SDR 277.0 million (100 per cent of quota), and under the oil facility amounting to SDR 91.7 million (33.1 per cent of quota). |
| Holdings of SDRs | SDR 60.1 million or 47.3 per cent of net cumulative allocation. |
| Distribution of profits from gold sales | US$32.9 million. |
| Gold distribution | 177,144.008 fine ounces. |

# *Office Memorandum*

MEMORANDUM

November 19, 1980

To: Mr. Hood
Mr. Goode
Mr. Mookerjee
Ms. Lachman
Mr. Wittich

From: Geoffrey Tyler GT

Subject: Yugoslavia--Draft Brief for Possible Use of Fund Resources

I attach a copy of the above brief. I would appreciate receiving your comments by close of business on Thursday, November 20, 1980. As I shall be absent, they should be sent to Mr. Manison, Ext. 7-3369.

Attachment

cc: Mr. Whittome
Mr. Rose

# Office Memorandum

TO : Mr. Whittome

FROM : L.G. Manison

DATE: November 17, 1980

SUBJECT : Yugoslavia--Briefing Paper

Please find attached a copy of the draft briefing paper for the forthcoming stand-by arrangement mission to Yugoslavia. Section III is essentially unchanged from the draft you saw last week.

Attachment

# *Office Memorandum*

TO : Mr. Whittome

FROM : Geoffrey Tyler GT

SUBJECT : Yugoslavia--Foreign Borrowing

DATE: November 17, 1980

I attach part of a minute dealing with our discussions on the above subject. It contains, inter alia, the present state of the various negotiations.

Attachment

cc: Mr. Manison

## II. Foreign Borrowing by the National Bank

Mr. Marjanović explained that he would only describe the prospective borrowing by the National Bank, as the overall indebtedness policy had been discussed already in earlier meetings. He described the various arrangements with commercial banks that had been concluded or were to be concluded by the end of the year.

| | Country | Amount 1980 | Amount 1981 |
|---|---|---|---|
| | | (in millions of U.S. dollars) | |
| 1. | Concluded | 425 | ... |
| | Kuwait | 250 | (250) not conclu |
| | Austria (syndicated loan) | 100 | ... |
| | Iraq | 75 | ... |
| 2. | To be concluded | 875 | 425 |
| | Libya | 75 | 75 |
| | Italy | 200 | 200 |
| | France | 150 | 150 |
| | Germany | 350(to 400) | Similar to 1980 |
| | Switzerland | 100 | ... |
| 3. | Possible | 400 | ... |
| | U.S., U.K., Canada, and Japan | 400 | ... |
| | Total (excluding 3) | 1,300 | 425 |

Among those agreements to be concluded, the Italian authorities had confirmed that they would abide by the commitments of the previous Government, agreed during the summer of 1980. The banks were now ready to initiate discussions, as they had special incentives to enter into agreements due to the special mechanisms by which loans were directly subsidized by the Government. When the agreements were concluded, the loans would be disbursed in liras since Yugoslavia would otherwise have to convert dollars into lira. French banks were considering an amount equivalent to US$150 million but it was possible that larger amounts might be obtained. Negotiations would commence during the next few days and there was a possibility that similar amounts would be granted for 1981. The German banks were currently offering about DM 600-700 million, somewhat less than previously expected. It was interesting to note that German banks were not currently asking for a guarangee by the Government. They preferred to link the borrowing to the limits of lending by HERMES (the export insurance agancy). They preferred to proceed in that fashion as it helped develop relations with commercial banks in Yugoslavia. But the negotiations at this point were held with the National Bank and the relations with other banks was effectively a by-product of the agreement. Swiss banks had been approached as well, and they had initially offered SWF 100 million, but an amount of US$100 million was being discussed at the moment. This loan was to be granted at the most favorable terms.

They are therefore tied loans?

The most complex situation related to negotiations with the American, British, Canadian, and Japanese banks. Ten banks were already willing to provide US$250 million, but the total amount could easily reach US$400 million.

The terms were in principle not unfavorable: the final maturity extended to seven years, while the grace period would be three years. The major problem was the interest rate spread. The banks had offered a 1 3/8 per cent over LIBOR, which was considerably higher than the spread previously offered to Yugoslav commercial banks, and those offered by Kuwait and Austrian banks. In addition, it placed Yugoslavia at a disadvantage with respect to the rating of other important borrowers and for future loans Yugoslavia considered the issue of the spread more important than the amounts and had objected to the proposal, on the grounds that an acceptance of the terms offered would deteriorate the position of the country vis-à-vis other creditors. Currently a new meeting was scheduled to try to find an adequate solution. It was possible that the terms would not be accepted as some of the proposed changes were purely cosmetic; the spread was reduced but the utilization fee was increased. In any event, the outcome was not certain at this point. It was clear that the established borrowing goals were difficult to achieve, but significant amounts would be obtained and disbursed during 1980.

With regard to the access to financial assistance from the Soviet Union, Mr. Marjanović indicated that the bilateral payments agreement with the U.S.S.R. did not envisage financial credits. Currently lines of credit existed for the purchase of machinery for an amount of between US$520 million to US$750 million. But these suppliers' credits were slow in their disbursement pattern and only about 55 per cent of the total had been utilized. In addition, the trade balance had been negative for the last year and a half, and the situation had deteriorated as a result of the increase in the price of oil over the last year.

The balance in favor of the U.S.S.R. had amounted to a total of US$800 million in recent months.

With regard to the general prospects in the global balance of payments, Mr. Marjanović indicated that significant amounts of short-term credit had been utilized in the recent past, but that the prospective foreign exchange developments in the last months of the year would provide for an adequate coverage of expenditures until the end of the year.. The increase in reserves would be lower than had been originally projected, because some short-term debt had to be repaid, but eventually reserves would be reconstituted to more appropriate levels. For the year as a whole, a small increase was projected in the reserves of the National Bank with somewhat smaller increases envisaged for the commercial banks. To a large extent the borrowing by the National Bank would not be channeled to the rest of the financial system. The commercial banks would, therefore, be forced to use part of their foreign exchange holdings, rather than those held by the National Bank. He estimated that gross reserves were to amount to about US$2.45 billion by the end of 1980.

Mr. Tyler inquired about the expected use of Fund resources in the near future and whether they would result in reserve increases. Mr. Marjanović explained that the authorities had the intention to channel most Fund resources to reserves, within the sovereign rights of Yugoslavia to use its assets.

After discussing the program of activities for the next two days, the meeting was adjourned at 5:45 p.m.

# Office Memorandum

Mr. Whittome
Very interesting
Nov. 19. 80

NOV 17 1980

TO : The Managing Director DATE: November 17, 1980

FROM : L.A. Whittome

SUBJECT : Yugoslavia--Comments on Paper "Yugoslavia--Waiver and Modification of Stand-By Arrangement"

Thank you for your comments on the Yugoslav paper.

The relationship between the growth rate of real GSP and the current account deficit of the balance of payments does raise problems in Yugoslavia, and at the time of the formulation of the stand-by program the staff team argued that, based on historical relationships, the current account deficit of US$2.5 billion did not seem compatible with the original planned growth rate of 5 per cent. Indeed, the staff has earlier persuaded the authorities to accept US$2.5 billion as the targeted current account deficit for the stand-by program instead of an officially projected US$2.0 billion. In the staff appraisal to the Staff Report (SM/80/119, pp. 12-13), it was further noted that "the targeted reduction to a deficit of no more than US$2.5 billion is ambitious" and "that the authorities have emphasized their determination to adjust policies if it appears that the external target is not being reached."

We therefore anticipated an incompatibility between the targets but foresaw that it would be the external target that would give. Instead the growth target was not reached, partly because the authorities were intent on keeping the current account deficit below US$2.5 billion. Moreover the current account target was more elusive than had been foreseen because of a deterioration in the terms of trade that was greater than originally anticiapted. In setting up the stand-by program for 1981, the staff will be paying close attention to historical relationships between real GSP and import flows, and stock movements in 1980, bearing in mind that past relationships have at times been distorted by administrative controls on imports.

You also questioned whether it would not have been more realistic to raise the limit for December 30, 1980 on National Bank credit to the budget of the Federation, given that the Federal Government had fully used up its credit allocation by mid-year. On this matter, Governor Bogoev and Deputy Governor Marjanovic of the National Bank of Yugoslavia stated emphatically that further National Bank credit would not be provided to the Federal Government budget in 1980, adding that the Federal Government would have to reduce expenditures or obtain finance from other sources. It should be noted that the impact of operations of the Federal Government on the implementation of the overall financial program are not of prime significance insofar as the budget of the Federation accounts for only about one fifth of total consolidated public sector transactions. We accepted the National Bank's views as we were very conscious that if we pushed a higher ceiling we would be undermining their ability to resist a growth in the monetary financing of the deficit.

cc: Mr. Tyler
Mr. Watson

Mr. Tyler

November 13, 1980

L.A. Whittome

Yugoslavia Paper

I have written in a number of suggestions and queries on the attached draft. May I also go back to paragraph 5 of the draft letter of intent. It may well be right but the last two sentences read oddly in the sense that after the reference to \$13.3 billion one would hardly expect to see a lower figure namely \$13.1 billion but perhaps I have misunderstood the inwardness of what is involved.

Besides the scribbled comments a couple of points concern me. The first is that we say remarkably little about the finances of the public sector despite the suggestion that we waive the September 30 subceiling. The draft letter mentions a decline in receipts but this point does not seem to have been picked up in the paper itself. There is also the associated point which may need something more being said about it namely that the Government will now borrow from the commercial banks instead of the central bank. My second concern is that the balance of the paper seems to give some overemphasis to the current account perhaps inevitably given the prominence on the current account target. But, however, a consequence is that the paper seems to be getting into the position in which an improvement in the current account is a good thing irrespective of the way in which it has come about and that is a step that I would hesitate to take too blandly.

Finally a small point are the credits that have been revalued credits in foreign exchange but if so do we need to explain how they are included in the net domestic assets of the banking system.

# *Office Memorandum*

TO : The Managing Director
The Deputy Managing Director

DATE: November 13, 1980

FROM : L. A. Whittome

SUBJECT : Yugoslavia--Waiver and Modification of Stand-By Arrangement

I attach a draft paper on the above subject. It has been approved by Messrs. Mookerjee (ETR), Rhomberg (RES), Wittich (TRE), and Ms. Lachman (LEG).

We have agreed with Secretary's Department to place it on the agenda for Wednesday, December 3, 1980, since that is the last date on which any member of the recent mission will be in Washington prior to departure to Belgrade for the second round of discussions regarding a new stand-by arrangement. In this circumstance, we must circulate the paper by next Wednesday. I would therefore be grateful if you could look at the draft as a matter of urgency. The paper is not on the list of those we expected to send to you this week, because the mission did not return until last Monday.

The paper should be returned to the European Department.

cc: Mr. Watson

INTERNATIONAL MONETARY FUND

L Ary

This is a rough first draft of part of the brief for the YS visit. You may wish to look at it before our meeting this afternoon

GT 11/13

Geoffrey Tyler

10W Mr Tyler

DRAFT
11/12/80

The Program for the Stand-By Arrangement

In theory, the mission might be requested only to discuss a continuation of the existing stand-by arrangement, in which case it would need to agree, ad referendum, on the quantified performance criteria for 1981. It is expected, however, that the discussion will concern a new enlarged stand-by arrangement for 2-3 years. On this assumption, the mission will be discussing a stand-by arrangement of up to a maximum amount of SDR 554 million (200 per cent of existing quota) per annum for two or three years. What follows relates ~~therefore~~ to an ad referendum negotiation of a new stand-by arrangement.

Refer

In examining the program that the authorities present, the mission will be guided by the following main principles:

(a) although the improvement in the current account will not continue in 1981 at the same pace as achieved in 1980, a further reduction in the deficit in 1981 by around US$0.5 billion to a level of not more than US$1.8 billion is a necessary condition for continued access to Fund resources;

(b) the current account deficit in 1981 should be covered to the maximum extent possible by medium- and long-term borrowing not by an increase in short-term debt. If possible, at least part of the increase in the latter debt in 1981 should be repaid;

(c) net purchases from the Fund under a stand-by arrangement should be used as much as possible to add to the official gross international reserves;

(d) exchange rate policy should ensure the continued competitiveness of Yugoslav exports of goods and services;

(e) while relatively restrictive demand policies will need to continue in 1981, the authorities should act to promote a pattern of production and investment that will assist the balance of payments in the medium-term. In particular, the planned structure of investment should be consistent with a lessening of the relative importance of imported energy and an increased supply of competitive exports. Interest rate policy should be such as to support investment aims; and

(f) incomes policy should continue to aim at keeping the growth of incomes at less than the increase in output per worker. It is realized, however, that a further reduction in real incomes such as occurred in 1980 is probably not possible.

The targets for domestic growth and expenditure described in the previous section would represent an adequate basis for demand management in 1981. The main target that looks difficult--indeed almost impossible to achieve--is the reduction in the social product deflator to 20 per cent for 1981, since this implies that during the course of the year prices would rise only some 12-15 per cent, compared with an increase of 30 per cent during 1980.

The policy instruments to be used to achieve the targets will continue to be those utilized in 1980, namely a variety of social compacts among the various bodies involved in policymaking (enterprises and all levels of government), dealing with public sector budget policies, incomes and prices policies, and external policy, and the main centralized macro-instrument, monetary policy. The mission will stress the need to continue with the relative effectiveness achieved in 1980 in arriving at consensus in the fields of incomes and fiscal policies.

For monetary policy, the intention currently is to have money supply and domestic credit increase by less than nominal social product. On the basis of a social product deflator of 20 per cent, the target would be an increase of about 22 per cent from December 1980, to December 1981. If prices rise faster than implied ~~with~~ by the above deflator, the pressure to expand monetary aggregates by more than 22 per cent would become strong, since there is evidence that at present, liquidity pressures on enterprises is strong. It is easy to envisage a modification of targets based on the above rate of increase being justifiable during the course of 1981. Given the uncertainties involved, it would be reasonable to set credit targets only for the first six months of the year with those for the second half being determined at a mid-term review. However, for domestic reasons, the authorities may wish to establish them from the beginning. If this is so the mission would be willing either to agree to them on the basis described at the beginning of the paragraph or on a slightly more pessimistic assumption~~s~~ regarding price performance.

Given that the federal budget is a small part of the public sector and that borrowing from the National Bank of Yugoslavia has not been excessive in recent years, there is an argument for not continuing with a subceiling on credit to the federal budget from the National Bank. Against this, discipline in the federal budget may help the federal authorities to gain similar discipline in the rest of the public sector. Unless there is strong pressure not to include such a ceiling, the stand-by arrangement should retain this feature.

The credit program should be accompanied by a more active interest rate policy. The authorities intend to increase the average level of both lending and borrowing interest rates, although they will still remain negative in real terms until the inflation rate declines significantly. It is not yet known whether the new system will operate from January 1, 1981. The letter of intent should describe the new system and should indicate that it will be introduced at an early date. Also, the letter should indicate the authorities' intention to adapt and, if necessary, strengthen the system in the light of experience.

Since the medium-term strategy is to redirect investment into priority areas and to discourage inefficient investment in general and investment in the non-productive sectors in particular the letter of intent should include a quantified description of the investment program and its structure in the 1981-85 Plan. It should also include as much information as possible on the expected impact on the balance of payments and the policies that will be used to realize the aims of the Plan.

In the external sector, the letter of intent should indicate the authorities' intention to maintain competitiveness by appropriate exchange rate policy. The mission should explain that this would imply following the policy, in effect prior to the large June 1980 depreciation, of relatively frequent depreciations, depending on relative cost developments in Yugoslavia.

The performance criteria relating to the balance of payments should be altered slightly in light of the new development in 1980 whereby the National Bank has become, in effect, an intermediary for Yugoslav enterprises in medium- and long-term borrowing. Ceilings on medium- and long-term borrowing should therefore include such borrowings by the National Bank. As a corollary the balance of payments test, the second performance criteria in the external sector, should exclude changes in National Bank foreign liabilities resulting from medium- and long-term loans.

The letter of intent, in addition to establishing a mid-term review for the 1981 period, will also provide for a review which will establish in more concrete terms the policies and targets for the second and third calendar years of the stand-by program. The authorities will be told that no purchases in a calendar year subsequent to 1981 will be possible until the detailed program and the quantified performance criteria for that year have been agreed with the Fund.

With respect to phasing of purchases within 1981, there seems no reason for significant front loading. The mission will propose that SDR 150 million be available at the commencement and the remaining amount be available in equal amounts in middle of May, August, and November, 1981.

# Office Memorandum

TO : Mr. Whittome

FROM : Geoffrey Tyler GT

SUBJECT : Yugoslavia--Board Meeting

DATE: November 12, 1980

BR

Will you take the Board [illegible]

I have spoken to Mr. Wright (Mr. Bhagwat is away) and we agreed that the Yugoslav waiver and modification would be placed on the agenda for Wednesday, December 3, 1980. I have informed Mr. de Vries, who has no problem with this.

Mr. Manison will delay his departure by one day so that he will be present at the Board meeting and I shall prepare for you a short brief covering questions that I can see Executive Directors possibly raising. However, I would hope--and I expect--that the discussion should not be a difficult one. Mr. Manison will miss the first day of meetings in Belgrade but this can be managed.

cc: Mr. Manison

cc: GT

# Office Memorandum

TO : Mr. Whittome Fair enough

DATE: November 10, 1980

FROM : G. Tyler GT

SUBJECT : Yugoslavia--Stand-By Agreement

Amount

In discussing the amount of the proposed new stand-by agreement, Mr. Bogoev made no bones about the fact that he was thinking in terms of the maximum of 200 per cent of quota per annum, i.e., SDR 554 million per annum.

He went further during the discussion and said that if market borrowing proved particularly difficult, then perhaps more might be requested. Regarding this, I said that I could see some grounds for believing that 1980 was a bad year for Yugoslavia that might not be repeated. In 1981 one could hope that political developments would be more favorable than in 1980 (e.g., Tito's death is over) and that bankers would be more aware of the improvement in the balance of payments. Also, with exports growing strongly, the debt service ratio could be improving rather than deteriorating. My own belief is that we should not encourage greater use at this stage.

Main areas which we would be looking at in Washington

Given that the prospect is for an adequate demand management stance, I indicated that four things seemed to me to be important in the forthcoming program:

(i) The balance of payments improvement on current account should be adequate in 1981. I suggested that a further improvement of around $0.5 billion was desirable. With the present probability that the 1980 result will be a deficit of $2.2-2.3 billion, a target of $1.8 billion would result. This is the current forecast for 1981 but I suggested that if the 1980 result were better than now expected, then something less than $1.8 billion might be needed.

(ii) Every endeavor should be made to replace the relatively large increase in short-term debt in 1980 by longer-term maturities. Bogoev took the point, but was obviously uncertain as to the possibility of doing this.

(iii) As far as possible, Fund purchases in 1981 should be used to bolster gross international reserves. (This year it is forecast that gross National Bank reserves will rise by $300 million. Our lending will be about $450 billion gross and $350 million net.) As with (ii), Bogoev accepts the principle but believes that market conditions may necessitate some use of our money for financing.

(iv) To support the structural aspects of the proposed 2-3 year program, we would need an adequately quantified description of the 1981-85

Plan and the policies to be used to implement it. In this regard, I emphasized the need to proceed with the proposed interest rate reform as a means of supporting investment policy. In particular, on the assumption that the initial move would probably not go as far as we would like, it should be made clear that the 1981 proposal was a first step, to be amended in the light of experience. Bogoev said this would be their own intention.

cc: Mr. Manison
Mr. Loser
Mr. Buyse

M. Whittome

# Office Memorandum

CONFIDENTIAL

TO : The Managing Director
Deputy Managing Director

DATE: November 10, 1980

FROM : G. Tyler GT

SUBJECT : Yugoslavia - Preliminary Discussions for New Stand-by Arrangement

A mission consisting of Messrs. Manison (EUR), Loser (ETR), Buyse (EUR), Bery (World Bank), Mrs. Padmore (secretary EUR), and myself was in Belgrade from October 28 to November 7, 1980. The mission discussed modifications to performance criteria in the current stand-by arrangement for September 30 and December 31, 1980 and had preliminary talks regarding the replacement of the existing stand-by arrangement with an enlarged one covering a longer period.

1. Performance under the modification of existing stand-by arrangement

The current stand-by arrangement was approved on June 6, 1980 for the period until December 31, 1981 in an amount of SDR 339.325 million (second and third tranches plus SFF). SDR 150 million was purchased in June and a further SDR 50 million is phased for November 15, 1980. However, as explained below, three performance criteria were not met on September 30, 1980, and two of these will need to be modified for December 31, 1980 A draft letter from the authorities requesting the necessary waiver and modification is attached for your approval, subject to any comments from relevant departments.

The program for 1980 had as its major aim, a reduction in the current account deficit from US$3.7 million in 1979 to US$2.5 billion in 1980 and a reduction in the rate of inflation from 20 per cent to 17 per cent. As a result of strong measures to restrain domestic demand (real gross domestic expenditure is forecast to decline by 2.6 per cent this year) and a substantial export drive, the main external target will be more than reached and the current account deficit is expected to fall to US$2.2-2.3 billion. It is noteworthy that the authorities fulfilled their undertaking to adjust domestic policies if this was needed to achieve the external target. As a result, the growth of real social product was cut from 5 per cent in the original program to an eventual 2.5 per cent. In addition to domestic restraint, the effective exchange rate of the dinar has been depreciated by about 30 per cent during 1980 and this has helped to increase the value of exports by 30 per cent (about 8.5 per cent in volume). In contrast the volume of imports is some 10.5 per cent less than 1979. The current account deficit is now only about 3 per cent of GNP (6 per cent in 1979). Domestically, real wages rates declined by about 8 per cent but the effect of higher world prices plus the effects of the depreciation accelerated price increases and the inflation rate is currently about 30 per cent. To accomodate slightly the higher than planned increase in nominal GNP, the authorities will permit the money supply to increase by 24 per cent during 1980 compared with the original target of 22 per cent. The new rate of increase is considerably below that in nominal GNP (32-33 per cent) and we believe it is acceptable. The apparent credit increase of 28 per cent during 1980 is an effective overstatement, since 2.5 percentage points arises from the increase in dinars (as a result of the June depreciation) of domestic credits linked to foreign exchange. The higher inflation rate also forced the Federal Government to use its total 1980 credit allocations from the National Bank by mid-year, thereby breaching the end-September performance criterion on that aggregate. However, the total allocation is not to be increased so that on December 31, 1980 the performance test will be met. We recommend that you approve the necessary waivers and modification with respect to the September and December 1980 performance criteria (see Attachment I).

While the current account of the balance of payments did well, the financing of the deficit was different in structure than originally intended. Instead of the deficit being covered basically by net medium- and long-term borrowing (US$1.3-1.7 billion) by commercial banks, it is to be done by the National Bank largely on a bilateral country basis, with varying degrees of official support in these countries. Also, the commercial banks in Yugoslavia had to use lines of short-term credit. This necessity is unwelcome but the authorities will try to substitute long-term borrowing in 1981. An important reason for this different structure of borrowing is that political events in the first half of the year plus delay in recognition outside Yugoslavia of the improved economic performance made banks hesitant to lend until late in the year. The shift in long-term borrowing to the National Bank in respect of financial credits (suppliers' credits have continued normally) does not, of course, increase either the net amount of debt or its servicing. It does, however, have the mathematical result of increasing sharply the net foreign liability position of the National Bank, which has phased upper limits as performance criteria. As with the domestic credit changes, we recommend that you approve the necessary modifications set out in Attachment I.

2. <u>Program for 1981 and beyond</u>

Projections for 1981 are in the process of being presented to the Federal Government by officials and discussed by the former. Domestically, gross expenditure is to increase by 0.5 per cent compared with a decline of 2.6 per cent in 1980. Expenditure on personal consumption will rise by slightly more than in 1981 (2 per cent compared with 1 per cent) but fixed investment will decline more sharply (-2 per cent in 1980 and -5 per cent in 1981). Real gross social product will rise by 3 per cent compared with 2.5 per cent in 1980.

It is hoped to reduce the social product deflator from 30 per cent to 20 per cent but we strongly doubt that this will be possible, since it implies a decline in inflation rates during the year from 30 per cent in 1980 to less then 15 per cent next year. Externally, import volume of goods and services is to decline by 2 per cent (-10.5 per cent in 1980) and export volume to rise by 8 per cent, about the same as this year. This is expected to lead to a current account deficit of about US$1.8 billion, which would be about 2.3 per cent of GNP. Wage rates will not decline in real terms in 1981 but the authorities are aiming at limiting the real increase to about 1-2 per cent. Credit policy thinking is that monetary aggregates should again rise by less than planned nominal GSP, which would imply a domestic credit creation of about 22 per cent. Especially since we believe prices will rise by more than 20 per cent, this would represent a continuation of current tight monetary policies.

Externally, the authorities are presently thinking of depreciating the exchange rate as required to maintain competitiveness in the current account of the balance of payments. In the mission's view, the 1981 program as currently proposed represents a satisfactory set of demand management policies and external improvement.

In the longer run, present low growth rates cannot be sustained without large unemployment problems emerging. The authorities' strategy in the draft 1981-85 Plan is to direct investment to priority sectors, especially those favoring exports or import replacement and domestic energy production, and to clamp down tightly on inefficient investment in general and investment in the nonproductive sectors in particular. The ratio of investment to GSP is to be reduced to 30 per cent in 1985 compared with 34 per cent in 1979. The Yugoslavs will do this partly through their unique system of self-management agreements and social compacts, which in 1980 worked much better than in the past. In addition, they are proposing to increase the average of level of interest rates on both borrowing and lending and to introduce more selectivity, to encourage longer-term deposits and to direct credit to the investment priority areas. To us, this measure seems important although we suspect that in its final form it may not go as far initially as we would like. However, the proposal represents a radical change in philosophy compared with the virtual absence of an interest rate policy in the past.

Quantitative details of the 1981-85 Plan, including external sector forecasts, could not be given to us--they will be available on our return visit in December. However, the emphasis is clearly on the side of increasing export supply and reducing relative demands for imported energy. From these preliminary talks, we consider that there is the basis for serious discussions on a medium-term Fund lending program.

3. Possible size of Yugoslavia requests from the Fund

The formal position of the Minister of Finance, Mr. Kostic, with whom we had one meeting and Mr. Bogoev, Governor of the National Bank, with whom we had four meetings, is that the government has yet to decide what amount it would wish to ask from the Fund. However, from the final discussion with Mr. Bogoev, and confirmed by private conversations with others, it is clear that there is every prospect of the authorities trying for the maximum that you authorized the mission to discuss at this stage, namely SDR 554 million per annum (200 per cent of existing quota) for a three-year period.

4. The next stage in the negotiations

First, we shall need to present a Board paper requesting a waiver and a modification under the existing stand-by arrangement. A draft paper will be with you shortly for approval on the assumption that you accept the attached draft letter.

Second, the mission will return to Belgrade early in December 1980 to have the formal discussions regarding the replacement of the current stand-by arrangement with a new one for a larger amount over a longer period. A draft brief covering the position the mission should take will be sent to you later for approval.

Attachments

cc: Mr. Habermeier
Mr. Hood
Mr. Whittome
Mr. Finch
Mr. Mohammed

Being Called: Mrs. Tyler
Mr. J-Clement
(for Mr. Buyse)
Mrs. R.Loser (for
Dr. Padmore

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TO: INTERFIUND,
WASHINGTON, D.C. U.S.A.

FOR PFEIFER:

YUGOSLAVIA MISSION. TYLER ARRIVING 1955 NATIONAL NOVEMBER 8 PANAM 800, MANISON 1708 NOVEMBER 8 DELTA 301, LOSER AND PADMORE 1645 BA 277, AND BUYSE NOVEMBER 11.

REGARDS TYLER

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EUR
ETR

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# OFFICIAL MESSAGE

# INTERNATIONAL MONETARY FUND

Washington, D.C. 20431

TIME RECEIVED

ADDRESS

Mr. Geoffrey Tyler
C/- National Bank of Yugoslavia
Belgrade, Yugoslavia

Special Instructions

Tried to phone without success in order to keep up to date with what is happening. If you are about to return then we can talk on your return. If, however, your departure has been delayed please phone me tomorrow, Friday.

Regards
Whittome

Distribution

MESSAGE MUST END HERE

Drafted by: LAWhittome
Department: European
Date: November 6, 1980

L.A. Whittome
NAME (TYPE) SIGNATURE

NAME (TYPE) SIGNATURE

FOR CABLE ROOM USE ONLY

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ATTACHMENT I

Yugoslavia: Quantitative Performance Criteria
for 1980 in Stand-By Arrangement

| | 1979 | 1980 | | | 1980 | | |
|---|---|---|---|---|---|---|---|
| | December 31 | June 30 | Sept. 30 | Dec. 31 | Ceiling Under Program | | |
| | Actual | Actual | | Fore-cast | June 30 | September 30 | December 31 |
| | | | | | (Proposed new ceilings in brackets) | | |
| Net domestic assets of the banking system; in billions of dinars | 1,201 | 1,368 | 1,450 | 1,538 | 1,321 | 1,381 (1,450) | 1,466 (1,538) |
| Net credit of the National Bank to the Budget of the Federation; in billions of dinars | 68.7 | 77.9 | 77.9 | 77.9 | 76.4 | 77.4 (77.9) | 77.9 |
| Cumulative change in net convertible foreign assets of the National Bank; in millions of U.S. dollars 1/ | ... | -972 | -937 | -1,600 | -900 | -500 (-937) | -- (-1,600) |
| Convertible currency debt outstanding; in billions of U.S. dollars 2/ | 12.3 | 13.1 | 13.3 | 13.1 | 13.6 | 14.2 (14.2) | 14.7 (13.1) |

Source: Data supplied by the Yugoslav authorities.

1/ Net of exceptional borrowing by commercial banks.
2/ Debt outstanding in convertible currency with original maturities of more than one year. Excluding outstanding purchases from the Fund and increases in exceptional borrowings by the commercial banks in 1980. Valued at exchange rates prevailing on December 31, 1979.

WORLDBANK440098

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Fund Communications

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INTERFUND

WASHINGTON, D.C. (U-S-A)

Being Called:
Mrs. Tyler
Mrs. Loser
Mr. J. Clement (for Mr. Buyse
Mrs. Padmore

FOR PFEIFER

TYLER, LOSER, MANISON, BUYSE, PADMORE ARRIVED.

TYLER
MOSKVA HOTEL
BELGRADE, YUGOSLAVIA

ORIG: EURO
CC: ETR

12717YU MOSKVA

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12717YU MOSKVA

EUR
ETR

# *Office Memorandum*

TO : Mr. Whittome

FROM : L.G. Manison LGM

DATE: October 23, 1980

SUBJECT : Yugoslavia--Conversation with Mr. Ruding, October 22, 1980

Prior to my conversation with Mr. Ruding on Cyprus, he said that the two-stage mission approach for formulating a stand-by program with Yugoslavia was particularly appropriate as it would allow the Fund to have an input into the preparation of the quantitative economic targets and objectives for 1981. Mr. Ruding indicated that the main issue related to the content of the program rather than to the amount of the stand-by arrangement which the Yugoslavs understood could be the maximum possible purchases on the Fund in 1981.

cc: Mr. Tyler

MEMORANDUM FOR THE FILES

Subject: Israel, Romania, and Yugoslavia October 17, 1980

Mr. Polak spoke to me this morning regarding the forthcoming missions to the above countries.

Israel:

I told him that my personal feeling was that the most useful time to visit Israel would be during the second half of the mission there. I thought that the first half of the mission would basically be fact finding and that the main negotiation, in which he could be of assistance, would take place in the second half.

Romania:

I said that the exact timing of this was not yet clear and it would depend partly on the results of Ms. Salop's visit in December and partly on the timing and post-mission work of the second Yugoslav visit. I told him that in my view there was not much of a choice from the staff point of view between his visiting Romania prior to the staff visit and during it. Going before the staff mission had the advantage that he would be able to let the Romanians know in advance about potential problems and thereby give the authorities time to think about them. Probably Mr. Polak will go before the staff mission and combine this with the visit to Israel.

Yugoslavia:

I informed him about the timing and basis of the two coming missions. Asked when we expected to be before the Board, I said that this would depend in part upon how quickly we could get back to Washington after the second visit but pointed out that it could depend to some extent on the timing of the Romanian mission. Ideally, it would be preferable to have the Yugoslav Board meeting finished before departing for Romania.

GT

Geoffrey Tyler

cc: Mr. Whittome
Mr. Schmitt
Mrs. Gürgen
Ms. Salop
Mr. Manison

Mr. Whittome

October 9, 1980

MEMORANDUM FOR FILES

Subject: Yugoslavia--Mission Timing

Mr. Rosenblatt rang from Paris to enquire about the schedule of missions to Yugoslavia. His reason was that the OECD intended to be in Belgrade on January 12-14, 1981 and hoped not to have its visit coincide with the Fund mission. I told Mr. Rosenblatt that we did not expect to be in Belgrade in January, and if on the off chance this became necessary, we should be able to avoid a conflict with the OECD date.

GT

Geoffrey Tyler

cc: Mr. Whittome ✓
Mr. Manison

# Office Memorandum

TO : The Managing Director

DATE: October 7, 1980

FROM : L.A. Whittome

SUBJECT : Yugoslavia--Staff Visit Regarding Stand-by Arrangement

As you know we had earlier indicated to the Yugoslav authorities that in principle we stood ready to discuss the replacement of the present stand-by arrangement (second and third tranches plus SFF, totaling SDR 339.3 million of which SDR 150 million has been drawn to date and a further SDR 50 million will be drawn in November), which lasts until December 31, 1981, with one for a larger sum. The subject was discussed further last week.

The Yugoslavs have had considerable success in reducing the current account deficit and in slowing the growth of domestic expenditures. However, they are meeting with some difficulties with their foreign borrowing. It is highly likely that they will need more from us in 1981 than the SDR 139.3 million that will remain under the existing stand-by arrangement. Given Yugoslav sensitivities regarding any appearance of the Fund imposing a program on their country, we have agreed to send a mission to Belgrade on October 28, 1980 before final Government decisions must be made on policies and targets for 1981. The mission would discuss and agree the general outlines of an acceptable program and then depart, leaving the authorities to go through their usual decision-making process. We would hope that in this way the outcome would be a program that would satisfactorily justify a new and larger stand-by arrangement which we would endorse during a second visit in December.

I believe that at this stage of the discussions it would be premature to specify particular ceilings. However, the mission should be guided by the view that the current account deficit of the balance of payments should decline from an estimated US$2.2 billion in 1980 (the Yugoslavs hope that the final figure may be marginally lower) to at least US$1.8 billion in 1981. (In 1979 the deficit was US$3.7 billion.) The mission would on its return in December negotiate in the usual way the details of the proposed stand-by arrangement, including quantified performance criteria.

The amount of a new stand-by arrangement is still a subject of some controversy within Yugoslavia. If the Yugoslavs requested an arrangement going to the top of the fourth credit tranche plus SFF, the amount available would be SDR 291.7 million under the existing quota and SDR 572.1 million under the new quota. It is possible that the authorities may not wish to go beyond the fourth credit tranche to avoid any appearance of too serious balance of payments problem. If they are willing to go beyond the fourth tranche, 200 per cent of the existing quota is SDR 554 million. I propose that in the preliminary discussions, the mission be authorized to consider any of the possible arrangements up to SDR 554 million per annum for three years, and that it encourage the authorities to make substantial use of the Fund's resources in order to ensure the consistency of the program and to build up the present very low level of reserves.

It will be necessary to modify some of the performance criteria for September 30, 1980 under the existing stand-by arrangement in order to permit a purchase of SDR 50 million before the end of the year. The need for modification arises primarily from the slow progress made to date in arranging foreign borrowing and because the sharp depreciation of the dinar has led to higher price increases than assumed in the program. The October mission would discuss ad referendum the necessary modifications with the Yugoslavs.

If you agree, I would propose the mission consist of Messrs. Tyler (EUR), Manison (EUR), Loser (ETR), and Buyse (EUR), with Mrs. Padmore (EUR), as secretary.

OK [illegible]

cc: Deputy Managing Director
Mr. Finch
Mr. Watson

# Office Memorandum

TO : The Managing Director

DATE: October 7, 1980

FROM : L.A. Whittome

SUBJECT: Yugoslavia--Staff Visit Regarding Stand-by Arrangement

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OK

cc: Deputy Managing Director
Mr. Finch
Mr. Watson

ADM ) After approval
SEC )

cc: EED

# Office Memorandum

OCT 8 1980

Whittome

I fully agree

It is a good case for big use

- program

- availability of external borrowing

- particularly

| | | |
|---|---|---|
| TO | : | The Managing Director |
| FROM | : | L.A. Whittome |
| SUBJECT | : | Yugoslavia--Staff Visit Regarding Stand-by Arrangement |

DATE: October 7, 1980

J. 8.X.

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yes

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If you agree, I would propose the mission consist of Messrs. Tyler (EUR), Manison (EUR), Loser (ETR), and Buyse (EUR), with Mrs. Padmore (EUR), as secretary.

cc: Deputy Managing Director
Mr. Finch
Mr. Watson

# *Office Memorandum*

TO : Mr. Whittome

DATE: October 6, 1980

FROM : Geoffrey Tyler

SUBJECT : Israel-Romania-Yugoslavia

I shall be taking tomorrow and perhaps Wednesday off for vacation.

I attach a draft memorandum to the Managing Director seeking approval of the Yugoslav mission. It was written in the light of our earlier discussions.

Tomorrow you will probably receive a draft memorandum from Mr. Mookerjee to Mr. Laske written in response to an earlier memorandum in which the latter asked whether a Romanian decree dealing, inter alia, with countertrade measures involved an exchange restriction. I discussed a draft of the memorandum with Mr. Donovan and I was satisfied with its amended form after our discussion. Ms. Salop is quite familiar with the matter.

Finally, with regard to staffing the Israel mission, I presume we shall need to include an ETR person, since a stand-by negotiation will be involved. I think we should find out from ETR as soon as possible so that the person that they would be providing can assist in the preparation of the background paper. Mrs. Gürgen will be starting on this task very shortly, and so too should the ETR person. If the mission consists of Messrs. Schmitt, Mountford, ~~Wald~~, ETR and Mrs. Gürgen, it would not technically be necessary to include the new colleague from the U.K. Treasury. However, if you wanted to include him--and I can see various reasons why one might--a five-person mission is not so exceptional these days.

Attachment

AP Would you the Palmer please

Jor Hooker
14J

MEMORANDUM FOR THE FILES

Subject: Yugoslavia--Purchases Available after 1980    October 3, 1980

The calculations set out below show the amounts potentially available under a stand-by arrangement on various assumptions. It is assumed that SDR 50 million is purchased before the end of 1980 so that outstanding purchases, excluding CFF and oil facility purchases, total SDR 269.25 million at the beginning of 1981.

Present stand-by arrangement and quota

SDR 139.325 million, derived from the total stand-by amount of SDR 339.325 less SDR 200 million purchased by end-1980.

New stand-by arrangement for four tranches plus SFF on existing quotas

SDR 291.6750 million derived as follows: SDR 277 million x (1.00 + 1.025) less SDR 269.25 million.

New stand-by arrangement with new quota

SDR 572.1375 million derived as follows: SDR 415.5 million x (1.00 + 1.025) less SDR 269.25 million.

New stand-by arrangement on basis of 200 per cent of present quota per annum

SDR 554 million per annum for three years derived as follows: SDR 277 million x 2.

GT

Geoffrey Tyler

cc: Mr. Whittome

Mr. Whittome

October 1, 1980

MEMORANDUM FOR FILES

Subject: Matters Discussed at Luncheon and Meeting With Yugoslav Delegates to Annual Meeting 1/

The Yugoslav delegates attending the luncheon and following meeting in Mr. Whittome's office on September 26, 1980 were Mr. Bogoev, Governor of the National Bank of Yugoslavia, Mr. G. Popovic, Assistant Federal Secretary for Finance, and Mrs. G. Hofmann, Director of Department for International Operations of the National Bank of Yugoslavia. The staff representatives comprised Messrs. Whittome, Rose, Tyler, and Manison.

During the luncheon and subsequent meeting, the following matters were discussed:

1. Balance of payments developments

a. Current account

Governor Bogoev stated that considerable progress had been made in reducing the current account deficit from the extremely high level of US$3.7 billion in 1979. Developments in the first eight months and 20 days of 1980 suggested that the current account deficit for 1980 could be around US$2.0-2.2 billion; on a cash flow basis it might be some US$0.2 billion lower. Developments in the trade account had been better than expected with the value and volume of exports rising by 34 per cent and 11 per cent, respectively, in the first eight months of 1980, compared with the corresponding period of 1979. Import volume fell by 10 per cent over the same period. Trends in invisible earnings from tourism and workers' remittances were very favorable also.

b. Capital account

Governor Bogoev said that disbursements of longer-term bank loans to date during 1980 were well below that planned earlier in the year. Although the flow of normal commercial credits, particularly those provided by suppliers, had been sufficient to finance the current account deficit, there was a need for additional external capital inflow to finance the amortization of loans (estimated to be nearly US$2.0 billion in 1980) and to help reconstitute the very low level of foreign reserves. Indeed, it was estimated that net capital inflow in 1980 should be around US$2.5 billion if gross official reserves were to rise by US$0.5 billion. Any shortfall in longer-term financial credits below US$2.0 million would be matched by increased drawings on shorter-term

1/ Some of the points raised with the Yugoslav delegates during the discussions were pursued in more detail at a subsequent meeting on September 29, 1980. This note has benefited from the latter meeting.

bank loans serving as bridging finance, implying at worst that gross official reserves would be restored to their end-1979 level. At the end of August, short-term bank credits outstanding amounted to US$1.7 billion; it was hoped to reduce them to US$0.6 billion by the end of the year.

2. External borrowing plans

Governor Bogoev noted that the shortfall in external inflow so far in 1980 was in part due to difficulties in obtaining the desired amount of loans from a number of overseas commercial banks. For 1980, the Yugoslav authorities had attempted to raise substantially the amount of external loans by approaching countries bilaterally in order to have them persuade their commercial banks to lend greater amounts to Yugoslavia. It was hoped that the terms on the new bank loans would be similar to those obtained in the past. The new approach to raising external funds on a bilateral basis had been prompted by the exceptionally high current account deficit recorded in 1979 and the resultant heavy drain on foreign exchange reserves. Governor Bogoev stressed that a discrete increase in the amount of gross inflows of capital would be needed for a number of years in order to not only finance heavy debt repayments and the reconstitution of reserves, but also to underpin the structural changes required in the Yugoslav economy. The sharp rise in oil prices and the poor agricultural harvest in 1980 and their very adverse effects on the balance of payments had emphasized the need for Yugoslavia to build up its domestic energy and agricultural supplies and to base domestic industry more on locally produced raw materials and energy sources. In addition, in view of the very large external financing needs, a coordinated approach was considered necessary. Moreover, if banks had been approached on ad hoc basis, as had been the past practice, failure to line up the requisite amount of financing may have resulted in very unfavorable consequences, including the need to obtain funds from sources where political strings were attached.

The Yugoslav authorities had now completed their exercise of approaching the countries from which they sought external finance. Governor Bogoev said that at this stage, it was very difficult to assess the amount of financing that could be secured from these countries. Final agreement on only a few loans had been reached while the amount provided by a number of commercial banks seemed to be dependent on how much would be provided to Yugoslavia by other sources, including the Fund.

Given the caveat of the various interrelated uncertainties involved, Governor Bogoev indicated that the following annual amounts might be forthcoming for a period of three years:

| | In millions of U.S. dollars |
|---|---|
| OPEC | |
| Kuwait | 250 |
| Others 1/ | 100 |
| Total | 350 |
| European countries | |
| Austria | 100 |
| Switzerland 2/ | 70 |
| France ) | 400 |
| Italy ) | |
| Germany 3/ | 300-400 |
| Total | 870-970 |
| Consortium of United States, United Kingdom, Canadian and Japanese banks | 350-400 |
| | 350-400 |
| Total | 1,570-1,720 |

1/ Efforts were being made to obtain loans from Iraq and Libya, while the United Arab Emirates could be approached also.
2/ Swiss banks had agreed to provide SF 100 million; the Yugoslav authorities were seeking US$100 million.
3/ This amount was confidently expected.

The Kuwait loan had been signed. Among the European countries with which loan negotiations had been conducted, Austria was the only one where the loan agreement had been finalized. German banks had been asked to provide US$750 million, but the actual amount obtained was likely to be considerably less. Direct negotiations with German commercial banks had yet to take place, but were likely to be completed in 6-7 weeks' time. Rapid progress could be made in disbursing loans once a government guarantee was given. The Yugoslav authorities hoped to obtain US$200 million per annum for a period of three years each from the Italian and French banks; problems relating to loan guarantees were delaying borrowing agreements with commercial banks. However, the French Minister of Finance had assured the Yugoslavs on Sunday that the Government would guarantee such loans.

With regard to obtaining funds from the United States and the United Kingdom, it had been agreed to set up a consortium of banks from North America, the United Kingdom, and Japan for the purpose of lending to Yugoslavia. Other banks could participate also in the arrangement, such as those from Scandinavian countries. Chase Manhattan, Manufacturers' Hanover, and Lloyd's Bank would be coordinating the consortia loan. This consortia was expected to provide at least US$350 million per annum.

Given the current outlook, it was possible that loans from Western banks for financing noncurrent account needs (longer-term financial credits) might total US$1.6-1.7 billion per annum. Mr. Tyler thought that the Yugoslav authorities should make every effort to accelerate net capital inflow in the final quarter of 1980. At the same time, they should use the shortfall expected in 1980 to argue that there would be a greater financing need in 1981. Mr. Whittome said that, in negotiating loans with the commercial banks, it would be better not to mention the build up of reserves as one of the major objectives of such loans. Commercial bankers might press the Yugoslav authorities to use the Fund resources solely for this purpose. It would be preferable for the authorities to state that they were acting in advance in making preparations for meeting a possible substantial financing need over the coming years. Mr. Tyler observed that it would be helpful also if the Yugoslav authorities could better inform the overseas financial community of the favorable developments in the Yugoslav economy.

3. Use of Fund resources

Mr. Whittome outlined possibilities on the extent to which Yugoslavia might avail of the Fund for financing its balance of payments needs. At one extreme, under a special set of circumstances, Yugoslavia might be able to borrow up to 200 per cent of quota (SDR 554 million) over a period of three years. At the other extreme, Yugoslavia might purchase the fourth credit tranche and related supplementary financing; together with the amounts still available under the existing stand-by arrangement; this would allow purchases totaling SDR 291 million in 1981. A range of other possible arrangements within these extremes could be envisaged also. Mr. Whittome noted that in the past, it had been the policy of the Yugoslav authorities to make prudent use of Fund resources and not use such resources up to the maximum limit, thus leaving something in reserve for meeting unforeseen contingencies.

On the question of whether the Yugoslav authorities might wish to either modify or replace the existing stand-by arrangement, this could be resolved when more data became available on the performance of Yugoslav economy and when there was greater certainty as to the amounts of longer-term bank credits available. Governor Bogoev agreed that this matter could be discussed during the course of a staff mission to Belgrade in the second half of October.

In its negotiations with commercial banks, the Yugoslav authorities could state that they would be obtaining a certain amount of external financing from the Fund and that a specified sum was required from the commercial banks in order to meet the residual financing need. Alternatively, the Fund could meet the residual financing need after the Yugoslav authorities had agreed to a certain sum from the commercial banks. The latter approach could, however, be hazardous insofar as bankers knew of the magnitude of external financing that Yugoslavia could obtain from the Fund.

4. Performance under stand-by program

Governor Bogoev gave an account of developments to date in meeting objectives and performance criteria under the stand-by arrangement. With respect to the domestic economy, the growth rates of real GSP and domestic expenditure components now forecast for 1980 were likely to be lower than the targets specified at the time of formulation of the stand-by program (Table 1). In contrast, the increase in domestic prices is likely to be considerably greater than the target for the GSP price deflator of 17 per cent. The GSP price deflator was now expected to rise by at least 27 per cent in 1980. The recent acceleration in inflation was explained largely by the effects of the June devaluation and administered price adjustments to correct distortions, particularly those relating to prices of energy and agricultural products. The rapid rate of inflation was considered to be the most disturbing feature of recent developments in Yugoslavia.

Despite a sharp rise in July, growth rate of the money supply was expected to be kept in line with the planned rate of 22 per cent, which was in line with the targeted increase in the GSP. However, the expansion in net domestic assets of the banking system had been greater than that programmed under the stand-by arrangement; the performance criteria for June 30, 1980 had not been met while figures for August 1980 indicated that the September 30, 1980 ceiling would most likely be exceeded also (Table 2). Revised figures indicated that the substantial increase in bank credit in July and August was largely in accord with normal seasonal behavior. The higher than planned rate of credit expansion was attributable in part to the need to offset the higher than previously foreseen fall in net foreign assets of the banking system and due to the faster than expected rise in domestic costs and prices. Nominal GSP was now expected to rise by over 30 per cent in 1980. However, although the rate of domestic credit expansion was expected to exceed 22 per cent in the 12 months to December 1980, it was expected to be at least 6 percentage points below that of nominal GSP. Commercial banks had in fact been pressing for the rate of credit expansion of 26 per cent.

The staff representatives pointed out that National Bank credits to the Federation had exceeded the performance criterion set for June 30, 1980, the actual level being the same as the ceiling set for December 31, 1980. They suggested that the Yugoslav authorities make every effort to meet the performance criteria on National Bank credits to the Federation set for September 30, 1980.

The balance of payments test for June 30, 1980 had not been met in so far as the decline in the level of net convertible foreign assets of the National Bank, less exceptional financing since end-1979 of US$972 million was US$72 million in excess of that permitted. Data through August 1980 indicated also that the September 30, 1980 performance criterion for the balance of payments would not be observed.

With external borrowing being less than planned during 1980 the level of external convertible currency debt outstanding was US$500 million less than the ceiling for June 30, 1980 and the September 30, 1980 performance criterion was likely to be easily met.

The staff representatives stated that given the likelihood that performance criteria set for September 30, 1980 would be breached, it would be necessary to modify the stand-by program in order that Yugoslavia could make a further Fund purchase before the end of the year. In view of the progress made in adjusting the current account of the balance of payments and in curbing the growth of domestic demand, the Fund would probably support such a modification.

5. Fund mission

It was agreed that a staff mission for purposes of modifying the current stand-by arrangement and for conducting preliminary talks on the use of Fund resources in 1981, should begin discussions in Belgrade on October 29, 1980. This mission would include a World Bank staff member, together with an economist under the Fund Economist Program. Questions and tables to be completed would be given to the Yugoslav delegation prior to their departure from Washington, D. C.

It was agreed that a subsequent staff mission visit Belgrade from the second week of December onward for purposes of formulating a stand-by program for 1981.

L. G. Manison

L. G. Manison

cc: Mr. Whittome
Mr. Rose
Mr. Tyler

Table 1. Yugoslavia: Targets and Latest Forecasts for Selected Economic Indicators for 1980

(Percentage change over 1979)

| | Target | Latest Forecast |
|---|---|---|
| Gross social product | 5 | < 4 |
| GSP price deflator | 17 | 27+ |
| Nominal GSP | 22 | 30+ |
| Real personal consumption | 3.8 | < 3 |
| Real government consumption | 2.1 | -6 |
| Real gross fixed investment | 5.8 | 3 |
| Exports, volume | 6.0 | 8 |
| Imports, volume | 1/ | -9 |
| Money supply | 22 | 22 |
| Domestic credit | 22 | 22+ 2/ |

Source: Staff estimate.

1/ It was intended to keep the growth of imports in line with balance of payments capabilities.
2/ To be kept to at least 6 percentage points below that of nominal GSP.

Table 2. Yugoslavia: Quantitative Performance
Criteria in Stand-By Arrangement 1/

| | 1979 | 1980 | | 1980 | | |
|---|---|---|---|---|---|---|
| | December 31 | June 30 | August 31 | Ceiling Under Program | | |
| | Actual | Actual | | June 30 | September 30 2/ | December 31 |
| Net domestic assets of the banking system; in billions of dinars | 1,201 | 1,368 | 1,400 | 1,321 | 1,381 | 1,466 |
| Net credit of the National Bank to the Budget of the Federation; in billions of dinars | 68.7 | 77.9 | | 76.4 | 77.4 | 77.9 |
| Cumulative change in net convertible foreign assets of the National Bank; in millions of U.S. dollars 3/ | ... | -972 | | -900 | -500 | -- |
| Convertible currency debt outstanding; in billions of U.S. dollars 4/ | 12.3 | 13.1 | | 13.6 | 14.2 | 14.7 |

Source: Data supplied by the Yugoslav authorities.

1/ Quantitative performance criteria for 1981 to be determined at the time of the mid-term review.
2/ As additional purchases from the Fund cannot be made before November 15, 1980 when data relating to performance criteria for September 30, 1980 should be available, the latter is effectively the trigger date.
3/ Net of exceptional borrowing by commercial banks.
4/ Debt outstanding in convertible currency with original maturities of more than one year. Excluding outstanding purchases from the Fund and increases in exceptional borrowings by the commercial banks in 1980. Valued at exchange rates prevailing on December 31, 1979.

September 26, 1980

MEMORANDUM FOR FILES

Subject: Yugoslavia

Governor Bogoev agreed that a mission should visit Belgrade during the last half of October and that it should include a member of the Bank staff.

L.A. Whittome

cc; EED

# *Office Memorandum*

TO : Mr. Whittome

DATE: September 25, 1980

FROM : Geoffrey Tyler GT

SUBJECT : Yugoslavia--Amounts Available Under Stand-By Arrangement

On the assumption that Yugoslavia purchases another SDR 50 million this year under the existing stand-by arrangement, total purchases under it by end-1980 will equal SDR 200 million.

On the present quota of SDR 277 million the amount available under a stand-by arrangement covering the second through fourth tranches plus SFF equals SDR (0.75 + 1.025) x 277, or SDR 491.675 million. Deducting SDR 200 million purchased by end-1980, the remaining available amount would be SDR 291.675 million. 291

On the new quota of SDR 415.5 million, the corresponding availability would be SDR 537.5125 million derived from SDR (0.75 + 1.025) x 415.5, or SDR 737.5125, less SDR 200 million. 537

or 554 = 200% of quota

Mr. Bogoev's schedule - September 26

He will be seeing Mr. Rockefeller at 10.00 a.m., leaving in time to catch the noon shuttle. He will be brought directly to the Fund by Embassy car arriving at about 1.15 p.m. He must leave by 3.45 p.m. for a meeting with Secretary Miller.

cc: Lynne

Pl show to [illegible] then in my Yugoslav folder for re-reading pl

September 24, 1980

MEMORANDUM FOR FILES

Subject: Yugoslavia--Annual Meeting

1. Where are they on the present stand-by; ceilings in September.

balance of payments test

(a) ~~balance of payments of banking system~~

(b) sub-ceiling on credit to Federal Government, get back on line by 30/9.

n.d.a

(c) ~~balance of payments~~ of banking system (main risk lies here)

2. Fund/Yugoslav financial relations next year and amounts involved. Views of other country creditors.

3. Paris meeting; difficult to do anything bilaterally. Yugoslavs should rely on market and envisage multinational credits.

4. Timing of visits October? Will take Bank person on October visit.

Fm basis of present stand-by [illegible] $50 [illegible]

Will credit tranche + SFF

L.A. Whittome

Bldg up of short term credit? Reserve [illegible]?

EFF

200%

$600-700 m

Iraq meeting [illegible] Corot

cc: A Meeting

# Office Memorandum

Ignore, For Yugoslav file

TO : Mr. Whittome

DATE: September 22, 1980

FROM : Geoffrey Tyler

SUBJECT : Yugoslavia--Possible Modification of Stand-By Arrangement

I attach a copy of a memorandum prepared by Mr. Manison. I share his views.

It seems most unlikely that the authorities will be able to meet the performance criteria of September 30, 1980. First, their current strong efforts to arrange substantial foreign borrowing cannot bring in any cash until the final quarter, so the chance of meeting the test on the net foreign asset position of the National Bank will probably not be met. Domestically, it is unlikely that the limit on net domestic assets of the banking system can be met, especially in view of the apparent spurt in credit in July.

We shall need to discuss the matter with the delegation. Assuming we are right in believing that a modification will be necessary, I consider that we should agree in principle to support one. However, we should make it clear that domestic credit restraint is essential for our support. In this respect, we shall need to be convinced that the July result was an aberration. It would also be helpful presentationally if the authorities could ensure that the sub-ceiling on credit to the Federation is met on September 30--this should be within the authorities' power. Externally, we shall need to be able to report that strong efforts are being made to raise medium- and long-term loans and that reasonable success is likely.

In terms of obtaining information for the necessary Board paper, the proposed visit to Belgrade next month will be convenient. Indeed, from the Yugoslavs' point of view, a modification exercise could provide a convenient explanation for the visit if it raises any public questions.

Incidentally, the World Bank has agreed and is anxious to supply a member for the mission. Mr. Chopra will provide a name during the Annual Meeting. We should probably alert the Yugoslavs that we shall probably include a Bank person.

Attachment

# Office Memorandum

(a) 79 v. big domestic then slow b of P only with reserves from dangerously [illegible] fe afs, remittances, dif of borrowing

TO : Mr. Tyler

DATE: September 22, 1980

(b) 80 so far domestic [illegible] but [illegible] b of P well on target but dif of borrowing [illegible] reserves

FROM : L.G. Manison [signature]

SUBJECT : Yugoslavia--Recent Economic Developments and Performance under the Current Stand-By Arrangement

Recent developments in the Yugoslav economy have been mixed and have been reflected in some of the performance criteria specified for June 30, 1980 under the existing stand-by arrangement (levels of net domestic assets of the banking system and National Bank credit to the Federation, and the decline in external reserves) being breached (Table 1). As further purchases under the stand-by arrangement can not be effected before November 15, 1980 when data relating to performance criteria for September 30, 1980 would be applicable, the latter in practice serves as the effective trigger date. The question arises as to whether the Fund would have been willing to modify performance criteria under the existing stand-by arrangement in lieu of developments to date during 1980, especially if one assumed that June 30, 1980 was the effective trigger date.

On the external side, the serious efforts of the Yugoslav authorities to reduce substantially the current account deficit of the balance of payments appear to be producing favorable results. In the first seven months of 1980, the trade deficit amounted to US$3.6 billion or approximately US$6.2 billion on an annual basis compared with the planned figure of US$7.2 billion for the full year. It is estimated that the volume of exports rose by 12 per cent in the first seven months of 1980 compared with the corresponding period of 1979, while import volume fell by 11 per cent. Preliminary estimates suggest that a sharp rise in foreign exchange receipts from tourism will be recorded in 1980. These developments together with the expected beneficial effects on the external accounts of the large devaluation in the foreign exchange value of the dinar in June and the slow down in the growth of the domestic economy should reduce the current account deficit from US$3.7 billion in 1979 to below US$2.5 billion in 1980, or from approximately 6 per cent of GDP to 4 per cent of that estimated for 1980.

The greater-than-planned for decline in external reserves during 1980, especially in net foreign assets of the banking system, has resulted from medium- and long-term external borrowing from commercial banks being considerably less than intended. Reflecting this shortfall, the rise in convertible currency external debt outstanding amounted to only US$800 million in the first six months of 1980 compared with the permissible increase of US$1.3 billion under the stand-by arrangement. The lower-than-planned level of longer-term commercial borrowing is attributable partly to delays in coordinating and putting into practice an elaborate and more thorough system of foreign borrowing limits for the republics and the provinces and for the enterprises within these territorial boundaries. Political and economic uncertainties associated with the death of ex-President Tito have had also a dampening effect on the flow of loans to Yugoslavia. As a consequence the current account deficit of the balance of payments has been financed by a higher than previously foreseen level of short-term borrowing by Yugoslav banks which in turn has raised external bank liabilities above planned levels.

(c) what in recent yrs has been [illegible] net long term flows + [illegible]

With top priority being given to reducing the current account deficit of the balance of payments the authorities have deliberately induced a marked slowdown in the growth of domestic production. After real gross social product had risen by around 7 per cent in each of the preceding three years the authorities reduced the growth rate target to 5 per cent for 1980; subsequently, this target has been revised downward to 4 per cent. Indeed, the original target for the increase in industrial production of 6 per cent has been lowered to 5 per cent and in the first seven months of 1980 the actual level of industrial production was 4.3 per cent above that of a year earlier after rising at an average rate of 8.7 per cent in the previous three years. Supply shortages of imported raw materials and spare parts appear to have contributed to the slackening of industrial production.

The greater-than-expected increase in domestic prices of late has been a disturbing development. Despite efforts to contain price increases following the devaluation of the dinar in early June consumer prices have risen sharply with the 12-monthly rate of increase in the retail price index advancing to 27.2 per cent in July. Although industrial and agricultural producer prices have been rising at a lower rate it is now expected that the increase in the GSP price deflator could be around 25 per cent in 1980. This contrasts with a target of 17 per cent under the stand-by arrangement program and an increase in the GSP price deflator of 20 per cent in 1979.

While the devaluation has led to abrupt increases in domestic prices inflationary pressures stemming from higher labor costs appear to be diminishing. The authorities seem to have achieved some success in their efforts to moderate the rise in nominal personal incomes and this in conjunction with the sharper rise in the cost of living is estimated to have reduced real average personal incomes by over 8 per cent in the first half of 1980. Statistics show that the increase in net average personal ~~savings~~ INCOMES in the socialized sector in the first half of 1980 was reduced to 18 per cent compared with 24 per cent in the 12 months to December 1979 and with a rise in total incomes of organizations of associated labor of around 28 per cent in the first six months of this year.

While the ceilings on domestic bank credit were not observed for June 30, 1980 it is debatable whether recent monetary developments have accommodated and even contributed to the acceleration in domestic price increases. The financial program underlying the stand-by arrangement calls for the 12-monthly rates of growth of domestic credit and the money supply to be reduced to 22 per cent by the end of 1980, a rate commersurate with the projected increase in nominal GSP. In the event, the rate of growth of domestic bank credit rose to 31 per cent by June 1980 (Table 2). However, the higher-than-planned increase in bank credit was more than offset by the greater-than-anticipated decline in net foreign assets. This led to the rise in the money supply which was considerably less than that programmed. In fact, in the six months to June 30, 1980 the money supply rose by 6.9 per cent compared with a planned increase of 8.3 per cent. Moreover, with domestic prices rising by around 13-15 per cent over this period the squeeze on real money balances was quite substantial. Partial information for July indicate an abrupt rise in the money supply as an acceleration in bank credit expansion was accompanied by a rise in net foreign assets. Newspaper reports indicate that with the rise in the money supply being over 5 per cent in July the 12-monthly rate of increase was raised to 25 per cent. The bulk of the increase in bank credit is reported to have flowed to organizations of associated labor.

We have little data on developments in the public sector during 1980. While credit extended by the National Bank to the Federation was above the ceiling set for June 30, 1980 the financing requirements of the Federal Government are relatively small and do not seem to be a destabilizing factor.

In answering the question posed initially on whether the staff should be willing to modify the stand-by arrangement in a situation where further purchases would be contingent on meeting the June 30, 1980 performance criteria, I would argue that in view of the measures taken to adjust the current account of the balance of payments and to reduce significantly the growth of real economic activity, a modification of the stand-by program would be justified provided the Yugoslav authorities give convincing evidence of their determination to accelerate their efforts to raise more medium- and long-term foreign bank loans and to reduce substantially the rate of expansion of domestic credit, especially in a situation of rising net foreign assets. In the past, as the data in Table 3 illustrates, the monetary authorities have failed to offset unforeseen increases in net foreign assets with appropriate adjustments in the expansion of National Bank credits.

Attachments

Table 1. Yugoslavia: Quantitative Performance
Criteria in Stand-By Arrangement 1/

| | 1979 December 31 Actual | 1980 June 30 Actual | 1980 Ceilings Under Program June 30 | September 30 2/ | December 31 |
|---|---|---|---|---|---|
| Net domestic assets of the banking system; in billions of dinars | 1,201 | 1,368 | 1,321 | 1,381 | 1,466 |
| Net credit of the National Bank to the Budget of the Federation; in billions of dinars | 68.7 | 77.9 | 76.4 | 77.4 | 77.9 |
| Cumulative change in net convertible foreign assets of the National Bank; in millions of U.S. dollars 3/ | ... | -972 | -900 | -500 | -- |
| Convertible currency debt outstanding; in billions of U.S. dollars 4/ | 12.3 | 13.1 | 13.6 | 14.2 | 14.7 |

Source: Data supplied by the Yugoslav authorities.

1/ Quantitative performance criteria for 1981 to be determined at the time of the mid-term review.
2/ As additional purchases from the Fund cannot be made before November 15, 1980 when data relating to performance criteria for September 30, 1980 should be available, the latter is effectively the trigger date.
3/ Net of exceptional borrowing by commercial banks.
4/ Debt outstanding in convertible currency with original maturities of more than one year. Excluding outstanding purchases from the Fund and increases in exceptional borrowings by the commercial banks in 1980. Valued at exchange rates prevailing on December 31, 1979.

## Table 2. Yugoslavia: Monetary Survey

(In billions of dinars)

| | Actuals | | | | Projections | | |
|---|---|---|---|---|---|---|---|
| | 1979 | | 1980 | | 1980 | | |
| | June | Dec. | March | June | June | Sept. | Dec. |
| Net foreign assets | -66.9 | -112.0 | -143.0 | -209.8 | -137.0 | -133.0 | -137.0 |
| Domestic credit | 1,043.5 | 1,201.3 | 1,261.3 | 1,368.3 | 1,320.3 | 1,380.3 | 1,465.3 |
| Of which: National Bank credit to the Federation | (65.5) | (68.7) | (73.4) | (77.9) | (76.4) | (77.4) | (77.9) |
| Money supply | 334.2 | 386.4 | 400.4 | 411.3 | 418.4 | 413.4 | 470.4 |
| Quasi-money | 514.9 | 585.9 | 598.7 | 700.2 ) | | | |
| | | | | ) | 768.1 | 807.1 | 860.1 |
| Other items, net | 108.7 | 119.2 | 119.2 | 46.7 ) | | | |

(Change in billions of dinars)

| | Actuals | | | Projected | | Actual Percentage Changes | |
|---|---|---|---|---|---|---|---|
| | 1979 | | 1980 | 1980 | | | |
| | 1st half | 2nd half | 1st half | 1st half | 2nd half | Dec. 78 to Dec. 79 | June 79 to June 80 |
| Net foreign assets | -33.5 | -45.1 | -97.8 | -25.0 | -- | -235.3 | -213.6 |
| Domestic credit | 94.5 | 157.8 | 167.0 | 120.0 | 145.0 | 26.7 | 31.1 |
| Of which: National Bank credit to the Federation | (5.0) | (3.5) | (9.2) | (7.7) | (1.5) | (13.6) | (18.9) |
| Money supply | 4.8 | 52.2 | 24.9 | 32.0 | 52.0 | 17.3 | 23.1 |
| Quasi-money | 51.3 | 71.0 ) | | | | | |
| | | ) | 41.8 | 63.0 | 92.0 | 24.4 | 19.8 |
| Other items, net | 5.9 | -10.5 ) | | | | | |

Source: Data supplied by the Yugoslav authorities.

Table 3. Yugoslavia: Actual and Projected Changes in the Monetary Aggregates

(Changes in billions of dinars)

| | 1971 | 1972 | 1973 | 1974 | 1975 | 1976 | 1977 | 1978 | 1979 |
|---|---|---|---|---|---|---|---|---|---|
| Net foreign assets of National Bank | | | | | | | | | |
| Projected | 0.1 | -0.9 | 1.7 | 0.8 | -7.3 | -1.6 | 4.6 | -1.3 | 0.5 |
| Actual | -1.4 | 8.3 | 7.6 | -7.6 | -1.7 | 15.8 | -5.0 | 4.3 | -39.1 |
| More (+), less (-) than projected | -1.5 | +9.2 | +5.9 | -8.4 | +5.6 | +17.4 | -9.6 | +5.6 | -39.6 |
| National Bank credits | | | | | | | | | |
| Projected | 4.5 | 5.8 | 5.9 | 8.3 | 17.1 | 21.2 | 13.1 | 19.8 | 22.0 |
| Actual | 9.1 | 10.2 | 10.8 | 14.9 | 18.1 | 27.0 | 26.4 | 44.5 | 68.3 |
| More (+), less (-) than projected | +4.6 | +4.4 | +4.9 | +6.6 | +1.0 | +6.8 | +13.3 | +24.7 | +46.3 |
| Reserve money issue 1/ | | | | | | | | | |
| Projected | 4.6 | 4.9 | 7.6 | 9.1 | 9.8 | 19.6 | 17.7 | 18.5 | 22.5 |
| Actual | 7.7 | 18.5 | 18.4 | 7.3 | 16.4 | 42.8 | 21.4 | 48.8 | 29.2 |
| More (+), less (-) than projected | +3.1 | +13.6 | +10.8 | -1.8 | +6.6 | +23.2 | +3.7 | +30.3 | +6.7 |
| Money supply 2/ | | | | | | | | | |
| Projected | 5.3 | 5.2 | 9.3 | 19.3 | 26.9 | 24.2 | 34.0 | 47.1 | 58.0 |
| Actual | 5.5 | 18.0 | 22.3 | 21.6 | 34.4 | 76.5 | 42.9 | 72.2 | 55.1 |
| More (+), less (-) than projected | +0.2 | +12.8 | +13.0 | +2.3 | +7.5 | +52.3 | +8.9 | +25.1 | -2.9 |

Source: Data supplied by the Yugoslav authorities.

1/ Consists of changes in net foreign assets of the National Bank plus changes in National Bank credits. This series differs from the IFS concept of reserve money as no account is taken of changes in deposits of the nonbank sector with the National Bank.
2/ M1. National Bank definition, defined as currency in circulation, demand deposits of the Federal Government and private sector, and "float."

MEMORANDUM FOR THE FILES

September 17, 1980

Subject: Yugoslavia

I spoke with Mr. Chopra, Chief of the Bank division that includes Yugoslavia, regarding the possible inclusion of a Bank man on the expected mission to Yugoslavia in late October. He said that in principle he would be very happy to have one of his staff take part. At the moment leave and work commitments make it difficult for him to say whether someone could come and who it would be. We agreed to keep in touch.

In the context of Yugoslavia's foreign borrowing, Mr. Chopra said that a co-financing loan totaling $110 million, headed by Swiss banks, was going ahead very well and should be finalized shortly.

GT

Geoffrey Tyler

cc: Mr. Whittome
Mr. Manison

decentralization but did not get full control of policies

## YUGOSLAVIA

1-3.7 bn in 80

1.5 in 81

Brief for Managing Director's Lunch With Executive Directors

The Yugoslav authorities have given top priority to halving the current account deficit to US$2.0-2.5 million in 1980 or from 6 per cent of GSP in 1979 to 4 per cent. Reflecting a deliberately engineered slowdown in the growth of the economy (growth rate of industrial production halved to 4.5 per cent in the first part of 1980) developments in the external trade account in the first six months of 1980 showed a marked improvement; compared with the first half of 1979, exports volume rose by 12 per cent while imports volume fell at a similar rate. The trade deficit of US$3.25 billion was less than half that planned for the full year. Receipts from tourism have risen appreciably with reports suggesting an increase of 50 per cent. In view of these developments, the current account deficit in 1980 should be below US$2.5 million which the Yugoslav authorities in their letter of intent stated would be the maximum permissible level. So far in 1980, medium- and long-term borrowing has been slower than planned, for at least partly explainable reasons, and hence temporarily more reliance has been placed on short-term borrowing.

Prices have risen at a considerably faster rate than planned and are now about 30 per cent higher than a year earlier. The implicit GSP deflator is likely to rise by about 25 per cent in 1980, compared with the planned increase of 17 per cent under the stand-by program and 20 per cent in 1979. In May 1980, net personal incomes per worker were 17 per cent above a year earlier implying a fall in real earnings of about 8 per cent over this period.

In the first five months of 1980, domestic bank credit expanded at an annual rate of over 24 per cent which compares with a planned rate of 20 per cent over the first half of 1980. With net foreign assets falling by a greater amount than expected, the increase in the money was approximately in line with the planned annual growth rate of 22 per cent.

Data on developments in the public sector in 1980 are very limited, but National Bank lending to the Federation is in line with the 1980 Plan.

Discussion of performance under the existing stand-by program and preliminary talks on its replacement by another arrangement will take place during the course of the Annual Meeting.

Debt $15 bn (all) 21% debt service

Ex Rate June 30% dep

X Bank problem

September 1980

# *Office Memorandum*

TO : Mr. Whittome | DATE: August 7, 1980

FROM : Geoffrey Tyler GT

SUBJECT : Yugoslavia--Performance under Stand-By Arrangement

The attached memorandum by Mr. Mountford summarizes performance up to June 30, 1980. The latter date is a trigger date in respect of purchases made up until the September 30, 1980 data apply. However, the earliest date for the next purchase is November 15, 1980, by which time the September 30, 1980 data will be applicable for the performance criteria. Thus, the breach of the June 30 criteria is not important as long as those for September 30 are observed.

My personal view is that the balance of payments performance on current account is quite satisfactory and the combination of foreign debt/reserves movement would be acceptable. Domestically it is probably understandable that credit is expanding a little further than planned. Inflation is worse than was allowed for in the credit ceilings and this may necessitate a little more credit. However, the failure to moderate the inflation is somewhat discouraging, especially as the large depreciation in early June 1980 cannot have worked its way through the domestic price structure by end-June.

cc: GT

Attachment

cc: Mr. Mountford

I think we ought to be and remain concerned. If the end June figures in fact provide the starting base for the programmed increase in the following quarter then if the June base is higher than had been expected but the increase is in line with what was agreed I would see no great difficulty in approving the end-Sept 'excess'. But if it is more other questions arise.

There is little doubt that some observers feel that we have repeated last years mistake & agreed to a program that will not produce the desired results. Therefore our need for concern.

WBD 7/8

GT- I think we ought to be and remain concerned. If the end-June figures in fact provide the starting base for the programmed increase in the following quarter then if the June base is higher than had been expected but the increase is in line with what was agreed I would see no great difficulty in approving the end-Sept. "excess". But if it is more other questions arise. There is little doubt that some observers feel that we have repeated last year's mistake and agreed to a program that will not produce the desired

# *Office Memorandum*

TO : Mr. Tyler

FROM : A. Mountford AM

DATE: August 7, 1980

SUBJECT : Yugoslavia--Monthly Report from the Authorities

The telexes received from the National Bank of Yugoslavia on August 4 and 6, allow a preliminary assessment of Yugoslavia's progress under the present stand-by arrangement.

In terms of overall economic performance, the information confirms what we have suspected from other partial indicators. Activity is slowing down sharply, with industrial production rising only 4.5 per cent in the first half of 1980, compared to the first half of 1970. The trade account is rather better than forecast (a half year trade deficit of US$3,254 million, less than half the forecast for the year as a whole). Prices are rising faster than intended, with increases in industrial producer prices of 21.7 per cent and retail prices of 26.6 per cent (averages from Janaury-June 1979 to January-June 1980).

The performance under the quantified performance criteria is as follows:

a. Credit ceilings

At end-May (latest data available), the domestic credit figure was Din 1,322.4 million, slightly higher than the end-June ceiling. There is, therefore, a strong chance that the June ceiling will be exceeded; this is not a trigger clause, but there may later be difficulties with the September ceiling. As for the subceiling on National Bank lending to the Federation, the end-May figure was Din 75.7 billion, compared to the end-June ceiling of Din 76.4 billion. This might also be a close call.

b. Foreign debt ceiling

At end-June the level of debt, as defined for purposes of the stand-by arrangement, was US$13,100 million, compared to the ceiling of US$13,600 million.

c. Balance of payments test

This test is defined in terms of maximum decline in the net convertible foreign assets of the National Bank of Yugoslavia, less exceptional financing from the level at end-1979 and adjusted for the net use of Fund resources: this decline should be no more than US$900 million by end-June, no more than US$500 million by September 30, 1980, and there should be no decline by December 30, 1980. By June 30, 1980, the decline from end-December was US$972 million: in other words the June test was exceeded by US$72 million: one should, however, be cautious in interpreting these figures, as the figure for exceptional financing is probably only an initial estimate. Moreover, medium- and long-term foreign borrowing was slow in the first half but should presumably pick up in the second half. On the basis of the data for end-June, there will have to be a gain in net reserves (less exceptional financing) of US$472 million by the end of September. There will be no purchase from the Fund in this period.

August 4, 1980

MEMORANDUM FOR FILES

Subject: Yugoslavia

Mr. Palmer said that he would make Mr. Loser available for the prospective mission to Yugoslavia. I informed him that the exact timing in October-November was as yet uncertain and that there might well be two visits in the fourth quarter. Definite decisions would probably not be taken until the time of the Annual Meeting.

A. Pfeifer

cc: Mr. Tyler

CONFIDENTIAL

MEMORANDUM FOR FILES July 15, 1980

Subject: Yugoslavia

Governor Bogoev called this afternoon. He talked primarily about the borrowing program which they were seeking to put in place. He said that they were looking for $2.5 billion per annum over three years which he reckoned would be sufficient to cover debt repayments and provide for some reconstitution of reserves.

He said that to date agreements had been reached with a number of OPEC countries. Kuwait had promised $250 million, the UAE $150 million and Iraq a minimum of $100 million. Each of these sums would be an annual amount payable in each of the next three years. In addition Libya had promised $75 million per year for two years. In Europe talks were well under way and the Italians had promised $200 million per annum for three years and the French were expected to agree to a similar sum. The Austrians, the British and the Swiss were each expected to provide $100 million per annum for three years. Bogoev went on to say that they had approached the Germans and had asked for $750 million per annum for three years and had carried forward discussions with the Americans asking for $500 million per annum for three years.

Governor Bogoev said that the program was going through as expected although prices were rising more strongly than he had hoped. He personally was very confident that they would achieve the targets which they had set themselves. In addition he said that there was a general realization that growth would have to be more restrained in future and the next five year plan would talk in terms of a rate of growth of GSP of not more than 4 per cent. He said general financial restraint would be accompanied by structural changes concentrating on the supply side and in particular on energy. He emphasized that they were intent on changing the present psychology which expected inflation and thus continuing depreciation.

In a meeting with the Managing Director the Yugoslavs talked in similar terms though they gave no details of their intended borrowing. Mr. Kostic talked at some length about the structural changes being needed to be made in order to stabilize the balance of payments position and set the scene for future growth.

The Managing Director applauded the emphasis being given to the supply side and said that the Fund was ready to assist the sort of program that the Yugoslavs had in mind.

In further conversations with Bogoev I said that we remained ready to cancel the present stand-by and replace it with one which would include the fourth credit tranche and associated SFF borrowing plus some special use of the SFF. I said that there would be no difficulty in a special use of SFF amounting to SDR 250 million and that we could go further than this if there were to be an obvious need. We agreed that this matter should be discussed further at the Annual Meeting. I further said to the Governor that on this occasion it would be important for us to hold discussions in Belgrade before the Government was committed to a program which it had begun to agree with the Republics. To this end I thought that a staff visit should be thought of for early October. After the end of this visit the Government would go ahead agreeing the program and a formal mission would take place probably around late November in order to agree a stand-by on the lines of the Government program which by then would have been adopted. Governor Bogoev said that he thought this was a fair way of approaching the matter.

L.A. Whittome

cc: EED

Office Memorandum

CONFIDENTIAL

TO : The Managing Director

DATE: July 15, 1980

FROM : L.A. Whittome /LAW/

SUBJECT : Visit of Yugoslavs

I have just seen Governor Bogoev who has told me that he definitely intends to make another approach to the Fund in the last quarter of this year. He wished to discuss what special "use" of the SFF might be made without giving rise to any unfavorable comment. I suggested that the special use of the SFF of SDR 250 million would be a fair figure to have in mind. This figure is to be seen against the present quota of SDR 277 million and the assumption that the stand-by to be negotiated will of course cover all four credit tranches plus full associated use of SFF. On this figuring a special use of SFF of SDR 255 million will bring the total use of SFF to about 200 per cent of quota. I have told Governor Bogoev privately that we would most probably be able to increase this figure if the Yugoslav needs made this appropriate. If you have any particular views on this matter you might wish to draw Governor Bogoev aside. I have some suspicion that Minister Kostic is not fully aware of these conversations.

You may also wish to know that the Yugoslavs have agreed with certain OPEC countries for loans of approximately $500 million per year over three years and with certain European countries for loans of $600 million per year for three years. They hope to obtain at least $500 million from the U.S. market and $750 million from the German market. Even if all these loans come through they will be short of their target which is for a minimum of $2.5 billion per year for three years.

cd
dm
3 yrs
quite

cc: Deputy Managing Director
Mr. Watson

num (?) reasons
(i) to contain rise in prices, wages & salaries to prevent infl entry into gain of demand
(ii) use (?) & intelligence to control [illegible] exp
(iii) support to X oriented branches & infrast sub of energy
ret in process struct changes [illegible] which are inevitable

B prog to stab bof p & re-est [illegible].

Cc: [illegible]

JUN 1 1 1980

Gentlemen:

I am enclosing herewith the text of the stand-by arrangement for Yugoslavia approved by the Executive Board on June 6, 1980.

Sincerely yours,

Anne Marie Al-Samarrie
Senior Operations Officer
Operations Division
for General Resources

Enclosure

Banque Nationale de Yougoslavie
Siege Central
P.O. Box 1010
Belgrade, Yugoslavia

CC: MR.RUDING
EUR
TRE

/kel
June 10, 1980

YUGOSLAVIA

CONFIDENTIAL

June 10, 1980

MEMORANDUM FOR FILES

Subject: Eastern Europe

When Mr. Whittome called from Basel yesterday he mentioned that:

1. Mr. Bogoev had told him there was a fifty-fifty chance that Yugoslavia would seek further Fund help in October and Mr. Whittome had replied that we should discuss the matter further at the Annual Meeting.

2. He had, through the Hungarians, met the Poles and it was clear that he must pay a visit to both countries in the fourth quarter. He asked me to warn Mr. Tyler that he would in due course need to be briefed.

Brian Rose BR

cc: Mr. Tyler

May 21, 1980

MEMORANDUM FOR FILES

Subject: Yugoslavia

During his discussions with Mr. Mountford, Governor Bogoev said that he fully accepted the need for a mission later in the year and also referred to the discussion he had with Mr. Whittome in Hamburg. If the possibility discussed then, that is, the cancellation of the existing stand-by and the formulation of a larger one, could be considered, and it could be done during the mission, which could be in October.

Governor Bogoev also told Mr. Mountford that the Government was about to announce additional economic measures. He was not free to give details but promised to inform us when the measures were announced.

G Tyler

Geoffrey Tyler

cc: Mr. Whittome

May 21, 1980

MEMORANDUM FOR FILES

Subject: Yugoslavia--CFF

Commodities Division has now calculated the shortfall for 1979 on the basis of the data telexed from Belgrade by Mr. Mountford. They confirm that the actual shortfall exceeds the amount purchased earlier this year. Mr. Kabni says that he will delay informing the Board that the purchase was justified on the basis of actual data until after Mr. Mountford's return in order to be able to confirm from Mr. Mountford his understanding of the figures.

GT

Geoffrey Tyler

cc: Mr. Whittome

cc: GT

Presumably there is now no longer a need for you & Sandy to visit Belgrade?

21/5

L.A.W.

No. which will make Sandy's visit to Vienna less rushed

GT 5/22

May 12, 1980

MEMORANDUM FOR FILES

Subject: Yugoslavia--Stand-By Arrangement

Now that the Managing Director and the Deputy Managing Director have agreed with the draft letter discussed in Belgrade, I have sent a telex to Governor Bogoev informing him of Management's decision. I have also spoken to Mrs. Hofmann to give her the information. She informs me that the draft letter we agreed in Belgrade has already been sent to the Government for approval. Belgrade will inform us as soon as they receive formal approval and will also tell us when the letter has been signed and by whom.

Geoffrey Tyler

cc: Mr. Whittome
Mr. Mountford

# *Office Memorandum*

Discussed with the MD. He agrees to leave "as is." 12/5

cc: Mr. Finch, Mr. Palmer

| | |
|---|---|
| TO : | The Managing Director<br>The Deputy Managing Director |
| FROM : | Geoffrey Tyler |
| SUBJECT : | <u>Yugoslavia--Request for a Stand-By Arrangement</u> |

DATE: May 8, 1980

What is the rationale for the 339? Could we not be more forthcoming in view of the

Messrs. Mountford (EUR), Loser (ETR) and I were in Belgrade from May 5-7, 1980 with Mrs. Pabst (EUR) as secretary, to complete discussions for a stand-by arrangement covering the second and third tranches plus associated use of SFF, equivalent in total to SDR 339 million and covering the period to December 31, 1981. The major elements of the program were agreed during the 1980 Article IV consultation discussions last February/March and reported to you in my memorandum of March 6, 1980. You agreed at that time that we should go ahead. The Governor of the National Bank, Mr. Bogoev, wished to proceed with the request but he had a somewhat difficult task to persuade his colleagues in the Administration, particularly in the Ministry of Finance, and the Government to accept the appearance of Fund conditionality being imposed upon Yugoslavia.

Subsequent to the earlier discussions, Mr. Bogoev was successful in persuading the Government to accept the idea of a stand-by arrangement. I would imagine that a not insignificant factor was that the 1979 current account deficit has now been found to have been somewhat worse than preliminary data indicated and official reserves have fallen in the first four months of this year. At the authorities' request we arrived on May 4 to finalize the details of the Letter of Intent agreed in March. The discussions were complicated by the death of President Tito on the day of our arrival, but the National Bank was extremely cooperative in pressing ahead with the meetings (and also in ensuring that the mission was able to retain hotel rooms and depart without problems).

May 9, 80

The basic elements of the program are the following:

(i) a reduction in the current account deficit from US$3.7 billion in 1979 (6 per cent of gross social product) to US$2.5 billion in 1980 (less than 4 per cent of GSP). A further reduction to around US$1.8 billion is tentatively planned for 1981;

(ii) a reduction in the growth of real GSP from 7 per cent in 1979 to 5 per cent in 1980 and probably 4-5 per cent in 1981;

(iii) a reduction in the rate of inflation from 20 per cent in 1979 to 17 per cent in 1980, with a further reduction in 1981. This may be difficult to achieve this year because of the oil price increase; and

(iv) a reduction in real wages in 1980 varying up to around 5 per cent.

The performance criteria enumerated in the attached table comprise:

(i) quarterly ceilings on the net domestic assets of the banking system;

(ii) subceilings on National Bank credit to the federal budget;

(iii) limits on total medium- and long-term foreign borrowing by the total nonbank sector; 277

(iv) minimum quarterly limits on the net convertible foreign assets of the National Bank defined so that the latter cannot be raised by more than specified amounts by borrowing by the commercial banks for balance of payments financing purposes; 200 600 SFF 800

(v) the usual clause on trade and payments restrictions; and

(vi) a mid-term consultation on performance criteria for 1981.

The authorities are convinced that the targets can be achieved and, moreover, they are to give strict priority to the external target. Indeed, the official target for the current account deficit has been retained at US$2 billion (i.e.US$0.5 less than that specified in the stand-by arrangement program). Since the performance criteria on the balance of payments specify all monetary movements and all capital movements except short-term capital inflow, which is normally small, the monitoring of current account performance under the stand-by arrangement is quite strict. In the Letter (and in practice, we were convinced) the authorities emphasize their intention to adjust policies if the external targets are not being realized.

Under the Yugoslav system, the Government can only establish firm quantitative targets on a calendar-year basis. For this reason, there is a performance criterion specifying that no purchases can be made in 1981 until quantified performance can be agreed for that year. A mission will visit Belgrade late in 1980 to discuss 1981 policies and numbers.

The mission believes that the program is reasonable and that the authorities are determined to implement it and we therefore recommend that you support it, the more so as it would mark a reversal of Yugoslavia's unwillingness for almost a decade to face up to the conditionality of Fund lending. Moreover, we believe that the gradual approach to a serious external problem, which it represents, and the fact that an important part of the external solution is based on improved supply in the external sector is in line with the approach to adjustment that you have been advocating--most recently at the Hamburg meeting.

For phasing, we agreed to propose SDR 100 million initially (of which SDR 34.6 million is the first credit tranche SFF equivalent) followed by four quarterly amounts of SDR 50 million in November 1980, February, May, and August 1981 with the final SDR 39 million in November 1981.

If you agree with the attached Letter, which is being cleared with the relevant departments, we shall cable Mr. Bogoev, who expects to then obtain final governmental approval next week. We are under some time pressure since Mr. Ruding wants to have the Board discussions on the stand-by arrangement and the 1980 Article IV consultation before he leaves for Romania in early June. This puts us on a very tight schedule in terms of drafting, clearing, and circulating to the Board the relevant staff papers. However, we should be able to meet the required timetable.

Attachment

cc: Mr. Habermeier
Mr. Whittome
Mr. Finch
Mr. Nicoletopoulos
Mr. Watson

Table . Yugoslavia: Quantitative Performance Criteria in Proposed Stand-By Arrangement

| | 1979 December 31 Actual | 1980 Proposed Ceilings Under Program 1/ June 30 | September 30 | December 31 |
|---|---|---|---|---|
| Net domestic assets of the banking system (In billions of dinars) | 1,201 | 1,321 | 1,381 | 1,466 |
| Net credit of the National Bank to the Budget of the Federation (In billions of dinars) | 68.7 | 76.4 | 77.4 | 77.9 |
| Cumulative change in net convertible foreign assets of the National Bank 2/ (In millions of U.S. dollars) | ... | -900.0 | -500.0 | -- |
| Convertible currency debt outstanding 3/ (In billions of U.S. dollars) | 12.3 | 13.6 | 14.2 | 14.7 |

Source: Data supplied by the Yugoslav authorities.

1/ Quantitative performance criteria for 1981 to be determined at the time of the mid-term review.

2/ Net of exceptional borrowing by commercial banks.

3/ Debt outstanding in convertible currency with original maturities of more than one year. Excluding outstanding purchases from the Fund and increases in exceptional borrowings by the commercial banks in 1980. Valued at exchange rates prevailing on December 31, 1979.

# *Office Memorandum*

TO : The Managing Director
The Deputy Managing Director

DATE: May 8, 1980

FROM : Geoffrey Tyler

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3/ Debt outstanding in convertible currency with original maturities of more than one year. Excluding outstanding purchases from the Fund and increases in exceptional borrowings by the commercial banks in 1980. Valued at exchange rates prevailing on December 31, 1979.

Dear Mr. de Larosiere:

1. The Yugoslav economy is passing through a particularly difficult period. The current account of the balance of payments was in deficit by US$1.3 billion in both 1977 and 1978 and domestic prices were increasing at rates well in excess of 10 per cent. Domestic activity was buoyant, with real gross social product increasing by 7.9 per cent in 1977 and 6.6 per cent in 1978. A relatively rapid rate of growth was considered necessary to prevent a serious problem of unemployment. However, it added to the existing domestic and external pressures. Moreover, as the growth of world economic activity decelerated, various restrictions were placed against important Yugoslav exports in some markets.

2. The Government decided in 1979 that a stabilization effort was required to moderate domestic pressures and to contain the deficit in the current account of the balance of payments to a level that would not require excessive foreign borrowing. Accordingly, the target for the increase in real gross social product was reduced to 6 per cent and the aim was to reduce the general rate of price increase from 15 per cent in 1978 to around 13 per cent in 1979. With regard to the balance of payments, the current account deficit was to be kept to US$1 billion, which would have implied that the debt service ratio for foreign debt in convertible currencies would remain below 20 per cent. These targets were to be achieved by the implementation of an integrated set of domestic and external policies, which included, inter alia, more restrictive credit policies and an exchange rate policy designed to maintain the external competitiveness of our economy. The stabilization program was supported by a stand-by arrangement with the Fund equivalent to SDR 69.125 million agreed to on May 23, 1979, covering the first credit tranche.

3. For several reasons, the course of events in 1979 deviated from the original plan. We probably had underestimated the underlying pressures on the economy that existed at the end of 1978 and which continued in the first part of 1979. As a result, domestic activity in the first half of the year was higher than we intended. Although additional measures were taken that reduced rates of growth in the second half of the year, the increase in real gross social product in 1979 as a whole is estimated to have been 7.1 per cent, some one percentage point above the target. However, there were important factors, all beyond our control, that prevented us from achieving our other goals. Above all, there was the unexpected and large increase in oil prices. Oil prices for Yugoslavia rose on average from US$101 per metric ton in 1978 to US$143 per metric ton in 1979. In addition, natural gas imports increased sharply in 1979, principally in order to fill a newly completed pipeline, while cereal imports increased because of a particularly poor corn harvest in 1978 and a bad wheat crop in 1979. The value of imports of these three commodity groups was almost US$1 billion higher than in 1978. Another major exogenous factor was the earthquake in Montenegro in April 1979, which adversely affected tourism not only in that region but also elsewhere; in addition, it reduced exports and necessitated additional imports for reconstruction. These factors, plus depressed deliveries of ships, a major export item, and a virtual cessation of corn exports because of the disastrous 1978 harvest, meant that the current account deficit rose to US$3.7 billion, leading to a decline of US$1.3 billion in gross convertible international reserves of the banking system to US$2 billion at the end of the year, and substantial net foreign borrowing totaling around US$2.1 billion.

The latter, combined with the rise in interest rates, increased the debt service ratio on debt in convertible currencies (excluding purchases from the Fund) from 16.9 per cent in 1978 to 19.5 per cent in 1979.

4. Domestically, higher import prices were an important factor contributing to a rise in the rate of inflation from some 14 per cent in 1978 (year-on-year average for all domestic expenditure) to almost 21 per cent in 1979, although the rate of increase declined in the second half of the year. It was not possible to prevent the increase in prices being largely reflected in increases in personal income payments per employee, but we believe it is significant that these rose by only about 20 per cent compared with the previous year. In this respect, it appears that workers exercised considerable self-restraint in the self-management agreements on income payments.

5. Although many of the reasons for the adverse developments in 1979 were beyond our control, the Government has to face the fact that the deterioration that occurred in the balance of payments must be reversed in 1980. Yugoslavia has therefore decided that policies this year must bring about a substantial reduction in the current account deficit and thereby limit the growth of external debt. To achieve this and to aid in reducing the rate of inflation, a slower growth of domestic activity will be necessary. Therefore, a major stabilization effort has been introduced and will continue until the necessary corrections in the domestic and external sectors have been made. Given the size of the imbalance in 1979, it will not be possible to achieve all of the needed corrections in 1980 and we realize that the effort must continue in 1981. To support the stabilization program, which is described in detail below in respect of the 1980 period, Yugoslavia is requesting a new stand-by arrangement from the Fund for the period up to December 31, 1981 in a

total amount equivalent to SDR 339.325 million, including the equivalent of SDR 200.825 million from the Supplementary Financing Facility.

6. Although the stabilization program will extend over both 1980 and 1981, we are convinced that substantial progress must be made in 1980 to reduce the current account deficit. We intend to do everything possible to reduce the deficit to US$2.0 billion this year and believe that there is a reasonable chance of achieving this. Such a large and rapid reduction might entail too great a disruption to real growth and employment but we are convinced that the current account deficit must not exceed US$2.5 billion this year with another large reduction in 1981. Thus in 1980, we aim to reduce the deficit by at least US$1.2 billion which would be a reduction of at least one third. As a percentage of gross social product, the current deficit would decline as a minimum from 6 per cent in 1979 to below 4 per cent in 1980. A deficit of this size would entail an amount of foreign borrowing that we consider manageable (see below).

7. A major effort will be required to reduce the deficit to the extent sought, but we believe the needed improvement can be made. While part of it will come from larger net invisible receipts, the major adjustment will be on the trade account, where exports must increase strongly and the growth in imports must be sharply reduced. To achieve these results, the pattern of domestic production and expenditure must change so as to release more production for export and to reduce the import intensiveness of domestic output. Under the Yugoslav system of workers' self-management, all enterprises involved in foreign trade must agree among themselves within the Communities of Interest for Foreign Economic Relations on foreign trade plans that will lead to a viable balance of payments. In 1980, enterprises

are making a major effort to produce more exportable goods and to substitute domestic products for imports wherever possible. They will be aided by the fact that a number of major development projects have recently been finished, which will reduce the demand for imported investment goods. Moreover, these projects will increase export supplies and permit greater import substitution. Throughout the economy, investment proposals are being re-examined to shift the emphasis for the time being toward projects that require few imports and away from import-intensive projects, especially those not directly related to export production or import replacement. Intensified efforts are being made to increase domestic supplies of raw materials, for example, coal and iron ore, and of intermediate products. Inter alia, this should keep the volume of oil imports, excluding amounts needed to fill a new pipeline, at no more than the 1979 level and possibly less.

8. In addition, in 1980 some of the particular trade difficulties of 1979 should not recur. So far, there is every indication that corn exports will revive and imports of wheat should not be needed to the extent experienced in 1979. Because of past orders, deliveries of ships will increase sharply in 1980 and 1981. The planned growth of gross social product is 2 percentage points less than the outcome in 1979, which will slow down import demand. Although overall world export demand may be weak in 1980, the main Yugoslav export markets are expected to be relatively less affected, and demand in them is expected to be around 6 per cent. Moreover, in 1979 we depreciated the dinar in terms of effective exchange rates by about 8 per cent following a depreciation of 9 per cent in the preceding year. We intend to continue with an exchange rate policy that will maintain our competitive position and we expect to regain some of the market shares lost in recent years.

Although its impact in 1980 will be limited, the recently concluded agreement with the European Community should have an increasingly favorable effect on our economic relations with its member countries in the coming years, including 1981. Taking all these factors into account, export volume is forecast to increase by 8 per cent and value by 21 per cent. Import volume should decline by around 9 per cent and the value would increase by some 9 per cent. The forecast turnaround in imports is not out of line with improvements made in previous periods when policies have been directed toward substantial improvement in the external sector. Workers' remittances should benefit from wage increases in Western Europe and tourism should show a recovery from 1979. Taking all the above into account, a current account deficit of US$2 billion in 1980 may be possible and it is our firm intention not to exceed a maximum level of US$2.5 billion.

9. The large deficit in the current account in 1979 necessitated a net increase of foreign borrowing in convertible currencies of US$2 billion and at the end of that year the outstanding level of such debt was US$13.5 billion, of which US$12.8 billion had an original maturity of more than one year. During 1979, there was a refinancing of debt totaling around US$0.8 billion and the conditions attached to the new credits generally provided for grace periods of three years and maturities of the order of 8-10 years. We intend to continue to pay careful attention to the terms of new foreign borrowing so as to avoid sharp peaks in servicing schedules, especially since, partly as a result of the rise in interest rates, the debt service ratio for convertible foreign debt, excluding purchase from the Fund, reached 19.5 per cent in 1979. To prevent a debt service problem from emerging and consistent with the maximum projected current account

deficit for 1980, outstanding foreign debt in convertible currencies with original maturities of more than one year, (excluding purchases from the Fund) which stood at US$12.3 billion at the end of 1979, will not exceed US$14.7 billion by the end of 1980 (based on exchange rates current on December 31, 1979 and excluding net exceptional financing during 1980). To ensure orderly borrowing during the year, quarterly limits on the outstanding amounts have been set as follows: no more than US$13.6 billion on June 30, 1980, US$14.2 billion on September 30, 1980, and US$14.7 billion on December 30, 1980.

10. As mentioned earlier, during 1979 the gross convertible international reserves of the banking system declined and in 1980 they will need to be built up again. It is our intention to increase the gross convertible reserves of the National Bank of Yugoslavia by at least US$0.7 billion during 1980. This will necessitate a continuation of exceptional financing by the commercial banks, which has involved borrowing abroad in convertible currencies to maintain the level of the international reserves. In 1979, such borrowing totaled US$250 million. To ensure an adequate level of liquidity in convertible currencies, the net convertible foreign assets of the National Bank of Yugoslavia less exceptional financing in convertible currencies by the commercial banks, which declined by US$1,702 million in 1979 will show no further decline by the end of 1980. Consistent with this target for end-1980, and allowing for the expected pattern of net foreign borrowing and for the seasonal movements in the current account deficit, targets have been established providing for a decline of no more than US$900 million by June 30, 1980 and no more than US$500 million by September 30, 1980.

11. If the various balance of payments targets are to be achieved, policies must ensure that domestic activity is not too expansionary. To ensure such consistency, it has been decided to reduce the planned increase in real gross social product to 5 per cent in 1980 and to aim for a reduction in the gross social product deflator to 17 per cent compared with 20 per cent in 1979. All categories of domestic demand are planned to show smaller increases in real terms--the growth of personal consumption will decelerate from 5.5 per cent to 3.8 per cent, public consumption from 5.9 per cent to 2.1 per cent, and fixed capital formation from about 8 per cent to 5.8 per cent.

12. The achievement of these targets will require an intensified restraint by all sectors of the economy--the public and enterprise sectors in particular. In this regard, we would point out that self-management agreements covering such factors as prices and personal income payments were implemented in a responsible and effective manner in 1979 and, with increasing experience with the new system, it is expected that it will operate even more effectively in 1980. The Government is convinced that a strong consensus exists in Yugoslavia that all decisions taken in the economic field should reflect the economic aims enunciated in the stabilization program.

13. In some recent years there has been the tendency for public sector consumption to grow more rapidly than social product, and in all years the Federal Government has borrowed from the National Bank of Yugoslavia. The ratio of public sector expenditure to gross social product rose from about 36 per cent in 1973 to about 43 per cent in 1978. In 1979, however, this ratio declined to about 41 per cent. For the federal budget, expenditure in 1979 rose by 25 per cent compared with increases of 29 per cent in

revenue and 28 per cent in nominal gross social product. The deficit declined from Din 5.3 billion in 1978 to Din 3.8 billion in 1979. For the public sector as a whole, there was virtually no deficit in 1979. For 1980, the intention is that the public sector will continue to grow more slowly than social product, although budget expenditure by the Federation will increase by 29 per cent. The deficit of the federal budget will rise to Din 6.2 billion but this is equivalent to only 0.4 per cent of gross social product. Gross borrowing from the National Bank will rise only fractionally (from Din 8.5 billion in 1979 to Din 9.2 billion in 1980), which is much less than the increase in expenditure. Current expenditure by the public sector as a whole is to increase by no more than 16 per cent.

14. Monetary policy is an important part of the stabilization program, since an excess supply of financial assets could weaken the implementation of other elements in the program. In 1978 there was an excessive rate of increase of money supply, which rose by 28 per cent and in 1979 strong steps were taken to decelerate monetary expansion, the target for the increase in money supply in that year being set at 18 per cent. In the first months of the year the demand for credit continued strongly and the National Bank had to take special measures to limit the expansion by imposing strict credit limits on the commercial banks and by reducing demand for consumer credits by raising downpayment provisions. These measures were effective, so much so that some relaxation was necessary in the second half of the year when the loss of liquidity of the commercial banks resulting from the continued external deficit threatened an abrupt decline in enterprise activity. At the end of 1979, money supply was only 17 per cent higher than a year earlier. Also, despite the need to counteract some of the liquidity loss

caused by the external deficit, the rate of domestic credit creation was 27 per cent in 1979 compared with 30 per cent in the previous year.

15. For 1980, we consider that money supply should rise broadly in line with the reduced rate of growth of nominal social product. To that end, and given the planned balance of payments targets, the increase in money supply will be kept to 22 per cent and the increase in net domestic assets of the banking system to 22 per cent. To ensure that money supply does not increase excessively in the first half of the year, thereby prejudicing the whole year result, limits have been set within the year on net domestic assets of the banking system, which totaled Din 1,201 billion on December 31, 1979. They are not to exceed Din 1,321 billion on June 30, 1980, Din 1,381 billion on September 30, 1980, and Din 1,466 billion on December 31, 1980. To ensure that lending by the National Bank of Yugoslavia to the budget of the Federation does not compromise the overall credit program, such net lending in 1980 is not to exceed Din 9.2 billion. As with total domestic credit creation, sublimits have been established within the year. Such credits to the federal budget, which totaled Din 68.7 billion on December 31, 1979, are not to exceed Din 76.4 billion on June 30, 1980, Din 77.4 billion on September 30, 1980, and Din 77.9 billion on December 31, 1980.

16. Detailed quantitative economic targets for 1981, including targets for increases in domestic credit, foreign borrowing and the net foreign assets of the National Bank of Yugoslavia cannot be established at this stage. However, as mentioned above, the Government is determined to continue with the stabilization program next year. Also, it intends to continue to give first priority to a further improvement in the balance of payments. Domestic policies in all fields will be formulated to maintain and if necessary

strengthen the current measures of restraint. On the basis of a preliminary examination of the possible 1981 Plan, domestic activity would grow no faster and perhaps somewhat more slowly than is planned for 1980. Externally, the planned current account deficit of the balance of payments will decline further, perhaps to around US$1.8 billion.

17. The Government of Yugoslavia does not intend to introduce any multiple currency practices or introduce new or intensify existing restrictions on payments and transfers for current international transactions or enter into any bilateral payments arrangements with Fund members; furthermore, the Government of Yugoslavia does not intend to introduce new restrictions or intensify existing restrictions on imports for balance of payments reasons.

18. The Government believes that the policies set forth in this letter are adequate to achieve the objectives of its program, but will take any further measures that may become appropriate for this purpose. The Government of Yugoslavia will consult with the Fund on the adoption of any measures that may become appropriate, in accordance with the policies of the Fund on consultations. Moreover, the Yugoslav authorities will consult with the Fund and reach understandings on quantitative aspects of the program relating to the period of the stand-by arrangement subsequent to December 31, 1980.

Yours sincerely,

cc: Mr. Tyler

May 8, 1980

MEMORANDUM

OK LPB 8/5

To: Mr. Habermeier
Mr. Whittome
Mr. Finch
Mr. Nicoletopoulos

From: Geoffrey Tyler GT

Subject: Yugoslavia--Stand-By Arrangement--Draft Letter of Intent

I attach a copy of the 48-hour report and of the draft Letter agreed with the Yugoslav authorities in respect of a proposed stand-by arrangement covering the second and third credit tranches plus associated use of SFF.

The Letter is virtually identical with that which you commented upon following initial discussions in Belgrade in February/March 1980 and takes account of your suggestions at that time. The quantitative performance numbers, which were blank in the earlier draft, are summarized in the attached table. Paragraph 16 is new and worth noting, since it gives a more specific indication of broad policies for 1981, the period for which quantified performance criteria will be discussed in late 1980 by a review mission.

Since we are under considerable time pressure, I would greatly appreciate receiving your comments by noon on Monday, May 12, 1980.

Attachments

cc: Mr. Mountford
Mr. Loser

ITT World Com

0745 EDT*
440040 FUND UI
12717YU MOSKVA

cc: EED
WED

RECEIVED
I.M.F.

1980 MAY -7 AM 9:09

CABLE
ROOM

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TELEX NO: 440040
WHITTOME
INTERFUND
WASHINGTON, D.C.20413EEE 20431

ORIG: EUR
CC: ETRD

Mrs. Tyler on mission
Called: Mr. Pabst
Being Called: Mrs. Mountford

MOUNTFORD, LOSER AND MYSELF RETURNING THURSDAY MAY 8 VIA NEW YORK AF 001. PABST ARRIVING SATURDAY ON BA 191 FROM LONDON. DISCUSSIONS COMPLETED ON BASIS OF DRAFT LETTER WE BROUGHT WITH US.9

EUR
ETR

ITT World Communications

CC: EED
WED

RECEIVED
I.M.F.

1980 MAY -5 AM 9:50

CABLE
ROOM

412699

ORIG: EUR
CC: ETRD

0942 EDT

440040 FUND UI

12717YU MOSKVA

12717YU MOSKVA

WHITTOME

INTERFUND

WASHINGTON , D.C.

MISSION ARRIVED AND HAD BRIEF MEETING WITH GOVERNOR BOGOEV THIS MORNING BUT NOT POSSIBLE FOR REASONS YOU WILL APPRECIATE TO G BEGIN SUBSTANTIVE DISCUSSIONS. TIMETABLE NOT CERTAIN BUT WE ARE TO MEET AGAIN TOMORROW MORNING. ARRANGING MEETINGS AND ALSO TRANSPORTATION LATE IN WEEK MAY BE DIFFICULT INPRESENT CIRCUMSTANCES: WILL INFORM YOU WHEN OUR SITUATION IS MORE CLEAR.

REGARDS:

TYLER++ Mrs. Tyler - out of the country

Called: Mr. Pabst

12717YU MOSKVA Being Called: Mrs. Mountford

440040 FUND UIT

EUR
ETR


ITT World Communications Inc.

# *Office Memorandum*

TO : Mr. Whittome

FROM : Geoffrey Tyler

SUBJECT : Yugoslavia

DATE: April 30, 1980

Mr. Syvrud, the U.S. Alternate Executive Director, asked me to have an informal discussion in his office with a few people from the U.S. Administration. It took place today, and Mr. Mountford was with me.

We explained to them developments in 1979 and policies and the prospects for 1980 in fairly good detail. However, toward the end of the meeting, the conversation turned more directly to the question of how much borrowing Yugoslavia would need to do in 1980 and what sources it should go to. In particular, we were told that Mr. Kostic had spoken to Mr. Miller asking for support not only with respect to borrowing from U.S. banks but also for direct financial support from the U.S. Government itself. They knew that Yugoslavia had approached the Fund regarding the possible use of Fund resources and knew that we were to go to Belgrade this weekend. I did not, of course, go into details of our early discussions or what might take place next week. I did, however, suggest that it would surely be sensible for Yugoslavia to look to a variety of sources of finance in its present payments difficulites, including the Fund and friendly governments. I pointed out that the external difficulty would surely continue past 1980 and that it would be sensible not to exhaust a single source of finance, e.g., the commercial banks, in any one year and then be forced to ask for much larger amounts from other sources later. I gained the impression that inside the Administration, some see problems in giving direct financial support to Yugoslavia. I could not guess whether they were political or financial. I indicated that any decision by the Board on an approach by Yugoslavia for a stand-by arrangement would be made by the end of May or very early in June.

The Deputy Managing Director April 29, 1980

A. Pfeifer

<u>Travel to Yugoslavia</u>

The Schedule of Official Staff Missions for the period May 1 to October 31, 1980 has not yet been approved. It provides for a mission to Yugoslavia by Messrs. Tyler, Mountford, and Loser, and Mrs. Pabst (Secretary), from May 5 to May 9 to discuss possible use of Fund resources. Could we please have your separate approval so that travel arrangements may be finalized?

April 28, 1980

MEMORANDUM FOR THE FILES

Subject: Yugoslavia and Israel

I told Mr. Tyler of what had passed at Mr. Whittome's lunch with Mr. Bogoev in Hamburg and we agreed that this constituted adequate briefing for the forthcoming mission. I also passed on Mr. Whittome's message about the possibility of a transaction with Israel later this year.

Brian Rose BR

cc: Mr. Tyler

INTERNATIONAL MONETARY FUND
WASHINGTON, D.C. 20431

CABLE ADDRESS
INTERFUND

Hamburg
April 24-25, 1980

Mr. Tyler,

I talked with Mr. Bogoev--Mrs. Hofmann was present as was Mr. Ruding.

He re-emphasized his and the Government's decision to cool the economy. He said that the present growth forecast for 1980 was 4 per cent to 5 per cent. The official current account deficit forecast remained $2 billion but unofficially they expected up to $2.5 billion but were determined that this should be the limit.

They are in the midst of a large borrowing campaign. Here they have met with Miller and Matthoefer and asked for general support. They are approaching U.S. and German banks direct as well as via the euromarkets. They are about to approach some oil exporters. They are seeking $2 billion to $2.5 billion in 1980 and commitments for further large sums in 1981 and 1982.

I said that it appeared to me that various indicators suggested a greater deterioration than was envisaged in March. He agreed and said that they would do more if necessary. I said that we stuck with the agreement reached in March but wanted a firm Government statement that they would do more if necessary. He promised this.

I also took the question of 1981 saying that it was essential that at the very least some definite commitments for 1981 be specified. He agreed.

Lastly I said that if by the end of the year it was apparent that the program was too weak then we should then break the stand-by and replace it with one covering the fourth credit tranche plus SFF (indeed we might then go above the normal limit for the SFF). He took this point on board.

The timetable looks tight. You start on May 5 and presumably can get through in two or three days. Presumably the stand-by paper can be short given the Article IV report. Ruding's last day in Washington is June 6 before leaving for quite a while and he is determined to be at the Board when Yugoslavia is taken. The Yugoslav papers will therefore need to be issued not later than May 23. I also presume that you will need to start in Bucharest around June 9.

Bogoev also raised phasing. I said that phasing was utterly essential but some small front loading should be possible and he should discuss it with you.

L.A. Whittome

cc: Mr. Rose

# Office Memorandum

TO : Mr. Whittome

DATE: April 18, 1980

FROM : A. Mountford AM.

SUBJECT : Yugoslavia--Stand-By Arrangement

The mission in February reached tentative agreement, ad referendum, with Mr. Bogoev on the broad outlines of a program (described below) covering the second and third credit tranches, plus SFF (SDR 339.325 million in total). On his part, Mr. Bogoev then sought the necessary approval in Belgrade to go ahead with negotiating an arrangement: he has telexed that the National Bank is now authorized to negotiate. On our part, the Managing Director has agreed to your suggestion that we should go ahead on the basis described in Mr. Tyler's back-to-office report (attached). You have so informed Mr. Bogoev.

A mission consisting of Messrs. Tyler, Mountford (both EUR), Loser (ETR), and a secretary, will resume talks in Belgrade on May 5. We hope to complete the negotiations in a week.

1. The program

In 1979, real GSP rose 7.1 per cent, the rate of inflation rose to 20 per cent (GSP deflator, annual average) and the current account deficit widened sharply to US$3.4 billion. This caused a large reduction in gross convertible international reserves (including those of commercial banks) by US$1.2 billion to US$2.0 billion (the equivalent of 1.3 months of estimated imports for 1980) at the end of 1979. The official reserves fell to US$1.3 billion.

For 1980, the authorities aim at reducing the GSP growth rate to 5 per cent (or less if necessary) and at a lower rate of inflation (17 per cent for the GSP deflator). They have forecast a very sharp reduction in the current account deficit, to US$2.0 billion. The mission in February doubted the consistency of the current account target with the 5 per cent real growth, and suggested that a somewhat larger current account target would be more likely to be achievable. The mission also indicated that such a target (higher than US$2.0 billion but no more than US$2.5 billion) would probably form an acceptable basis for negotiation of a two-year stand-by arrangement, provided the authorities aimed at a further substantial reduction in the current account deficit in 1981.

The main element in the financial program for 1980, as discussed by the last mission, was a ceiling on DCE of 21.3 per cent, which would limit the increase in money supply to about 22 per cent, the same as the forecast increase in nominal GSP. You will recall that the mission had some doubts (which you shared) about the DCE target, and would have preferred a slightly lower one, but on balance the mission concluded that it was acceptable. More recently, you have expressed the view that it might be desirable to try to reach a separate understanding with the National Bank that the monetary authorities would aim at a lower DCE than expressed in the Letter of Intent. I think there are a number of reasons why we should not try for this: (1) we have already accepted the 22 per cent target, and it would be difficult to go back on that acceptance unless we are prepared to argue that the situation has changed markedly in the meantime; (2) there are already strong domestic pressures on Governor Bogoev to increase the existing published credit ceilings; and (3) the fact that inflation in the first two months of 1980 was apparently much higher than would be implied by the annual target means that the existing ceilings, if they can be enforced, will be more restrictive than we had thought in February.

Apart from the monetary target, the financial program also contains a limit on borrowing by the Federation from the National Bank. In our view, however, the borrowing requirements of the Federation are not of great financial significance. The budget of the Federation is now a small part of the total public sector (20 per cent of total public expenditures in 1978, or 15 per cent excluding grants to the rest of the public sector). The federal deficit was an insignificant Din 3.8 billion in 1979 and will be Din 6.2 billion in 1980 (0.4 per cent of GSP). The deficit of the public sector as a whole, for which we do not have data beyond 1978, was probably less than that of the Federation in 1979. Federal budget borrowing from the National Bank was Din 8.5 billion in 1979, and is budgeted at Din 9.2 billion in 1980. We have been assured that the rest of the public sector does not resort to borrowing from the banking system. I think it is fair to say that the sub-ceiling on borrowing by the Federation has been included mainly for the sake of form, rather than because the mission felt it was essential as a constraint on fiscal policy. We are reasonably satisfied that fiscal policy is not expansionary.

The program will also contain a foreign debt ceiling and a balance of payments test. The mission did not set precise figures for the annual 1980 targets, because it was not yet decided whether the program would be designed to produce a current account deficit of US$2.0 billion or of US$2.5 billion (or some intermediate figure). Since these two tests are mainly intended to ensure that the exchange rate adjusts sufficiently, it is worth bearing in mind that in both 1978 and 1979 there were quite large effective depreciations (about 15 per cent in total), enough to produce a real effective depreciation of about 9 per cent over the two-year period. The rate has continued to move so far in 1980, and we have had ample reasons to believe that the authorities are serious in their stated intention to depreciate enough to maintain competitiveness.

2. Matters still to be negotiated

a. Phasing of drawings in 1980 and 1981. We have been thinking in terms of roughly equal amounts in the two years.

b. Quarterly ceilings on net domestic assets of the banking system for 1980.

c. Quarterly ceilings on net borrowing by the budget of the Federation from the National Bank for 1980.

d. Foreign debt ceiling for 1980, defined in terms of the increase in outstanding foreign debt in convertible currencies with original maturities of more than one year. The mission had discussed the possibility of quarterly ceilings, but after consulting you and ETR we could instead go for half-yearly ceilings (which Mr. Bogoev would prefer).

e. Quarterly balance of payments test for 1980, defined in terms of net convertible foreign assets of the National Bank less exceptional financing in convertible currencies by the commercial banks.

f. Current account target for 1980. It should be more than US$2.0 billion, preferably, but no more than US$2.5 billion.

3. Possible talking points for your meeting with Mr. Bogoev

a. Recent developments

Press reports suggest the following: Prices apparently rose rapidly in January and February, so that the February-79 to February-80 increase in CPI was 27 per cent. The trade deficit apparently widened slightly in the first two months despite a strong export performance (20 per cent increase in volume, and 42 per cent in value, presumably by comparison with a year earlier) and a low increase in imports (stagnation in volume, and a 20 per cent increase in value). One hard fact we have is that the official reserves fell sharply, from SDR 1,014 million at end-December 1979 to SDR 762 million at end-February.

b. OECD review

Per Hedfors called from Paris to say that the Economic Development Review Committee would discuss Yugoslavia. The most interesting point is that the OECD staff believes the US$2.0 billion deficit is achievable, because they are very impressed by Yugoslavia's incomes policies.

c. The program for 1980

Do they share your view that in view of the most recent indicators, the program may need strengthening? Is there in practice any chance for them to tighten the credit ceilings? If not, we are surely bound morally to go ahead on the present basis?

d. 1981

The February mission did not really discuss 1981, because under the Yugoslav system it would be difficult for the authorities to discuss 1981 so much in advance of the preparation of the 1981 Plan. However, as you have mentioned, several weeks have passed since then, and the Executive Directors would be critical of an 18-month program, presented to it in June 1980, that did not include a program for 1981.

Accordingly, it would be helpful if the Yugoslav authorities could discuss the broad macroeconomic and balance of payments magnitudes for 1981 with the mission in May. It would be understood that the negotiation of credit ceilings and other performance criteria would be done later by a review mission.

Attachments

cc: Mr. Rose
Mr. Tyler
Mr. Loser

YS

# Office Memorandum

A. Whittome
Excellent
Thank you
J. 16. Apr. 80

APR 16 1980

TO : The Managing Director

DATE: April 15, 1980

FROM : L.A. Whittome

SUBJECT :

Two points in case you meet with the delegations concerned in Hamburg.

1. Romania. We now have the formal agreement of the Minister to publish an IFS page ~~and~~, we already have most of the data required. We hope to include a Romanian page in the June issue of IFS.

2. Yugoslavia. They have decided to go ahead with a stand-by covering up to the third credit tranche plus SFF. The final discussions will be begun in Belgrade in early May.

cc: Deputy Managing Director

# *Office Memorandum*

TO : Mr. Ruding

DATE: April 11, 1980

FROM : L.A. Whittome

SUBJECT :

I phoned Mr. Bogoev this morning. Next week Yugoslav officials will be largely concerned with pre-Hamburg matters. The following week is taken up by Hamburg and that beginning April 28 contains the May 1 holiday. We shall therefore resume talks in Belgrade during the week beginning May 5.

cc: EED

April 11, 1980

MEMORANDUM FOR FILES

Subject: Yugoslavia

I phoned Governor Bogoev this morning in order to arrange a date for the resumption of talks on the stand-by. He agreed that next week would be difficult given the need of Yugoslav officials to agree their positions for Hamburg; in addition he said that there were a number of national issues that needed to be tidied up.

Looking further ahead the week beginning April 21 was taken up by the Hamburg meetings, that beginning April 28 contained the May 1 holiday so we could not begin work in Belgrade until the week beginning May 5; the precise starting day will be agreed later.

L.A. Whittome

cc: EED

CHECK SERVICE

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# OFFICIAL MESSAGE
# INTERNATIONAL MONETARY FUND
Washington, D.C. 20431

1980 APR 10 AM 8 36

TIME RECEIVED

ADDRESS

Mr. K. Bogoev
National Bank of Yugoslavia
Belgrade
Yugoslavia

Special Instructions

Will telephone you 9.45 a.m. Washington time tomorrow.

Best regards

Whittome

Distribution

cc Mr. Ruding

MESSAGE MUST END HERE

Drafted by: LAWhittome
Department: European
Date: April 10, 1980

L.A. Whittome
NAME (TYPE)

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FOR CABLE ROOM USE ONLY

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Operator: MRA

SEC-17/OCR
9-2-76

# Office Memorandum

TO : Mr. Whittome

FROM : Geoffrey Tyler GT

SUBJECT : Yugoslavia

DATE: April 4, 1980

Stojiljkovic rang me to say that Bogoev has sent Ruding a telex saying that he "expects and hopes" to inform Ruding of the decision on the stand-by in the coming week. Stojiljkovic said that Thursday would probably be the day although it could come earlier. He said in passing that he will be in Belgrade late next week and the following to have discussions with the National Bank.

cc: Mr. Mountford

April 2, 1980

MEMORANDUM FOR FILES

Subject: Israel, Romania, and Yugoslavia--
Conversation With Mr. Ruding

Israel

I explained to Mr. Ruding that Israel had been quite willing to have the Article IV consultation discussions in June, because work on the annual report of the Bank of Israel would be completed and there would be a couple of months experience with respect to the 1980/81 Budget. I continued, however, that June for us would be almost impossible and that I thought we would suggest to the Bank of Israel that the mission take place in the second half of the year. I said that I would be ringing the Bank to inform them of this position.

Romania

Mr. Ruding asked about the timing of the special IFS mission and its possible length. I said that Mr. Nosč and I would be arriving in Bucharest on April 8 and that our aim would be to get rid of the IFS problem for once and for all. I said that for obvious reasons I hoped that a decision could be made quickly, but that events in Bucharest did not always move rapidly.

With respect to the Article IV consultation discussions, I said that we were working on the basis of a mission commencing in June. Mr. Ruding would like to make his annual visit at that time; he was thinking of being there in the week commencing June 9. I said that because of other commitments, it was probably unlikely that we would be at all deeply into our discussion by that time. We agreed that it would still be reasonable for him to visit during the above week on the basis that he would have in any case a clear idea of the potential problem about any use of the Fund resources or about the likely contents of the mission view on Romania's difficulties. (Mr. Ruding is working on the assumption that the Romanians would want to discuss the use of Fund resources.)

He asked about our timing with respect to Board discussion of the CFF request. His own preference would be for May. I said that apart from the IFS question, our desire would be to have any Board discussion as early as possible since undue delay would always risk bringing the economic justification more into doubt.

Yugoslavia

Mr. Ruding outlined what he had told Mr. Whittome earlier today regarding the likely decision to be made by the authorities on a request for a stand-by arrangement. I said that our view was that the sooner we could conclude any further discussions the better. At the same time, there was obviously connection between IFS mission to Romania and the visit to Yugoslavia. I said that I expected it would be possible to coordinate the two.

Geoffrey Tyler

cc: Mr. Whittome

April 2, 1980

MEMORANDUM FOR FILES

Subject: Yugoslavia

Mr. Ruding tells me that the Yugoslavs intend to take a decision on the Fund stand-by by the end of this week. I have warned him of the travel plans of those most concerned but he personally does not think that once a decision is taken there will be any great urgency from their side over the follow-up.

L.A. Whittome

cc: EED

March 12, 1980

MEMORANDUM

To: Mr. Habermeier
Mr. Finch
Mr. Nicoletopoulos

From: L. A. Whittome

Subject: Yugoslavia--Draft Letter of Intent

The Article IV consultation mission that was recently in Yugoslavia also had preliminary discussions about a possible two-year stand-by arrangement in the second and third credit tranches plus associated use of the supplementary financing facility. The mission prepared and left with the Yugoslav authorities a draft letter of intent, a copy of which is attached for your comments. The details of quarterly performance criteria for 1980 are to be negotiated by a mission that may have to leave for Belgrade by Friday, March 21, 1980.

Please direct your comments to Mr. Mountford, room 9-406, by Wednesday, March 19, 1980.

Attachment

CHECK SERVICE

Telex ☒
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Full Rate ☐
Code ☐

# OFFICIAL MESSAGE
# INTERNATIONAL MONETARY FUND
Washington, D.C. 20431

TIME RECEIVED

ADDRESS

Governor Bogoev
National Bank of Yugoslavia
Belgrade, Yugoslavia

Special Instructions

Managing Director is willing to proceed on basis of general approach discussed by Mr. Tyler with you last week, subject to agreement on quarterly ceilings for 1980.

Regards
Whittome
Interfund

Distribution

MESSAGE MUST END HERE

Drafted by: AMountford
Department: European
Date: March 12, 1980

L.A. Whittome
NAME (TYPE)

SIGNATURE

NAME (TYPE)

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Operator: SL

SEC-17/OCR
9-2-76

INTERNATIONAL MONETARY FUND
WASHINGTON, D.C. 20431

CABLE ADDRESS
INTERFUND

CONFIDENTIAL

March 10, 1980

Dear Alan:

Sandy will fill you in with all the details but perhaps I can make a few general and personal observations.

My personal view is that we should be willing to support a stand-by if the Yugoslavs decide to ask for one. It would be a strong forward step in our relations with a country that has both its own importance and some significance of a more general character as an important member of the developing group.

The targets of the program are surely acceptable. They go beyond what the brief specified and we found ourselves in the unusual position of having to restrain the Yugoslavs from including targets that seemed to us to be too stringent. Moreover, the results of the program in the external sector are measurable through the performance criteria dealing with foreign debt and convertible reserves movements.

Will the program succeed? In the case of a Yugoslav stand-by any program will, in my opinion, depend more upon the ability of the central government to impose or mobilize a political willingness on the part of the republics and enterprises to act responsibly. I have become reasonably convinced that the effectiveness of the new self-management machinery is steadily improving. In addition, I have become convinced that there is a recognition of the size of the problem and a political consensus that will permit policies to be followed through and adjusted if necessary. However, I realize that in this kind of area judgments are necessarily subjective and nonquantifiable. However, I would favor quite strongly that the Fund take the risk involved. I think that presentationally the program can be shown as an adequate adjustment.

Will the authorities actually request a stand-by? The National Bank definitely wants to, and one can see why access to more than $400 million might sway them. Both Popovic and Gudac have been much more cautious, and the former made it quite evident in a private discussion that he is against using the Fund. Against this, I have a strong impression that the National Bank's relative strength has increased and Bogoev has been a leading proponent in the Executive Council and the Federal Assembly of a strong domestic and external program. Marjanovic's personal guess was that there was a more than 50 per cent chance of a request being forthcoming.

Finally, I think it would be unfair to hold the apparent failure of the 1979 stand-by against the Yugoslavs. In retrospect they misjudged the position at the end of 1978 as we warned them they might have. But they introduced new policies during the year and in some areas--incomes and fiscal, for example--they made more progress than we had realized.

Sandy knows my views and I am sure will represent them fairly. In passing, I should comment that he carried out the first week of the consultation discussions most competently and has, as previously, been a support to me.

With personal regards.

(GT)

The M.D.
I have no doubt. We should be prepared to enter into a standby covering up to the third credit tranche + S.F.F. (i.e. [illegible] $400 [illegible]
The politics and economics and our general policies all make this advisable. Do you want to discuss it? [illegible]

Mr Whittome

I think we should go forward.

10/3

# Office Memorandum

CONFIDENTIAL

TO : The Managing Director
The Deputy Managing Director

DATE: March 6, 1980

FROM : Geoffrey Tyler

SUBJECT : Yugoslavia--Stand-By Arrangement

cc: ED

The brief for the 1980 Article IV Consultation discussions, on which I have reported to you separately, authorized the mission to discuss with the authorities a possible request for a stand-by arrangement covering the second and third credit tranches and the associated amount available under the Supplementary Financing Facility.

During the Article IV discussions it became evident that a basis did exist for a possible agreement on such a use of Fund resources. In particular, the authorities' policies for 1980 aim at the following targets:

1. A reduction in real growth from 7.1 per cent in 1979 to 5.0 per cent in 1980 with real rates of growth of personal consumption declining from 5.5 per cent to 3.8 per cent, real public consumption from 5.9 per cent to 2.1 per cent and real fixed investment from about 8 per cent to 6 per cent;

2. A reduction in the social product deflator from 22 per cent in 1979 to 17 per cent in 1980; and

3. A reduction in the current account deficit from $3.4 billion (3%) in 1979 to $2.0 billion in 1980. (1.8%)

After carefully examining the targets and associated policies the mission informed the authorities that, in its view, the big reduction planned for the current account deficit, which implies a large shift in the structure of production and resource use to exports and away from imports, would be difficult to achieve. In the context of a possible stand-by arrangement, we said we considered a somewhat more gradual approach with a current account deficit of, say, $2.5 billion in 1980 to be followed by a further reduction in 1981 would have greater internal consistency between the external and domestic targets and be less disruptive in terms of real growth and employment.

Governor Bogoev of the National Bank accepts this view and will approach the Government to see if they believe a program of this modified character would be acceptable. He made it quite plain, however, that it would not be possible at this stage for the Government to reduce the target for real growth from 5 per cent or the associated monetary and credit targets, which limit the increase in money supply to the rate of increase in nominal social product, i.e., an increase of 22 per cent during 1980. However, he was equally firm that the target for the current account balance was paramount and that domestic growth and credit targets would be reduced if this proved necessary. Exchange rate policy continues to depreciate the effective rate and, domestically, incomes and fiscal policies are operating more effectively. The Governor and his colleagues were convincing when they described to the mission the strong political will that exists throughout the economy with respect to achieving the desired external improvement.

The mission drafted a letter of intent for the Governor, which describes policies but which does not contain the detailed numbers for the current account target or for the performance criteria. The latter comprise those specified in the brief, namely:

1. Quarterly ceilings for net domestic assets;

2. Sub-ceilings for credit to the Federal budget;

3. Quarterly ceilings for net foreign borrowing in convertible currency with a maturity of more than one year; and

4. Quarterly balance of payments tests covering the net convertible reserves of the banking system.

The National Bank has undertaken to telex to us during the week beginning March 10, 1980 their proposals for the missing figures. The stand-by arrangement would cover the period until December 31, 1981, but quantification of the period subsequent to December 31, 1980 would need to be decided in the context of a mid-term review.

The National Bank expects to know by mid-March whether the Government will accept the basic approach contained in the draft letter. If it does, and if you are willing to endorse the basic approach, provided it is supported by satisfactory quantification of the quarterly ceilings, then it would be possible for a small mission to be in Belgrade in the last part of March to finalize the letter. Logistically, such a timetable would not present major difficulties in that I shall be returning from a mission to Israel around March 22-24 and could easily be in Belgrade on the way back to Washington.

The members of the mission personally believe that there is a sufficient basis to enable you to support the proposed program, but we realize that our belief is predicated upon several intangible factors such as the ability to effect significant structural changes in the external sector relatively quickly, the willingness of the Government to be flexible in its policies and above all in the willingness of all economic units to accept short-term sacrifices. To this extent, acceptance of the proposal will entail some degree of trust on the Fund's part. On the other hand, the performance criteria on foreign borrowing and the balance of payments test will quickly show whether the program is working or not. We can only repeat that it is not the easiest of programs to judge but on balance we recommend it for your consideration.

Procedurally, we have undertaken to inform Governor Bogoev as soon as possible of your decision on whether to authorize further discussions.

cc: Mr. Whittome ✓
Mr. Finch
Mr. Watson

March 4, 1980

MEMORANDUM FOR FILES

Subject: Yugoslavia--Stand-By Arrangement

Mr. Gudac saw me today prior to leaving for New York to enquire about the status of discussions regarding a possible stand-by arrangement. I told him that we had begun informal talks with the National Bank and that we would probably describe a program that include (a) a rate of growth of 5 per cent; (b) a money supply target of 22 per cent during 1980; and (c) a current account target somewhat greater than the current official one of $2 billion, but which would not, of course, prohibit the authorities from endeavoring to reach a lower one. I said that we would probably furnish a draft letter for illustrative purposes. After that, it would be for the Yugoslav authorities to decide whether they wished to proceed further. In the meantime, on its return to Washington, the mission would ascertain whether a program along the lines discussed would be acceptable to the Managing Director.

On timing, Mr. Gudac thought it would take the authorities from 6-8 weeks to decide whether they wished to proceed and economic developments in that period could influence their thinking.

On a personal basis, Mr. Gudac said that the Ministry of Finance was more cautious than the National Bank in approaching upper tranche use. Partly this was because the Minister was directly involved in the G-77 discussions criticizing Fund conditionality and therefore found it more difficult to envisage an about-face by accepting present conditionality. He said that in contrast the National Bank was more interested in the financial aspects, given their responsibility for maintaining Yugoslavia's international liquidity.

AR. for G.T.

Geoffrey Tyler

cc: Mr. Whittome ✓

March 4, 1980

MEMORANDUM FOR FILES

Subject: Yugoslavia

I spoke to Mr. Tyler in Belgrade this morning. He said that a draft letter of intent had been provided to the Yugoslav authorities. It is largely based on present Yugoslav intentions and objectives. Although no figures had been included those that lay behind the thinking suggested that the current account position over the next 12 months might improve by some $1 billion in comparison with the current account deficit foreseen for 1979 ($3.4 billion). The Yugoslav authorities were intent on achieving a substantially bigger improvement but there were questions regarding the consistency of their aims regarding the external accounts and those regarding the domestic accounts. The Yugoslavs will now consider the position further. Mr. Tyler said that one difficulty was the difference of opinion between the National Bank and the Ministry. It seems that the National Bank were ready to go forward with a Fund operation but that the Ministry, influenced particularly by the leading role it continuously sought to play within the G-24 and G-77 was most reluctant for presentational reasons to be seen to be accepting Fund conditionality. At present it was impossible to say how these differences of view would be resolved.

L.A. Whittome

cc: Managing Director
Deputy Managing Director
EED

P.S. I gave Ruding the gist of this conversation.

Fo

INTERNATIONAL MONETARY FUND

Yugoslavia--Fund Mission in October-November 1980

Preliminary List of Questions

October 3, 1980

PLEASE UPDATE AND REVISE THE ATTACHED TABLES AT THE BACK OF THE QUESTIONNAIRE.

1. Please discuss developments in the major domestic demand components in 1980. What are the preliminary views of the authorities as to the expected growth rates of private consumption, public consumption, and fixed investment in 1980. Please analyze inventory movements by main commodity groups in 1979 and 1980 and expectations for 1981.

2. Please outline developments in aggregate production and its principal components in 1980 and the tentative targets for 1981.

3. Please analyze developments in prices in 1980. Why have prices risen at a faster rate than foreseen at the time of the last Fund mission in May 1980? What is the preliminary thinking of the authorities as to the objectives of price policy for 1981?

4. Please describe trends in personal incomes in 1980. What are present objectives of incomes policy and what specific measures and arrangements have been made to ensure that these objectives will be achieved?

5. Please analyze the developments in the main monetary and credit aggregates (Table 6) in 1980, including an assessment of the factors accounting for the higher-than-programmed rate of credit expansion.

Please comment on the forecasts provided for end-December 1980 for domestic credit and National Bank of Yugoslavia credit to the Federation (Table 6a).

6. Kindly discuss your preliminary thoughts on the targets and objectives of monetary and credit policy for 1981, indicating the key assumptions on which the targets are based.

7. Please provide a written list of the principal monetary credit measures introduced since May 1980, including those affecting credit extended on the basis of foreign exchange deposits.

8. Please analyze developments in revenues, expenditures, and financing of the federal budget in 1980.

9. Please discuss trends in major fiscal aggregates for the public sector in 1979 and 1980. What are your preliminary views on the objectives of fiscal policy in 1981 and on measures that might be taken to achieve them?

10. Please supply a written list of the main fiscal measures introduced since May 1980.

11. Please analyze the significant developments in the current account of the balance of payments in 1980.

12. Please discuss your preliminary forecasts for the current account of the balance of payments for 1981. What are the price assumptions including those for imported oil underlying these forecasts?

13. Kindly discuss the effects of June 1980 devaluation on export performance and prospects, including tourism. What will be the probable objectives of exchange rate policy for 1981?

14. Please comment on significant developments in the external capital account in 1980. To what extent has increased short-term borrowing to date during 1980 been used to offset the shortfall in obtaining longer-term financial credits? What are the prospects for capital inflow from longer-term bank loans during the remainder of 1980? Please provide a detailed account of the status of loan agreements with Western creditor countries giving longer-term financial credits.

15. Please provide an assessment of prospects for long- and short-term external capital movements in 1981.

16. Please describe trends in trade with other socialist countries in 1980 and also capital transactions with these countries. What developments are expected in 1981?

17. Please indicate the tentative plans for increasing external reserves in 1981 and the role expected to be played by foreign borrowing in meeting these plans. Please provide data for 1980 (quarterly) showing the foreign asset position of deposit banks.

18. Please review the present short-term and longer-term foreign debt positions with particular reference to the future debt service.

19. Please describe developments in borrowing by the commercial banks in 1980, including exceptional financing. What are the preliminary expectations for 1981?

20. Please provide a chronological listing of the main changes in trade and exchange regulations since May 1980, including any significant shifts in the allocation of imports between the various categories.

Revision and Updating of Tables

In the attached tables, we would appreciate that the latest revised figures for 1979 be entered. Figures for 1980 should be the latest forecasts or projections based on the most recent development. With respect to forecasts for 1980 we would be grateful if figures could be provided based on the preliminary thinking of the Yugoslav authorities.

Table 1. Yugoslavia: National Accounts, 1/ 1970-80

| | 1979 | 1970-75 | 1976 | 1977 | 1978 | 1979 | 1980 | | 1981 |
|---|---|---|---|---|---|---|---|---|---|
| | In billions of dinars at current prices | Annual average | | | | | Latest forecast | Plan | Preliminary forecast |
| | | Percentage change in constant prices | | | | | | | |
| Private consumption | | 5.5 | 4.4 | 7.0 | 7.0 | | | 3.8 | |
| Public consumption 2/ | | 4.2 | 3.4 | 7.4 | 5.3 | | | 2.1 | |
| Gross fixed capital formation | | 7.2 | 6.2 | 11.1 | 11.2 | | | 5.8 | |
| Increase in stocks 3/ | | ... | (0.6) | (1.0) | (0.7) | | | (0.7) | |
| Gross domestic expenditure | | 5.7 | -0.5 | 12.8 | 5.9 | | | 3.7 | |
| Exports | | 7.3 | 10.6 | -4.4 | 0.4 | | | 6.0 | |
| Imports | | 6.0 | -5.0 | 12.5 | -1.0 | | | -- 4/ | |
| Gross social product | | 5.9 | 3.9 | 7.9 | 6.6 | | | 5.0 | |
| Memorandum item: | | | | | | | | | |
| Gross social product deflator | | ... | 13.4 | 14.8 | 15.2 | | | 16.0 | |

Sources: Resolutions on Realization of Social Plan 1976-80 for 1979 and 1980; and data supplied by the Yugoslav authorities.

1/ Based on material product national income accounting according to Yugoslav methodology, which excludes services rendered to individuals from the gross material product. Gross domestic product is estimated to be about 15 per cent higher than gross material product or gross social product.
2/ Includes material costs of general and collective consumption only.
3/ Includes statistical discrepancy; percentage changes indicate contribution of growth in real gross social product.
4/ The Yugoslav authorities intend to keep growth of imports in line with balance of payments capabilities.

Table 2. Yugoslavia: Oil--Imports, Exports, Domestic Production, and Consumption, 1976-80

(In thousands of tons)

| | 1976 | 1977 | 1978 | 1979 | 1980 Latest Forecast |
|---|---|---|---|---|---|
| Imports | | | | | |
| Crude oil | 8,293 | 9,650 | 10,380 | 11,814 | |
| Refined products | 913 | 1,330 | 1,640 | 1,412 | |
| Exports | | | | | |
| Refined products | 268 | 1,033 | 1,074 | 750 | |
| Total net imports | 8,939 | 9,947 | 10,946 | 12,276 | |
| Domestic production of crude oil | 3,880 | 3,951 | 4,076 | 4,143 | |
| Consumption | 12,819 | 13,898 | 15,022 | 16,419 | |
| Price of imported crude oil 1/ | 12.7 | 13.9 | 13.9 | 23.2 | |

Source: Data supplied by the Yugoslav authorities.

1/ U.S. dollars per barrel.

Table 3. Yugoslavia: Selected Components of Household Income 1/

| | 1976 | 1977 | 1978 | 1979 | 1980 Latest forecast | 1977 | 1978 | 1979 | 1980 Latest forecast |
|---|---|---|---|---|---|---|---|---|---|
| | In billions of dinars | | | | | Annual percentage change | | | |
| Net personal income from socialized sector | 211.6 | 269.1 | 342.8 | 443.5 | | 27.1 | 15.8 | 29.4 | |
| Social security transfers | 52.9 | 64.4 | 82.6 | 109.0 | | 21.7 | 28.3 | 32.0 | |
| Proceeds from sale of agricultural products and cattle | 26.2 | 33.1 | 39.9 | 45.6 | | 26.3 | 20.1 | 14.3 | |
| Net remittances from abroad | 24.1 | 24.3 | 30.8 | 37.6 | | 0.8 | 26.7 | 22.1 | |

Source: Statisticki Bilten.

1/ The data in this table relate to the incomes of household units and hence are not directly comparable with Table 14 where the data are on a "per employee" basis.

Table 4. Yugoslavia: Quarterly Changes in Price Indices

(Percentage change over same quarter of previous year)

| | 1976 | 1977 | 1978 | 1979 | 1980 |
|---|---|---|---|---|---|
| Producers' prices of industrial goods | | | | | |
| I | 9.5 | 7.7 | 9.8 | 9.6 | |
| II | 6.1 | 9.5 | 7.8 | 12.5 | |
| III | 3.9 | 10.3 | 7.6 | 15.2 | |
| IV | 6.8 | 10.0 | 8.4 | 15.1 | |
| Annual quarterly average | 6.6 | 9.4 | 8.9 | 13.1 | |
| Retail prices | | | | | |
| I | 13.1 | 11.1 | 12.5 | 18.2 | |
| II | 10.0 | 13.1 | 13.1 | 21.0 | |
| III | 6.4 | 14.2 | 13.2 | 25.0 | |
| IV | 8.4 | 14.5 | 14.6 | 24.5 | |
| Annual quarterly average | 9.5 | 13.2 | 13.4 | 22.1 | |
| Cost of living | | | | | |
| I | 16.5 | 15.1 | 12.0 | 17.0 | |
| II | 13.2 | 13.6 | 13.4 | 20.1 | |
| III | 7.6 | 15.2 | 14.7 | 22.4 | |
| IV | 8.1 | 14.8 | 15.9 | 22.3 | |
| Annual quarterly average | 11.4 | 14.7 | 14.0 | 20.4 | |

Sources: Indeks; and data supplied by the Yugoslav authorities.

Table 5. Yugoslavia: Annual Changes in Price Indices

(Annual percentage change)

| | 1976 | 1977 | 1978 | 1979 | 1980 1/ |
|---|---|---|---|---|---|
| Producers' prices | | | | | |
| Industrial goods, total | 6.1 | 9.5 | 8.3 | 13.2 | |
| Investment goods | 11.2 | 9.5 | 5.3 | 6.1 | |
| Semifinished goods | 6.1 | 8.8 | 7.9 | 16.0 | |
| Consumption goods | 5.3 | 10.7 | 9.7 | 11.1 | |
| Agricultural goods, total | 14.4 | 12.1 | 11.4 | | |
| Retail prices | | | | | |
| General index | 8.6 | 13.3 | 13.4 | 21.9 | |
| Agricultural goods | 13.2 | 13.6 | 15.4 | 20.4 | |
| Industrial goods | 8.5 | 12.4 | 13.3 | 22.9 | |
| Services | 12.8 | 13.6 | 13.9 | 21.7 | |
| Cost of living | | | | | |
| General index | 11.6 | 15.0 | 14.3 | 20.4 | |
| Food | 13.5 | 19.0 | 15.2 | 18.3 | |
| Clothing | 11.1 | 11.1 | 16.8 | 20.7 | |
| Rent | 11.3 | 12.4 | 14.5 | 18.4 | |
| Services 2/ | 12.8 | 13.6 | 14.5 | 26.4 | |
| Export prices 3/ | 4.0 | 13.0 | 9.0 | 15.0 | |
| Import prices 3/ | 3.0 | 14.0 | 5.0 | 19.0 | |

Sources: Indeks; and data supplied by the Yugoslav authorities.

1/ Latest period of 1980 for which data are available compared with corresponding period of 1979

2/ Exclusive of rent.

3/ Unit values of goods in dinars.

Table 6. Yugoslavia: Monetary Survey 1/

(In billions of dinars)

| | 1977 | 1978 | 1979 | 1980 | | | | 1978 | 1979 | 1980 | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | I | II | III | IV Forecast | | | I | II | III | IV Forecast |
| | Level at end of period | | | | | | | Changes during period | | | | | |
| Net foreign assets | -14.0 | -33.4 | -112.0 | | | | | -19.4 | -78.6 | | | | |
| Domestic credit | 731.9 | 948.0 | 201.3 | | | | | 216.1 | 253.3 | | | | |
| Short-term | 155.5 | 193.0 | 246.6 | | | | | 37.5 | 53.6 | | | | |
| Long-term | 514.5 | 637.8 | 787.4 | | | | | 123.3 | 149.6 | | | | |
| Other 2/ | 61.9 | 117.2 | 167.3 | | | | | 55.3 | 50.1 | | | | |
| Money supply 3/ | 257.2 | 329.4 | 386.4 | | | | | 72.2 | 57.0 | | | | |
| Quasi-money 4/ | 326.7 | 436.1 | 560.2 | | | | | 109.4 | 124.1 | | | | |
| Of which: | | | | | | | | | | | | | |
| Foreign exchange deposits | 99.5 | 155.3 | 200.2 | | | | | 55.8 | 44.9 | | | | |
| Other, net | 134.0 | 149.1 | 142.7 | | | | | 15.1 | -6.4 | | | | |

Source: Social Accounting Service of Yugoslavia, Statistical Bulletin, various issues.

1/ Derived from the balance sheet for all banks.
2/ Includes foreign exchange claims on domestic clients, and investments in short-term and long-term securities.
3/ National Bank definition of money supply.
4/ Comprises foreign exchange deposits of residents, other sight deposits, time deposits, restricted deposits, securities issued by banks, and claims on banks in respect of pooled resources.

Table 6a. Yugoslavia: Quantitative Performance Criteria in Stand-By Arrangement 1/

| | 1979 December 31 Actual | 1980 June 30 Actual | 1980 Sept. 30 Actual | 1980 Dec. 31 Forecast | 1980 Ceiling Under Program: June 30 | September 30 2/ | December 31 |
|---|---|---|---|---|---|---|---|
| Net domestic assets of the banking system; in billions of dinars | 1,201 | 1,368 | 1,400 | | 1,321 | 1,381 | 1,466 |
| Net credit of the National Bank to the Budget of the Federation; in billions of dinars | 68.7 | 77.9 | | | 76.4 | 77.4 | 77.9 |
| Cumulative change in net convertible foreign assets of the National Bank; in millions of U.S. dollars 3/ | ... | -972 | | | -900 | -500 | -- |
| Convertible currency debt outstanding; in billions of U.S. dollars 4/ | 12.3 | 13.1 | | | 13.6 | 14.2 | 14.7 |

Source: Data supplied by the Yugoslav authorities.

1/ Quantitative performance criteria for 1981 to be determined at the time of the mid-term review.
2/ As additional purchases from the Fund cannot be made before November 15, 1980 when data relating to performance criteria for September 30, 1980 should be available, the latter is effectively the trigger date.
3/ Net of exceptional borrowing by commercial banks.
4/ Debt outstanding in convertible currency with original maturities of more than one year. Excluding outstanding purchases from the Fund and increases in exceptional borrowings by the commercial banks in 1980. Valued at exchange rates prevailing on December 31, 1979.

Table 7. Yugoslavia: Money Supply, 1/ Distribution by Sector

(End of period)

| | 1970 | 1975 | 1978 | 1979 | 1980 Sept. | 1970–75 | 1976 | 1977 | 1978 | 1979 | 1980 Sept. 1/ |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Percentage of total | | | | | Annual percentage change | | | | | |
| Total money supply 1/ | 100.0 | 100.0 | 100.0 | 100.0 | | 30.1 | 55.5 | 20.0 | 28.1 | 17.3 | |
| Socialist enterprises | 20.0 | 33.5 | 42.6 | 41.2 | | 44.3 | 109.9 | 23.3 | 17.2 | 13.6 | |
| Federal Government | 3.5 | 1.8 | 1.9 | 2.3 | | 14.0 | 8.0 | 44.4 | 64.1 | 40.6 | |
| Other sociopolitical communities | 9.2 | 8.1 | 8.2 | 9.0 | | 26.9 | 33.9 | 8.7 | 66.3 | 27.7 | |
| Social funds | 1.1 | 2.4 | 1.2 | 1.5 | | 53.0 | 18.2 | -10.3 | 11.4 | 46.2 | |
| Other organizations | 18.1 | 17.3 | 17.1 | 17.4 | | 28.6 | 51.7 | 28.3 | 21.6 | 19.7 | |
| Households | 41.6 | 31.4 | 24.6 | 25.6 | | 22.9 | 19.5 | 18.7 | 32.6 | 22.1 | |
| Rest of the world | 0.3 | 0.3 | 0.1 | 0.1 | | 32.0 | -25.0 | 66.7 | -- | -- | |
| Float | 6.2 | 5.2 | 4.3 | 2.9 | | 25.2 | 11.3 | -22.8 | 131.1 | -20.6 | |

Source: National Bank of Yugoslavia, Quarterly Bulletin.

1/ Compared with September 1979.
2/ M1. National Bank definition.

Table 8. Yugoslavia: Distribution of Bank Credit by Sector

| | 1975 | 1978 | 1979 | 1980 Sept. | 1976 | 1977 | 1978 | 1979 | 1980 1/ Sept. |
|---|---|---|---|---|---|---|---|---|---|
| | Percentage of total at end of period | | | | Percentage change during period | | | | |
| Short-term | 23.6 | 21.9 | 22.1 | | 24.7 | 17.9 | 23.7 | 27.5 | |
| Long-term | 76.4 | 78.1 | 77.9 | ___ | 26.4 | 24.4 | 27.2 | 25.8 | ___ |
| Total | 100.0 | 100.0 | 100.0 | | 26.0 | 22.9 | 26.4 | 26.2 | |
| Socialist enterprises | 77.6 | 77.3 | 78.0 | | 25.6 | 21.6 | 27.4 | 27.5 | |
| Federal Government | 9.3 | 7.3 | 6.5 | | 15.6 | 24.4 | 7.7 | 12.5 | |
| Other sociopolitical communities and social funds | 3.0 | 1.9 | 1.8 | | 5.8 | 6.2 | 11.7 | 14.0 | |
| Other organizations | 2.3 | 3.3 | 3.2 | | 49.5 | 48.7 | 26.6 | 22.4 | |
| Households | 7.8 | 10.2 | 10.5 | | 43.1 | 28.9 | 38.7 | 29.7 | |

Source: National Bank of Yugoslavia, Quarterly Bulletin.

1/ Compared with September 1979.

Table 9. Yugoslavia: Budget of the Federation

(In millions of dinars)

| | 1975 | 1976 | 1977 | 1978 | 1979 | 1980 Original plan | 1980 Latest forecast |
|---|---|---|---|---|---|---|---|
| Revenue | | | | | | | |
| Customs duties and other import fees | 25,386 | 30,071 | 39,755 | 23,333 | 23,765 | 30,591.0 | |
| Contributions from republics and provinces | 27,701 | 33,374 | 38,996 | 20,827 | 28,436 | 36,914.5 | |
| General turnover and sales taxes | -- | -- | -- | 26,273 | 38,510 | 48,859.0 | |
| Exchange profits | 1,668 | 76 | 80 | -- | -- | -- | |
| Other taxes | 113 | 86 | 96 | 121 | 164 | 154.7 | |
| Nontax revenues | 961 | 1,271 | 1,085 | 2,047 | 2,689 | 2,568.4 | |
| Total revenue | 55,829 | 64,878 | 80,012 | 72,601 | 93,564 | 119,087.6 | |
| Expenditure | | | | | | | |
| Administration | 6,090 | 8,662 | 10,908 | 13,066 | 15,325 | 17,491.0 | |
| Defense | 28,465 | 32,587 | 38,131 | 42,595 | 55,051 | 73,597.8 | |
| Grants to republics and provinces | 4,554 | 5,448 | 6,139 | 7,028 | 10,502 | 13,833.9 | |
| Grants to funds and communities of interest | 6,151 | 9,548 | 10,410 | 12,441 | 14,794 | 18,519.2 | |
| Intervention in the economy | 13,024 | 17,714 | 22,257 | 1,415 | -- | -- | |
| Foreign trade | (9,743) | (13,271) | (19,809) | (1,277) | (--) | (--) | |
| Agriculture | (3,281) | (4,443) | (2,448) | (138) | (--) | (--) | |
| Investment | 556 | 734 | 547 | 551 | 654 | 765.2 | |
| Other or discrepancy | 708 | 847 | 590 | 790 | 1,054 | 1,121.9 | |
| Total expenditure | 59,548 | 75,540 | 88,982 | 77,886 | 97,380 | 125,329.0 | |
| Surplus or deficit | -3,719 | -10,662 | -8,970 | -5,285 | -3,816 | -6,241.4 | |
| Financing, net domestic 1/ | 3,719 | 10,662 | 8,970 | 5,285 | 3,816 | 6,241.4 | |
| Bond issues | 3,608 | 6,805 | 3,980 | -- | -- | -- | |
| Bank credits, net 2/ | 10,100 | 5,800 | 13,000 | ... | ... | ... | |
| Of which: National Bank | (8,400) | (7,900) | (11,200) | (9,487) | (8,451) | (9,200.0) | |
| Repayment of bank credits 2/ | -176 | -1,145 | -562 | -847 | -1,614 | -1,373.1 | |
| Bond amortization | ... | -1,492 | -3,621 | -3,055 | -2,857 | -1,349.8 | |
| Allocation to budgetary reserves | -220 | -247 | -284 | -300 | -164 | -235.7 | |
| Additions to deposits and cash balances | -1,900 | 1,400 | -1,700 | -- | -- | -- | |
| Other or residual | -7,869 3/ | -1,604 | -2,405 | -- | -- | -- | |

Sources: Data supplied by the Yugoslav authorities; budget documents published in Sluzbeni List; and National Bank of Yugoslavia, Annual Report, 1977 and Quarterly Bulletins.

1/ Foreign loans are no longer used to finance the federal budget deficit. Repayment of most previously constracted foreign loans is now the responsibility of the organizations of associated labor, which were the actual beneficiaries of the loans.
2/ For 1975, 1976, and the 1977 outturns, data on repayment of bank credits are included in net bank credits. The revised Plan for 1978 and the Plan for 1979 do not include data on repayment of bank credits in net bank credits.
3/ It is likely that this residual is primarily accounted for by bond amortization, but data are not available.

Table 10. Yugoslavia: Public Sector Operations by Level of Government

(In billions of dinars)

| | 1975 | 1976 | 1977 | 1978 | 1979 1/ |
|---|---|---|---|---|---|
| Federal budget | | | | | |
| Revenues | 55.8 | 64.9 | 80.0 | 72.6 | |
| Expenditures | 59.5 | 75.5 | 89.0 | 77.8 | |
| Of which: | | | | | |
| Transfers to other budgets | (4.6) | (5.4) | (6.1) | (7.0) | |
| Transfers to funds and communities of interest | (6.2) | (9.6) | (10.4) | (13.8) | |
| Surplus or deficit | -3.7 | -10.6 | -9.0 | -5.2 | |
| Budgets of republics and autonomous provinces | | | | | |
| Revenues | 18.2 | 21.0 | 25.5 | 37.5 | |
| Of which: | | | | | |
| Grants from other governmental units | (4.9) | (5.2) | (6.1) | (7.0) | |
| Expenditures | 18.9 | 21.9 | 25.3 | 37.1 | |
| Of which: | | | | | |
| Transfers to other governmental units 2/ | (2.1) | (1.7) | (2.5) | (3.0) | |
| Surplus or deficit | -0.7 | -0.9 | 0.2 | 0.4 | |
| Budgets of communes and cities | | | | | |
| Revenues | 18.2 | 20.2 | 22.7 | 30.9 | |
| Of which: | | | | | |
| Grants from other governmental units | (2.0) | (1.7) | (--) | (3.0) | |
| Expenditures | 18.2 | 20.5 | 26.8 | 31.5 | |
| Of which: | | | | | |
| Transfers to other governmental units | (0.6) | (0.3) | (--) | (--) | |
| Surplus or deficit | -- | -0.3 | -4.1 | -0.6 | |
| Social security funds 3/ | | | | | |
| Revenues | 66.8 | 85.2 | 105.8 | 135.8 | |
| Of which: | | | | | |
| Grants from federal budget | (5.5) | (7.8) | (7.1) | (12.4) | |
| Grants from other budgets | (--) | (--) | (2.5) | (--) | |
| Expenditures | 69.0 | 89.0 | 105.3 | 136.0 | |
| Surplus or deficit | -2.2 | -3.8 | 0.5 | -0.2 | |
| Funds and interest communities 4/ | | | | | |
| Revenues | 52.3 5/ | 67.1 6/ | 89.7 | 131.3 | |
| Of which: | | | | | |
| Grants from federal budget | (0.7) | (1.8) | (3.3) | (1.4) | |
| Expenditures | 48.3 | 63.4 | 84.5 | 130.7 | |
| Surplus or deficit | 4.0 | 3.7 | 5.2 | 0.6 | |
| Consolidated public sector 7/ | | | | | |
| Revenues | 197.8 | 241.4 | 304.7 | 384.3 | |
| Expenditures | 200.4 | 253.3 | 311.9 | 389.3 | |
| Surplus or deficit | -2.6 | -11.9 | -7.2 | -5.0 | |
| Financing | | | | | |
| External, net | -2.2 | -1.5 | -0.1 | -0.1 | |
| Domestic, net | 4.8 | 13.4 | 7.3 | 5.1 | |

Sources: Data supplied by the Yugoslav authorities; Sluzbeni List; National Bank of Yugoslavia, Annual Reports and Quarterly Bulletins; and IMF Government Finance Statistics Yearbooks.

1/ Preliminary.
2/ Not including agreed contributions to the federal budget.
3/ Including communities for child protection and health, pension, and invalid insurance.
4/ Excluding social security funds above and the fund for the development of the underdeveloped regions. Data on these funds and interest communities are estimated by treating them as a residual using data on the consolidated public sector, grants and transfers, and on expenditures and revenues of other levels of government.
5/ Due to rounding errors, the estimated expenditure and revenue data resulted in a surplus of Din 3.6 billion, instead of Din 4.0 billion. Revenues were adjusted upward by Din 0.4 billion.
6/ Due to rounding errors, revenues were adjusted upward by Din 0.5 billion.
7/ Exclusive of grants and transfers among governmental units.

Table 11. Yugoslavia: Balance of Payments, 1976-80 1/

(In millions of U.S. dollars)

| | 1977 | 1978 | Revised estimate 1979 | Projection 1980 | Latest forecast 1980 | Preliminary forecast 1981 |
|---|---|---|---|---|---|---|
| A. Goods and services and unrequited transfers | -1,346 | -1,283 | | -2,490 | | |
| Exports f.o.b. | 5,191 | 5,809 | | 8,240 | | |
| Imports c.i.f. | -9,789 | -10,439 | | -15,260 | | |
| Trade balance | -4,598 | -4,630 | | -7,020 | | |
| Services and unrequited transfers | | | | | | |
| Credits: | | | | | | |
| Workers and emigrants remittances 2/ | 2,505 | 2,950 | | 4,490 | | |
| Travel | 915 | 1,130 | | 1,360 | | |
| Transportation | 1,100 | 1,200 | | 1,460 | | |
| Interest | 135 | 170 | | 120 | | |
| Other | 740 | 810 | | 1,720 | | |
| Total | 5,395 | 6,260 | | 9,150 | | |
| Debits: | | | | | | |
| Workers and emigrants remittances 2/ | -725 | -1,280 | | 2,080 | | |
| Travel | -98 | -128 | | 160 | | |
| Transportation | -505 | -590 | | 700 | | |
| Interest | -410 | -495 | | 900 | | |
| Other | -405 | -420 | | 780 | | |
| Total | -2,143 | -2,913 | | 4,630 | | |
| Services and unrequited transfers (net) | 3,252 | 3,347 | | 4,530 | | |
| B. Long-term capital | 1,402 | 1,350 | | 2,470 | | |
| C. Total (A through B) | 56 | 67 | | -20 | | |
| D. Short-term capital incl. bilateral balances, errors and omissions | 40 | 12 | | — | | |
| E. Total (A through D) | 96 | 79 | | -20 | | |
| F. Allocation of SDRs | — | — | | 37 | | |
| G. Exceptional financing | 75 | 350 | | 400 | | |
| H. Total (A through G) | 171 | 429 | | 417 | | |
| I. Reserve movements | | | | | | |
| Use of Fund credit | -112 | -74 | | ... | | |
| SDRs | -3 | -7 | | ... | | |
| Reserve position in the Fund | — | -81 | | ... | | |
| Gold | -5 | -10 | | ... | | |
| Official foreign exchange (increase -) | -51 | -257 | | ... | | |
| Total | -171 | -429 | | -417 | | |

Sources: National Bank of Yugoslavia; and staff estimates.

1/ Data on capital account converted on statistical exchange rate basis.
2/ Data for 1979 and 1980 on a different statistical basis than for 1977 and 1978. Data for former two years include, and for earlier two years exclude, internal transactions between foreign exchange accounts of residents.

Table 12. Yugoslavia: Balance of Payments (Convertible Currency Area), 1977-80 1/

(In millions of U.S. dollars)

| | 1977 | 1978 | Revised Estimate 1979 | Projection 1980 | Latest forecast 1981 | Preliminar forecast 1981 |
|---|---|---|---|---|---|---|
| A. Goods and services and unrequited transfers | -1,020 | -1,272 | | -2,330 | | |
| Exports f.o.b. | 3,540 | 3,971 | | 5,490 | | |
| Imports c.i.f. | -7,600 | -8,373 | | -12,020 | | |
| Trade balance | -4,060 | -4,402 | | -6,530 | | |
| Services and unrequited transfers(net) | 3,040 | 3,130 | | 4,200 | | |
| B. Long-term capital | | | | | | |
| Long-term capital received | | | | | | |
| Drawings | 2,289 | 2,430 | | 3,970 | | |
| Repayments | -901 | -1,200 | | -1,570 | | |
| Long-term loans extended | -208 | -130 | | -90 | | |
| Total | 1,180 | 1,100 | | 2,310 | | |
| C. Total (A + B) | 160 | -172 | | -20 | | |
| D. Short-term capital errors and omissions excl. Item G | 64 | 251 | | -- | | |
| E. Total (A through D) | 96 | 79 | | -20 | | |
| F. Allocation of SDRs | -- | -- | | 37 | | |
| G. Exceptional financing | 75 | 350 | | 400 | | |
| H. Total (A through G) | 171 | 429 | | 417 | | |
| I. Reserve movements | | | | | | |
| Use of Fund credit | -112 | -74 | | ... | | |
| SDRs | -3 | -7 | | ... | | |
| Reserve position in the Fund | -- | -81 | | ... | | |
| Gold | -5 | -10 | | ... | | |
| Official foreign exchange (increase -) | -51 | -257 | | ... | | |
| | -171 | -429 | | -417 | | |

Sources: National Bank of Yugoslavia; and staff estimates.

1/ Data on capital account converted on statistical exchange rate basis.

Table 13. Yugoslavia: Foreign Trade Indicators

(Percentage change over previous year, in terms of US$)

| | 1976 | 1977 | 1978 | 1979 | Latest period 1980 1/ |
|---|---|---|---|---|---|
| Exports | | | | | |
| Value | 16.7 | 8.0 | 11.9 | 16.9 | |
| Volume 2/ | 15.2 | -2.7 | 2.7 | 1.6 | |
| Price | 4.0 | 11.0 | 9.0 | 15.0 | |
| Imports | | | | | |
| Value | -7.4 | 32.5 | 6.6 | 34.3 | |
| Volume 2/ | -10.1 | 16.6 | 1.5 | 12.9 | |
| Price | 3.0 | 13.6 | 5.0 | 19.0 | |
| Terms of trade | 1.0 | -2.6 | 3.8 | -4.3 | |

Sources: Data supplied by the Yugoslav authorities; IMF, International Financial Statistics; and staff calculations.

1/ Latest period of 1980 for which data are available compared with corresponding period of 1979.
2/ Derived from value data converted at current exchange rates and price indices reported to IFS.

Table 14. Yugoslavia: Commodity Composition of Foreign Trade

| | Exports | | | | | | | Imports | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Percentage Share of Total | | | | Per cent Change Over Previous Year 1/ | | | Percentage Share of Total | | | | Per cent Change Over Previous Year 1/ | | |
| | 1970 | 1978 | 1979 | 1980 2/ | 1978 | 1979 | 1980 3/ | 1970 | 1978 | 1979 | 1980 2/ | 1978 | 1979 | 1980 3/ |
| Economic classification | 100.0 | 100.0 | 100.0 | | 7.9 | 14.5 | | 100.0 | 100.0 | 100.0 | | 3.7 | 28.8 | |
| Raw materials and semi-manufactures | 52.4 | 49.6 | 53.5 | | 5.3 | 23.5 | | 63.2 | 63.3 | 64.7 | | 5.6 | 31.5 | |
| Equipment | 14.4 | 19.9 | 17.5 | | 4.8 | 0.4 | | 17.9 | 25.7 | 24.4 | | 5.3 | 22.8 | |
| Consumer goods | 33.2 | 30.5 | 29.0 | | 14.6 | 9.1 | | 15.4 | 11.0 | 10.9 | | -9.0 | 27.8 | |
| SITC classification | 100.0 | 100.0 | 100.0 | | 7.9 | 14.5 | | 100.0 | 100.0 | 100.0 | | 3.7 | 28.8 | |
| Food | 15.2 | 10.0 | 8.3 | | 11.7 | -4.9 | | 7.0 | 5.9 | 7.2 | | -23.1 | 57.0 | |
| Beverages and tobacco | 3.5 | 2.2 | 2.2 | | 21.8 | 13.9 | | 0.2 | 0.2 | 0.2 | | -11.8 | 57.5 | |
| Raw materials | 9.4 | 7.9 | 9.2 | | -11.4 | 31.4 | | 10.9 | 10.0 | 9.2 | | 5.9 | 17.2 | |
| Fuels and lubricants | 1.2 | 2.6 | 3.0 | | -3.2 | 32.7 | | 4.8 | 14.3 | 17.4 | | 10.6 | 56.6 | |
| Animal and vegetable fats | 0.1 | 0.3 | 0.7 | | 220.0 | 182.4 | | 0.7 | 0.3 | 0.2 | | -29.8 | -11.3 | |
| Chemicals | 5.8 | 8.3 | 9.6 | | 41.3 | 32.2 | | 9.3 | 11.4 | 11.3 | | 15.3 | 27.4 | |
| Manufactured goods and equipment | 29.3 | 22.2 | 23.6 | | 4.5 | 22.0 | | 28.8 | 17.0 | 15.9 | | -3.7 | 20.3 | |
| Electrical and transport machinery | 22.7 | 31.7 | 29.8 | | 7.4 | 7.6 | | 33.2 | 36.4 | 34.4 | | 7.1 | 22.1 | |
| Miscellaneous manufactured goods | 12.8 | 14.1 | 13.3 | | 9.3 | 8.4 | | 5.1 | 4.3 | 4.1 | | 8.1 | 24.4 | |
| Other | -- | 0.7 | 0.3 | | 11.8 | -45.8 | | -- | 0.2 | 0.1 | | 100.0 | -21.1 | |

Source: Social Accounting Service; *Index*.
1/ Value data converted at statistical exchange rate.
2/ January-September 1980 or latest period for which data are available.
3/ Latest period compared with corresponding period of 1979.

Table 15. Yugoslavia: Structure and Geographic Distribution of External Capital Account Transactions

(In millions of U.S. dollars)

| | 1978 | 1979 | 1980 | 1981 |
|---|---|---|---|---|
| | Actuals | | Latest forecast | Preliminary forecast |
| Medium- and long-term capital flows | | | | |
| Gross repayments | | | | |
| Of which to: | | | | |
| Europe | | | | |
| Austria | | | | |
| France | | | | |
| Germany | | | | |
| Italy | | | | |
| Switzerland | | | | |
| Other | | | | |
| North America, Japan, and the United Kingdom | | | | |
| United States | | | | |
| Canada | | | | |
| United Kingdom | | | | |
| Japan | | | | |
| OPEC countries | | | | |
| Iraq | | | | |
| Kuwait | | | | |
| Libya | | | | |
| Other | | | | |
| Other countries | | | | |
| Normal suppliers' credits and trade-related loans 1/ | | | | |
| Of which from: | | | | |
| Europe | | | | |
| Austria | | | | |
| France | | | | |
| Germany | | | | |
| Italy | | | | |
| Switzerland | | | | |
| Other | | | | |
| North America, Japan, and the United Kingdom | | | | |
| United States | | | | |
| Canada | | | | |
| United Kingdom | | | | |
| Japan | | | | |
| OPEC countries | | | | |
| Iraq | | | | |
| Kuwait | | | | |
| Libya | | | | |
| Other | | | | |
| Other countries | | | | |
| Financial credits (gross) | | | | |
| Of which from: | | | | |
| Europe | | | | |
| Austria | | | | |
| France | | | | |
| Germany | | | | |
| Italy | | | | |
| Switzerland | | | | |
| Other | | | | |
| North America, Japan, and the United Kingdom | | | | |
| United States | | | | |
| Canada | | | | |
| United Kingdom | | | | |
| Japan | | | | |
| OPEC countries | | | | |
| Iraq | | | | |
| Kuwait | | | | |
| Libya | | | | |
| Other | | | | |
| Other countries | | | | |
| Loan extensions (net) | | | | |

1/ Comprise normal trade-related credits and World Bank loans.

Table 16. Yugoslavia: External Debt Disbursed and Oustanding, 1974-79 1/

(In millions of U.S. dollars)

| | End of Period Totals | | | | | | |
|---|---|---|---|---|---|---|---|
| | 1974 | 1975 | 1976 | 1977 | 1978 | 1979 | 1980 Sept. |
| A. Repayable in convertible currencies | 4,851 | 5,819 | 6,998 | 8,413 | 10,471 | | |
| Medium and long-term 2/ | 4,661 | 5,616 | 6,748 | 8,063 | 10,039 | | |
| Public or publicly guaranteed | (1,724) | (2,294) | (2,368) | (2,192) | (2,332) | | |
| Private, not officially guaranteed | (2,937) | (3,321) | (4,380) | (5,871) | (7,707) | | |
| Short-term 3/ | 190 | 203 | 250 | 350 | 432 | | |
| Bank liabilities | (154) | (92) | ... | ... | ... | | |
| Trade credits | (36) | (111) | ... | ... | ... | | |
| B. Repayable in bilateral currencies | 591 | 768 | 934 | 1,127 | 1,362 | | |
| C. Total (A and B) | 5,442 | 6,587 | 7,932 | 9,540 | 11,833 | | |

Source: Data supplied by the Yugoslav authorities.
1/ Values converted at statistical exchange rate.
2/ Original maturity over one year (includes IMF drawings).
3/ Original maturity up to and including one year.

Table 17. Yugoslavia: External Debt Flows, 1975-79 1/

(In millions of U.S. dollars, unless otherwise specified)

| | 1975 | 1976 | 1977 | 1978 | 1979 | Forecast 1980 |
|---|---|---|---|---|---|---|
| A. Repayable in convertible currencies | | | | | | |
| Drawings | 1,770 | 1,751 | 2,289 | 2,430 | | |
| Debt service | 1,218 | 1,199 | 1,297 | 1,678 | | |
| Amortization | (877) | (813) | (901) | (1,200) | | |
| Interest 2/ | (341) | (386) | (396) | (478) | | |
| B. Repayable in bilateral currencies | | | | | | |
| Drawings | 400 | 345 | 376 | 370 | | |
| Debt service | 137 | 99 | 163 | 117 | | |
| Amortization | (128) | (90) | (149) | (100) | | |
| Interest 2/ | (9) | (9) | (14) | (17) | | |
| C. Total debt (A+B) | | | | | | |
| Drawings | 2,170 | 2,096 | 2,665 | 2,800 | | |
| Debt service | 1,355 | 1,298 | 1,460 | 1,795 | | |
| Amortization | (1,005) | (903) | (1,050) | (1,300) | | |
| Interest 2/ | (350) | (395) | (410) | (495) | | |
| D. Debt service ratios 3/ (in per cent) | | | | | | |
| a. Convertible currencies | 18.4 | 15.9 | 15.0 | 16.9 | | |
| b. Total | 16.0 | 13.6 | 13.8 | 14.9 | | |

Sources: Data supplied by Yugoslav authorities; and Fund staff estimates.

1/ Excludes transactions with the International Monetary Fund.
2/ Based on data valued at current exchange rates.
3/ Ratio of debt service to exports of goods and services (valued at current exchange rates).

Table 18. Yugoslavia: Medium- and Long-Term External Debt 1/ and Scheduled Debt Service Payments

(In millions of U.S. dollars)

| | Amount Outstanding September 30, 1980 2/ | | Schedule of Debt Service Payments | | | | |
|---|---|---|---|---|---|---|---|
| | Disbursed | Including Undisbursed | 1980 | 1981 | 1982 | 1983 | Beyond 1983 |
| A. Repayable in convertible currencies | | | | | | | |
| Amortization | | | 1,600 | 1,500 | 1,400 | 1,550 | 9,415 |
| Interest | | | 850 | 950 | 1,150 | 1,300 | |
| Total debt service | | | 2,450 | 2,450 | 2,550 | 2,850 | |
| B. Repayable in bilateral currencies | | | | | | | |
| Amortization | | | 150 | 180 | 200 | 250 | 1,275 |
| Interest | | | 50 | 70 | 80 | 100 | |
| Total debt service | | | 200 | 250 | 280 | 350 | |
| C. Total (A and B) | | | | | | | |
| Amortization | | | 1,750 | 1,680 | 1,600 | 1,800 | 10,690 |
| Interest | | | 900 | 1,020 | 1,230 | 1,400 | |
| Total debt service | | | 2,650 | 2,700 | 2,830 | 3,200 | |

Source: Data supplied by the Yugoslav authorities.

1/ Original maturity of more than one year; data valued on statistical exchange rate basis.

2/ On latest date for which data sought are available.

F. O.

INTERNATIONAL MONETARY FUND

Yugoslavia

Minutes of Meeting No. 1
Held at the National Bank of Yugoslavia
on Wednesday, October 29, 1980, at 9:00 a.m.

Yugoslav representatives

Mr. I. Marjanovic, Deputy Governor, National Bank
Mr. D. Dimitrevic, Director National Bank
Mrs. G. Hofmann, Director, National Bank
Mr. J. Petrovic, National Bank
Mr. S. Stamenkovic, Assistant Secretary, Federal Secretariat for Market and General Economic Affairs
Mr. Prica, Advisor, Federal Secretariat for Foreign Trade
Mrs. A. Djermanovic, Advisor, Federal Secretariat for Foreign Trade
Mr. A. Jovičić, Advisor, Federal Secretariat for Prices
Mr. T. Gudac, Special Advisor, Federal Secretariat for Finance
Miss G. Djurdjevic, Interpreter

IMF representatives

Mr. Tyler
Mr. Manison
Mr. Loser
Mr. Buyse

IBRD representative

Mr. Bery

Mr. Marjanovic initiated the meeting by welcoming the Fund mission, and suggested a timetable of meetings for the following days. Reflecting earlier informal discussions with Mr. Bogoev, it was agreed that during the visit a selection of topics related to the current stand-by arrangement and any future use of Fund resources would be discussed. Those would be based on the questionaire sent earlier during the month by the Fund staff to the authorities. It was further agreed that developments and prospects for 1980 would be discussed during the next days, while the projections for 1981 would be covered during the following week. The rest of the meeting could be devoted to reviewing demand and supply developments during 1980.

## I. Aggregate Demand

Mr. Stamenkovic said that his views on developments in aggregate demand during the first part of 1980 were based on partial indicators most of which were complete through to September 1980. He then discussed the major developments in aggregate demand over the first months of 1980. The main feature of demand during the first part of the year was the continued high levels of expenditure during the first two months of the year, that reflected a considerable disequilibrium between supply and domestic demand, aggravated by a sharp increase in exports. At the end of the first quarter and during the second quarter of the year these expansionary tendencies ameliorated and the imbalances were reduced. For the year as a whole, aggregate demand was not expected to increase appreciably while GSP was projected to increase at a rate of no more than 2.5 per cent over 1980.

The rise in private consumption was expected to decelerate markedly during 1980, although no complete information was currently available to fully confirm the view. To a large extent, the assertion was based on the effectiveness of incomes policies, which had been considerably more successful than in previous years. For the first nine months of the year, personal income in nominal terms increased by 22 per cent relative to the same period of 1979, while the personal consumption price deflator was estimated to have increased by 28 per cent. Therefore, after adjusting for increases in employment, income per employee declined by around 8 per cent, considerably in excess of the originally envisaged fall, on account of the higher than projected increase in prices. Although personal incomes declined in real terms, personal consumption appeared to have increased marginally in real terms. The only data available were that of retail sales, which had increased by 29 per cent in nominal terms and by about 1 per cent in real terms over the first eight months of 1980 compared with the same period of 1979. Despite no information being available for other forms of private consumption, an analysis of recent trends indicated that the total increase in private consumption would range between 0 and 1 per cent for all of 1980. The discrepancy between the growth in personal incomes and private consumption could be explained by the saving behavior of the household sector. As had occurred in 1979, the consumption spending was partly financed by a drawdown of savings accounts. The level of savings deposits denominated in dinars had declined by 1.5 per cent between the end of the year 1979 and September 1980. By contrast, during the same period of the previous year, savings deposits had increased by 10 per cent.

Information on public consumption was incomplete; only data based on receipts of the socio-political communities (the Federation, Republics. autonomous provinces, communes, and municipalities) were available. Nonetheless, that information provided a reasonable basis for assessment of public consumption, as only the Federation was able to borrow, the amounts being limited to no more than Din 10 billion for 1980. The Economic Resolution had provided for measures in public consumption of 16 per cent in 1980. Over the first nine months of the year, receipts had increased by 18.8 per cent, below the limit of 20 to 21 per cent that had been envisaged in the budget of the Federation, and notwithstanding the acceleration of inflation.

Turning to the collective consumption. Mr. Stamenkovic explained that expenditure on education, health, and social security increased by 24 per cent over the first nine months of 1980 relative to the same period of 1979. The amounts were higher than those envisaged in the Resolution but in view of the higher level of nominal GSP, the ratio of collective consumption to GSP has remained within the expected limits.

Fixed investment expenditures had decelerated substantially during 1980 and a decline of 2 to 3 per cent in real terms was expected for the full year. On account of the large carryover from 1979, investment payments increased by 35 per cent during the first two months of 1980. compared with the same period of 1979. Thereafter the rates of increase declined from 31.2 per cent in the first quarter, to 28.3 per cent in the first half. to 24.5 per cent in the first nine months. The deceleration has been particularly noticeable during recent months: over the period August-September investment payments were only 13 per cent higher than the corresponding months of 1979. Based on recent trends in both material balances and investment payments statistics, Mr. Stamenkovic concluded that fixed investment was expected to decline by between 2 to 3 per cent for the year 1980 implying a decline in the ratio of investment to GSP in real terms. Moreover, it was envisaged that the trend would continue and that investment would fall by a further 5 per cent in 1981.

Mr. Tyler inquired about the behavior of inventories during 1980. In particular, he pointed out that the movements of stocks were of crucial importance for a correct assessment of balance of payments developments over the year. It was possible that part of the sharp adjustments in the current account of the balance of payments had been affected by reductions in stocks rather than by actual declines in underlying import demand or actual increases in the production of exportables. If that had been the case, an improvement in the balance of payments outcome for 1981 would be considerably more difficult to achieve than if stocks had not been changed significantly in 1980.

Mr. Stamenkovic replied that no data were available for all economic sectors, although information on finished goods and raw materials in the industrial sector indicated a sharper real decline during the first nine months of the year compared with the same period of 1979. As an illustration he provided the following details:

| Industrial sector | Percentage change during the first nine months of the year | | Percentage change September 1980 over September 1979 |
|---|---|---|---|
| | 1979 | 1980 | |
| Total (finished goods and raw materials) | -4.0 | -10 0 | . . |
| Finished goods | ... | ... | -5.1 |
| Consumer goods | -12.3 | -18.3 | -6.0 |
| Investment goods | 2.7 | 15.3 | +2.0 |
| Raw materials (for sale) | 6.7 | -6.5 | -6.2 |
| Raw materials (for production) | ... | -7.5 | -1.0 |

No information was available on changes in inventories of imported commodities in real terms. However, the nominal value of stocks in the trade sector had increased by 25 per cent from August 1979 to August 1980, and by 17 per cent from December 1979. In the early part of the year with there being shortages of certain raw materials and products there was further evidence that the stocks of real imported goods had been run down. However, it was noted that the sharp rise in real exports had contributed also to supply shortfalls. With regard to 1981, the drawdown of stocks during this year was not viewed with concern. In 1979 the levels of total inventories had been much higher than normal and at this point in 1980 they could still be considered adequate. Moreover, the draft resolution for 1981, envisaged an increase in the imports of raw materials and intermediate goods, that would offset any previous decline. Total imports were projected to decline by about 1 to 2 per cent but its composition was to change drastically. Imports of equipment were projected to decrease by about 50 per cent, while raw materials were projected to increase by 5 per cent in volume, in line with a currently projected increase of GSP of 3 per cent.

Mr. Stamenkovic concluded that there was no evidence that inventories of imported goods had declined to abnormally low levels. The situation to some extent had been improved by the tendency for supply shortages to induce local production of raw materials. However, in view of the importance of the subject for the balance of payments, he proposed to supply more detailed information on the subject by the following week.

## II. Production

Mr. Stamenkovic indicated that currently GSP for 1980 was projected to increase by 2.5 per cent, considerably below the 5 per cent rate originally envisaged. During the first nine months of the year, industrial activity had increased by 4 per cent, but a rate of growth of 3 per cent was projected for all of 1980, based on current tendencies and seasonality. Over the first nine months of the year the output of raw materials increased by 5 per cent: finished goods by 3 per cent; while the output of investment goods rose by 4 per cent. The output of consumer durables was expected to remain at the levels achieved in 1979 on account of restrictions to consumer credits and the decline in real personal incomes.

Agricultural output was projected to decline by 2 per cent in 1980, due largely to unfavorable weather conditions. The winter had been longer than usual and agricultural planting and harvesting had been delayed by about 20 to 30 days with consequent adverse effects on yields. Construction activity was projected to stagnate reflecting the slowdown of investment for the year. The prospects for tourism were excellent. No complete data existed for the first months of the year, but information on receipts indicated an increase of 45 per cent in terms of U.S. dollars, for the first nine months of 1980 relative to the same period of 1979. Energy developments had been favorable for 1980. Output of electricity had increased by 8 per cent, while coal production rose by 6 per cent with a tendency to accelerate--in the third quarter the increase had been 11 per cent. Coal processing output rose by 14 per cent. The most disappointing outcome in the field of energy had been that of petroleum. Output rose by only 2.5 per cent, somewhat less than projected although most of the improvement in terms of imports was expected to occur through reduced consumption and substitution by alternative energy sources.

The output of ships in the first nine months of 1980 was 7 per cent below the level of the same period of 1979. Nevertheless, these developments were not to be viewed with concern; output and exports had reached record levels in August and no serious problems were envisaged. Output of other transportation equipment increased by 0.5 per cent while production of furniture increased by 9 per cent, and that of other consumer durables declined by 3 per cent.

Mr. Tyler inquired whether production problems had arisen with respect to the nonavailability of raw materials as a consequence of the sharp decline in the volume of imports. Mr. Stamenkovic indicated that the adjustment of imports in the balance of payments required an adjustment in the economy but no stoppage in production had occurred. Some problems emerged after the devaluation with regard to availability of imported goods but no serious production problems had followed. Shortages of raw materials appeared only with respect to oil derivatives, steel products, and other metals and resulted in a slowdown of these activities.

## III. Investment Strategy

Mr. Tyler explained that because the Yugoslav balance of payments problems seemed to reflect in part both the size and the distribution of investments, the details about the Yugoslav investment strategy for the coming years would be of interest.

Mr. Prica then gave a detailed overview of the Yugoslav investment strategy highlighting the balance of payments implications. The main objective of investment was to increase the export capacity of the economy and to encourage rational forms of import substitution. To achieve the desired results, the following priority sectors were specified:

--domestic energy sources in order to reduce the country's dependence on foreign sources of energy, notably oil;

--ferrous and nonferrous metals and chemicals so as to reduce the import dependence and thus enable stable domestic supplies of these items to the manufacturing sector;

--the equipment sector (notably electromachinery) and shipbuilding, since this has a pronounced export orientation;

--agriculture in order to supply the population with better foodstuffs and promote exports;

--transportation so as to better integrate the Yugoslav system into the European network;

--tourism should be further encouraged by the building of new hotels.

The 1976-80 Five-Year Plan had envisaged that 65 per cent of total investment be allocated to these sectors compared with 50 per cent of total investment in the previous Five-Year Plan. Between 1976 and 1979, however, only 58 per cent of total investment was directed to these priority sectors. Given the capital intensiveness of most projects, domestic resources were clearly insufficient. Foreign credits were used extensively, but fell short of needs and many projects were delayed in their implementation. Moreover, inflation was very high in the capital goods sector. In 1980 results were better after measures were taken to decrease or delay noneconomic investment. During the first six months of 1980 there was a marked increase in investment activity in priority sectors compared with the same period of the preceding year.

Nominal investment was up 32 per cent in the electricity sector and 50 per cent in coal. Investment doubled in the oil and gas sectors as well as in ferrous metallurgy. In basic chemistry, the increase in investment amounted to 77 per cent.

Notwithstanding the expected good results for 1980, only about 60 per cent of total investment will have been allocated to the priority sectors, 5 per cent less than planned. This shortfall was to affect adversely the balance of payments since the next Five-Year Plan would start with a series of unfinished projects. The completion of these projects, however, were to lead in the longer run to increased export capacity or to import substitution. The next Five-Year Plan would include as priority sectors energy, raw materials such as basic metals and basic chemicals, basic agricultural products, export oriented or import substituting activities, equipment and technology, and transportation (notably highways).

Mr. Tyler remarked that basically the priority sectors have remained the same. If no new mechanisms were created to ensure the realization of targets in the 1981-85 Five-Year Plan, results could be expected to be as disappointing as in the previous Five-Year Plan. Mr. Tyler asked also for more details about the 1976-80 shortfalls.

Mr. Prica replied that in addition to the previously mentioned causes of investment shortfalls in the 1976-80 Five-Year Plan, an additional factor had been the deficiency of social compacts, which sometimes took more than two years to be concluded. For the next Five-Year Plan the harmonization of different interests were to be improved as social compacts were already an integral part of the planning procedure, contrary to what happened previously. Moreover, specific agreements on foreign relations and on the faster development of less developed regions have already been reached.

Mr. Tyler suggested that under the current system it was very difficult to reach a national concensus on the level and distribution of investment. Experience had shown that intervention of the Federation was frequently required to reconcile the decisions of the other bodies. In 1979 the republics did not agree to consistent balance of payments projections and the Federation had to use its influence to coordinate the exercise. There was no reason to expect that such a situation would not occur with respect to investment.

Mr. Prica answered that while the Yugoslav constitution assured the decentralization of power, the Federation could take temporary measures to solve acute discrepancies. However, the Federation made a very restricted use of this prerogative and would continue to do so. Long-term solutions would be brought about by improving self-management agreements.

Mr. Tyler remarked that investment in Yugoslavia was hindered by the small capacity and proliferation of existing plants, and therefore measures had to be taken to increase the efficiency of investment. Mr. Prica agreed and indicated that he saw a solution in working out new criteria for optimal capacity. Further duplications of small plants were to be avoided but such an aim was constrained by employment problems, notably in the underdeveloped areas.

Mr. Tyler remarked that the recent balance of payments improvement was due largely to short-term factors. In the longer run, the structure of investment had to be changed so as to achieve a better balance between imports and exports. Mr. Prica agreed that improving the investment structure was one of the preconditions for better results during the next Five-Year Plan and that the highest political bodies of the country were aware of the issue. The Federation could, to a certain extent, create the climate and the conditions to stimulate investment in particular branches, notably through tax incentives and specific customer facilities. The coordination system however, remained quite complex as it started from the basic level.

Mr. Bery remarked that some priority sectors suffered from adverse price relationships. It seemed to be assumed that by defining certain sectors as priority sectors and channeling investments to them all problems would be solved. Mr. Bery had the impression that over the last four years there was a conflict between adverse price relationships and interest rates on the one hand and the objectives of planners on the other hand. It was not clear what the Government had to offer enterprises to offset these adverse price relationships. Mechanisms which would more effectively avoid duplication of investments and increase the competitiveness of exports were not used and had to be reviewed thoroughly.

Mr. Tyler concluded by noting that if the Government had undertaken particular measures to improve the allocation of investment toward priority sectors it would be helpful if the mission could be supplied with their details. He added, that he thought that the authorities may be considering the more active use of interest rates to achieve a better resource allocation.

The meeting adjourned at 12:30 p.m.

INTERNATIONAL MONETARY FUND

Yugoslavia

Minutes of Meeting No. 2
Held at the National Bank of Yugoslavia
on Thursday, October 30, 1980, at 9:30 a.m.

Yugoslav representatives

Mr. D. Dimitrijevic, National Bank of Yugoslavia
Mrs. G. Hofmann, Director, National Bank of Yugoslavia
Mr. A. Jovičić, Advisor, Federal Secretariat for Prices
Mr. D. Knežević, Assistant to the President, Federal Committee for Labor and Health
Mr. J. Petrović, Director, National Bank of Yugoslavia
Mr. T. Gudac, Federal Secretariat for Finance
Mrs. A. Djermanović, Federal Secretariat for Foreign Trade
Miss G. Djurdjević, National Bank of Yugoslavia

IMF representatives

Mr. Tyler
Mr. Manison
Mr. Loser
Mr. Buyse

IBRD representative

Mr. Bery

The meeting discussed developments and policies with respect to prices and incomes and trends and prospects for monetary and credit aggregates.

## I. Price Developments and Policies

Mr. Jovičić stated that domestic prices during the first nine months of 1980 had risen at a considerably faster rate than targeted in the Annual Resolution for 1980. The rate of increase of prices was faster than in any other year of the current Five-Year Plan (1976-80) and was similar to those in 1975. Price developments in relation to targets were as follows:

| | Annual Resolution target for 12 months to December 1980 | Actuals December 1979 to September 1980 | September 1979 to September 1980 |
|---|---|---|---|
| | | (Percentage change) | |
| Producer prices | | | |
| Agriculture | 13.0 | 21.9 1/ | 26.7 1/ |
| Industry | 13.0 | 28.4 | 29.5 |
| Services | 12.0 | 17.5 | 19.0 |
| Retail | 19.0 | 25.8 | 30.9 |
| Cost of living | 19.0 | 23.3 | 30.8 |

1/ Changes to July.

Mr. Jovičić pointed out that the devaluation in the foreign exchange value of the dinar in the first half of 1980 had necessitated a change in the agreement on the implementation of the price policy. Following the devaluation, the Government initiated a price freeze. At the time of the devaluation it was proposed that the prices of 30 products be subsequently adjusted (Gazette No. 32, June 6, 1980). However, in the aftermath of the devaluation there had been a need for the Government to adjust upward the prices of many more products due in large part to the strong direct and indirect effects of higher import costs and the diversion of local production to the export market. For example, with local car producers taking advantage of the more profitable opportunities for exports, domestic car prices were raised so as to avoid a limited home supply. Shortages emerged also with respect to certain goods like oil derivatives, medicines, and detergents, which necessitated price changes in July.

Energy prices were not only adjusted to take account of the effects of the devaluation but were raised also to correct previous price distortions so as to promote the output of domestic energy sources. Overall prices in the energy sector were raised by 77.6 per cent in the first nine months of 1980 compared with the corresponding period of 1979. For the various energy sources, price increases ranged from 36.6 per cent for electricity, through 47.8 per cent for coal, 18.9 per cent for coke, to 100.8 per cent and 127.0 per cent for oil derivatives and oil and gas, respectively. Such rises were three to ten times that expected when the price policy for 1980 was formulated. It was noted that increases in crude oil prices had little direct impact on electricity energy prices. The sharp rise in energy prices was having a strong impact on costs in other sectors. For example, it was estimated that the rise in the price of oil derivatives would add Din 33 billion to the costs of industry on an annual basis.

Within the industrial sector prices of different products had risen at widely divergent rates. Mr. Jovičić supplied the following figures:

| Industrial sector | December 1979 to September 1980 | September 1979 to September 1980 |
|---|---|---|
| | (Percentage change) | |
| Raw materials | 36.3 | 39.2 |
| Intermediate goods | 10.0 | 10.7 |
| Finished consumer goods | 20.1 | 21.6 |
| Metallurgy and nonferrous and ferrous metals | 33.0+ | |
| Basic chemicals | 22.5 | |
| Food processing | 26.6 | |
| Other industries | 17.2 | |

Mr. Jovičić stated that substantial administered adjustments had been made also to correct price distortions in the agricultural sector. For example, the wheat purchase price had been raised by 40 per cent while considerable rises had been effected also for prices of oil seeds and sugar beet. Mr. Jovičić agreed to supply the mission with a list of administered price increases.

Mr. Jovičić stated that in the period June 6 to August 30 a price freeze had been operating insofar as the Government had placed a ceiling on the prices of all products and services. However, the Government had changed many ceiling prices during the freeze period partly in response to imbalances between supply and demand in particular sectors. Mr. Jovičić noted also that the supervision of price ceilings had not been effective in certain cases. A new decision on price policy adjusting certain prices and allowing others to be determined by market forces was to be published shortly.

Mr. Tyler observed that it was somewhat difficult to explain the substantial acceleration in price increases during 1980 noting that the moderation of domestic demand pressures and the success in containing the growth of personal incomes seemed to be factors that would contribute to an easing of inflationary pressures. Mr. Jovičić replied that the higher rate of inflation in 1980 had resulted largely from the sharp rise in import costs, particularly of oil products, from the effects of the devaluation, and from the unusually high number of administered price adjustments made to correct price distortions. It was estimated from an input/output analyses that about one quarter of the increase in industrial producer prices in the first nine months of 1980 compared with the corresponding period of 1979 was due to the direct effects of higher import costs, while a further 10 percentage points was attributable to the need to make sympathetic price adjustments to domestic products, especially of raw materials. Prices of nonferrous metals were formulated on the basis of movements in prices in international commodity markets while those for ferrous metals were linked to changes of prices of corresponding products in the West German market. Between December 1979 and September 1980 local producer prices for nonferrous and ferrous metals had risen by 35 per cent and 33 per cent, respectively. Mr. Gudac reiterated that with the diversion of certain raw materials to the export market it had been necessary to raise particular prices.

Mr. Jovičić said that while there was no global excess demand there had been particular shortages of products such as automobiles, refrigerators, construction materials, ceramics, furniture, and wooden tiles. These shortages stemmed largely from internal production inefficiencies rather than from alleged limitations on imported raw materials. The shortfall in coal production could not be blamed on a lack of imports, while shortages of edible oil, beer, and mineral water had reflected the low production of glass bottles.

Mr. Tyler raised the question that in view of the higher than expected rise in prices in 1980 what could be done to achieve a moderation of inflationary pressures in 1981. Mr. Jovičić replied that relative price changes would not be as great as in 1980. The price adjustments in 1980 had helped improve external competitiveness which had not been the case in the previous three years. Furthermore, the global balance between supply and demand was expected to be maintained in 1981.

For the period 1981-85, the aims of the prices policy were as follows:

(1) The increase in oil prices should decelerate compared with the current Five-Year Plan period.

(2) External competitiveness should be improved.

(3) Relative prices should be changed when necessary to correct distortions, especially for raw materials and energy products.

(4) The principle of taking account of cost increases to raise prices should be moderated--personal income payments were not treated as costs, and

(5) Linked to the third aim it was intended to use the price structure to promote the production of new products, such as through changes in tariff rates.

These aims would be incorporated into the Resolution on price policy for 1981. The Resolution, unlike in earlier years, would not specify sectoral price targets but implement price policy according to qualitative guidelines.

Mr. Tyler noted that there had been inter-republican agreements on price policies in the current and previous years. However, these arguments did not seem to be very effective in limiting price increases. Accordingly, in the absence of new measures and institutional changes, it was difficult to foresee how the moderation in price increases would occur. Mr. Dimitrijevic said that the year 1980 was extraordinary in that the large devaluation had combined with the relative price distortions to produce a very high rate of inflation. In 1981 inflationary pressures would be eased because of lesser relative price distortions, less depreciation of the dinar, and by the equating of domestic demand and supply. The Yugoslav representatives said that based on their preliminary thinking, they were aiming to reduce the rate of inflation (GSP deflator) to 20 per cent in 1981, and to a lower level in 1982. Mr. Tyler, while acknowledging that the reduced domestic demand pressures might have a delayed impact in moderating price increases, was not convinced that the mechanisms were in place to ensure a substantial reduction in the rate of inflation.

## II. Personal Incomes

In his remarks, Mr. Knežević stated that policy on personal incomes had been oriented toward stabilization from the beginning of the year. In November 1979 it had been agreed at various levels of the society that the level of personal incomes prevailing in November 1979 should be taken as the basis for incomes in the period up to March 1980, while more detailed guidelines on incomes policy were being prepared. In January the republics and provinces had agreed on their incomes policies and in February the basic organizations of associated labor (BOALS) had adjusted their agreements to correspond with these policies. It had been anticipated that, overall, personal incomes would rise by 23 per cent in nominal terms. Income guidelines for individual enterprises were set with reference to the growth in enterprise earnings, and were additionally differentiated by sectors of activity. For enterprises engaged in economic activities, growth in personal incomes was restricted to 95 per cent of the growth in enterprise gross income; for noneconomic activities the equivalent restriction was between 91 and 93 per cent. An exception was made in the case of more arduous and socially important economic activities like coal mining, other energy-related activities and shipbuilding, where personal income growth was permitted to exceed growth in enterprise income by up to 5 per cent.

In the event, trends in personal incomes this year revealed incomes policy to have been extremely effective. In the first six months of the year enterprise incomes had risen by 32 per cent over the equivalent period last year; while on the basis of incomes policy personal incomes could have risen by 27 per cent,they had in fact risen by only 17 per cent. Given movements in the cost of living over the same period this implied a reduction in real personal incomes of 7 per cent as against a reduction of 2 per cent planned for the year. For the first nine months nominal average personal incomes per employee in the social sector had risen by 19 per cent. Efforts were being made at the enterprise level and through social welfare policy to protect the conditions of the lowest paid employees.

In response to Mr. Knežević's presentation, Mr. Tyler expressed his admiration for the achievement in the area of incomes policy which, in contrast to the past, appeared to have been extremely effective this year. Indeed, the degree of reduction in real personal incomes was of a quite extraordinary degree and, even with the degree of popular participation indicated by Mr. Knežević, it was still difficult to understand how this compression had been effected. Had there been widespread complaints within workers' councils as a result?

Mr. Knežević said that there had been no general complaints about the sacrifices involved, although there had been more specific complaints about working conditions in some of the branches mentioned earlier. However, the decision had been taken to prevent any further drop in personal incomes and to permit real incomes to rise hereafter in line with productivity. This was to be the framework for the remainder of 1980 and for 1981, and a real increase of 1.5 per cent was projected for 1981.

Mr. Tyler then asked about trends in other benefits. Mr. Knežević said that the policy for collective consumption in 1980 allowed a nominal increase of 14 per cent over 1979. Data for the first six months indicated growth at an annual rate of 8.3 per cent over the period, below that permitted under the resolution. Such expenditures covered items such as severance pay, meals, transportation to work, and allowances for vacations. In response to a further question, Mr. Knežević said that in the typical enterprise expenditures for collective consumption were the equivalent of two months direct pay. He also mentioned that productivity would remain essentially level in 1980, with employment growing at 3.8 per cent and industrial production around 4 per cent. With respect to targets for 1981, Mr. Knežević repeated that the growth of real per capita personal income would be held to 1.5 per cent. In addition, there was a desire to reduce disparities between branches, in favor of those where working conditions were harder, and away from those where the personal incomes were high primarily on account of their higher capital intensity.

## III. Monetary Policy

Mr. Petrović started his review of monetary policy during 1980 by saying that the monetary statistics given to the mission had been adjusted for the valuation changes brought about by the June 6 devaluation. The amount of outstanding domestic credit had been reduced by Din 31 billion in order to offset the increase in dinar value of foreign currency credits to residents. Similarly, the dinar value of net foreign assets had been reduced by Din 50 billion. Furthermore, the definition of the money supply had been changed. Since there were no reliable data concerning the float or payments in transit, this item was eliminated from the defined money stock.

Mr. Tyler replied by saying that while monetary statistics adjusted for valuation changes related to the dinar devaluation were certainly useful from an analytical point of view, they could not be used for reviewing the achievement of performance criteria, since no arrangements had been made to explicitly take account of these changes when the stand-by arrangement was agreed upon. However, the mission could report to the Executive Board that credit ceilings had been exceeded in part because of the devaluation which increased the dinar value of foreign currency credits to residents. The change in definition of the money supply, however, was not as important for the monitoring of the stand-by arrangement because the money supply was not a performance criteria.

Mr. Petrović continued by saying that the money supply had been planned originally to increase by 22 per cent or Din 83 billion over the whole year. By the end of September the increase was planned to be 15 per cent or Din 57 billion relative to end-1979, but now the effective increase was expected to have been only 14 per cent or Din 53.5 billion. These were preliminary data; final data might be available next week. During the same period, domestic credit (adjusted) increased by 17 per cent and the components of long-term and short-term domestic credit together increased by 16 per cent.

Originally, the increase in money supply and domestic credit was planned to be 22 per cent, equal to the growth rate of nominal GSP. Given the much higher than planned inflation rate, monetary policy thus turned out to be quite restrictive. Because of the effects of the devaluation and the higher than expected rate of increase of nominal GSP, the Yugoslav authorities now planned to increase the money stock by 26 per cent, so that it would reach Din 473 billion at the end of the year. It was intended also to increase domestic bank credit (adjusted) by 26 per cent and obtain a level of Din 1,515 billion at the end of the year. Net foreign assets were forecast to fall by Din 82 billion over the whole year (Din 32 billion adjusted) implying a rise in their level of Din 27 billion or about US$1 billion in the final quarter.

Mr. Tyler expressed his concern that the planned increase in the expansion of the money supply and of credit might undo the good results stemming from the firm implementation of the stabilization program in the first part of 1980. A sudden increase in monetary aggregates could have adverse consequences for the balance of payments. Moreover, the higher monetary growth rates did not really seem justified. Prices of industrial goods increased by only 23 per cent and retail prices by 29 per cent. From past experience, the GSP deflator could be expected to be around 25 per cent. Finally, raising the annual monetary growth rate to 26 per cent, when this growth rate had been limited to 22 per cent on a yearly basis till the end of September, would lead to a very large monetary expansion in the final quarter of the year. While the money stock had increased on average by Din 12 billion during the first two quarters of the year, the projected increase would amount to Din 44 billion in the last quarter of the year, by far exceeding any seasonal need. Mr. Dimitrijevic remarked that the increase in money supply was always greatest during the last part of the year and Mr. Petrović added that monetary policy during the first part of the year had definitely been too restrictive and that an increase in the growth rate from 22 per cent to 26 per cent would only lead to an additional growth in the money stocks of Din 15 billion. Mr. Tyler replied that an additional increase of Din 15 billion in just one quarter seemed excessively large. Given the data for September, money supply would have to increase by Din 29 billion in the fourth quarter to reach an annual growth rate of 22 per cent. In order to reach an annual growth rate of 26 per cent, however, money supply would have to increase by Din 44.4 billion in the fourth quarter, exceeding by more than 50 per cent the previous figure. Such a massive increase would certainly have consequences for the balance of payments possibly during the fourth quarter of 1980 and in the beginning of 1981.

Mr. Petrović indicated that in 1979 the money supply had increased by far less than nominal GSP. During the first nine months of 1980, the situation was similar and this was bound to lead to serious illiquidity problems. Mr. Dimitrijevic suggested that this discussion be continued when the projections for 1981 would be discussed. Mr. Tyler agreed but said that the 1981 Plan would be reviewed in the Executive Board at the same time as when performance for 1980 was assessed. A reversal of policies in the last quarter of 1980 would make a very bad impression and might prejudice the approval of an enlarged stand-by program. This would be regrettable since this mission had come to Yugoslavia with a very positive attitude toward approval of a larger stand-by program.

Mr. Tyler inquired if the proposed monetary target of 26 per cent had been unanimously accepted. Mr. Dimitrijevic said that the 26 per cent target was a compromise. Some wanted the increase in money supply to be equal to the nominal increase of GSP, others, like the Government, wanted to stick to the original 22 per cent target. He added that there was a need for credit to decrease payments arrears between enterprises and bring actual investments up to planned limits. Mr. Tyler recalled that the Yugoslav authorities had said that the current account deficit would be limited to US$2 billion, and that other targets would be subordinated to this end. Now it seemed that the deficit would exceed US$2 billion, but nevertheless monetary policy would become accommodating. The argument justifying an increase in credit traditionally had been that monetary expansion would only lead to the settlement of inter-enterprise credits. In the event, however, this had never been the case and increased bank credits had often quickly led to higher imports as investment activity was stimulated.

Mr. Petrović noted that reserve requirements had been liberalized during the course of 1980. This was consistent with the money supply targets since it aimed only at offsetting the decrease in primary money caused by the decrease of net foreign assets. Despite these measures the increase in primary money issue was less than expected, and banks did not have excess liquidity.

Mr. Tyler said that the staff team required both adjusted and unadjusted data on the monetary survey table for 1980 as well as projections for December 1980 so that these topics could be discussed when Mr. Marjanovic returned from abroad. Mr. Tyler asked about the evolution of foreign currency deposits held by residents. Did the decrease of net foreign assets of the National Bank not lead to a lack of confidence in the dinar and so to a reduction of these deposits? Mr. Dimitrijevic answered that the evolution of these foreign currency deposits was more affected by rumors concerning the imposition of limits on their use than by confidence in the dinar. In the beginning of the year such rumors circulated and led to a withdrawal of these deposits. Later this situation was reversed.

Mr. Dimitrijevic replied that the greater increase in money supply would not necessarily lead to an increased current account deficit. Mr. Petrovič agreed with this statement and said that he did not believe in a one for one relationship between money supply and the balance of payments.

Mr. Tyler observed that the lending of the National Bank to the budget of the Federation had reached already by June 1980 its end-of-year ceiling under the stand-by arrangement. The Yugoslav representatives stated that National Bank credits to the Federation would be kept at Din 77.9 billion for the remainder of the year.

The meeting adjourned at 1:30 p.m.

INTERNATIONAL MONETARY FUND

Yugoslavia

Minutes of Meeting No. 3
Held at the National Bank of Yugoslavia
on Friday, October 31, 1980, at 9:30 a.m.

Yugoslav representatives

Mr. Aleksandar Milošević, Federal Secretariat for Foreign Trade, Special Advisor to the Secretary
Mrs. Aneta Djermanović, Federal Secretariat for Foreign Trade, Advisor
Mr. Dimitrije Dimitrijević, National Bank of Yugoslavia, General Manager
Mr. Vladimir Dragomanović, National Bank of Yugoslavia, Deputy General Manager
Mrs. Gordona Hofmann, National Bank of Yugoslavia, Director
Mr. Duško Veličković, National Bank of Yugoslavia
Mr. Mijajlo Nikolić, Federal Secretariat for Finances
Mr. Duro Podunavac, Assistant President, Federal Bureau for Energy and Industry
Mr. Noviga Smilanić, National Bank of Yugoslavia, Director

IMF representatives

Mr. Tyler
Mr. Manison
Mr. Loser
Mr. Buyse

IBRD representative

Mr. Bery

The meeting discussed developments in foreign trade, exchange rate policy, and the energy situation.

## I. Foreign Trade

Mr. Milošević began by describing developments in foreign trade in 1980. He stated that in the first 10 months of 1980 the value of exports had risen by 30 per cent compared with the corresponding period of 1979 as a result of a volume increase of 10 per cent and average price rises of

19 per cent. Indeed, exports had risen at a faster rate than forecast by the staff earlier in the year. The promotion of exports had become a major focus of the policies of the Yugoslav authorities with technicians and political bodies now cooperating in studying export prospects and policies through to 1980. Mr. Tyler agreed that the placing of the balance of payments on a sound basis was a longer-term problem and could not be solved in just one year.

Mr. Milošević stated that one of the most dynamic areas of foreign trade for Yugoslavia in 1980 was that with the socialist countries of Eastern Europe. Such a development did not reflect any significant policy shift, but was the result of a change in the structure of Yugoslav imports and the need to balance higher imports with greater exports. In particular, the substantial increase in the value of energy imports from the U.S.S.R. gave scope for greater export potential. While total exports rose by 32 per cent in the first nine months of 1980, those to the socialist countries of Eastern Europe increased by 43 per cent. Imports from the socialist countries rose by 32.5 per cent over the same period compared with a global increase of 8.5 per cent.

Of the countries with which Yugoslavia had bilateral payments agreements, namely Bulgaria, Romania, Poland, and Hungary, the total value of exports had increased by 15 per cent in the first nine months of 1980 compared with the corresponding period of 1979 and total imports had fallen by one per cent. General policy objectives had been achieved, with better trade balances being attained with all of these countries. In fact, the export/import ratio had risen from 73 per cent in the first nine months of 1979 to 85 per cent in the same period of 1980. The following growth rates occurred in Yugoslav trade with these countries:

| | January-September 1980 / January-September 1979 (Percentage change) |
|---|---|
| Bulgaria | |
| Exports | 25 |
| Imports | 11 |
| Hungary | |
| Exports | 17 |
| Imports | -- |
| Poland | |
| Exports | 12 |
| Imports | 2 |
| Romania | |
| Exports | 11 |
| Imports | -15 |

Mr. Milošević said that there was still scope for increasing the volume of exports to these socialist countries.

Trade with the U.S.S.R. recorded a very large rise with exports and imports increasing by 60 per cent and 58 per cent, respectively, in the first nine months of 1980. The substantial increase in exports reflected a rise in payments on the basis of physical deliveries. The rapid growth of imports from the U.S.S.R. was due to high imports of gas, oil, and raw materials (cotton, coal for coking, scrap iron, and semi-finished ferrous metals), which in turn reflected sharp increases in the price of these commodities.

In 1979, of total imports from the U.S.S.R. of US$1,234 million, about half (US$615 million) were from oil and energy (SITC III). In fact, over half of the increase in imports from the U.S.S.R. in the first nine months of 1980 was due to the higher value of oil and other energy produced imports. Moreover, in this period imports of energy and raw materials accounted for 64 per cent of total imports from the U.S.S.R. compared with 50 per cent in the corresponding period of 1979. According to the SITC classification, the greatest import increases in the first nine months of 1980 were recorded in fuels and lubricants (105 per cent to US$1,264 million), and raw materials (37 per cent to US$265 million). Imports by other economic sectors stagnated. Although the volume of crude oil imports from the U.S.S.R. had only increased from 3.3 million tons in the first nine months of 1979 to 3.5 million tons in the same period of 1980, the sharp rise in oil prices increased the value of such imports from US$414 million to US$870 million. The price the U.S.S.R. charged Yugoslavia for crude oil imports was close to the world market prices.

In regard to exports to the U.S.S.R. the highest rates of increase were in agricultural products, leather goods, and chemical products (plastics, sulphuric acid, superphosphate, etc.), the latter group reflecting the coming on stream of new productive capacities. In this connection it was noted that the production of basic chemicals and processed chemicals had risen by 11 per cent and 17 per cent, respectively, in the first nine months of 1980 and compared with an average increase in industrial production of 4.3 per cent in the same period of 1979. The development of the petrochemical industry was expected to lead to considerable import replacement of substantial exports over the next five years.

For trade with East Germany and Czechoslovakia the rate of increase in exports had been considerably higher than that of imports in the first nine months of 1980. The percentage changes were as follows:

| | |
|---|---|
| Czechoslovakia | |
| Exports | 15 |
| Imports | 17 |
| East Germany | |
| Exports | 20 |
| Imports | 8 |

With these two countries and the U.S.S.R. the export/import coverage rose from 75 per cent in the first nine months of 1979 to 80 per cent in the first nine months of 1980. For the seven socialist countries the coverage ratio improved from 74 per cent to 81 per cent between the same periods, while the corresponding ratio for Yugoslavia's total trade rose from 47 per cent to 57 per cent. The total value of exports to the seven socialist countries increased by 41 per cent to US$2,595 million in the first nine months of 1980, while imports rose by 29 per cent to US$3,207 million over the same period.

Mr. Tyler remarked that despite the large increase in exports to the socialist countries, there was still a sizable trade deficit with this group of countries. He raised the question of whether partner countries were still willing to finance the deficit or would the trade balance be quickly reversed. Mr. Milošević replied that much of the trade deficit reflected higher oil prices. Moreover, it was appropriate that Yugoslavia had a trade deficit with these countries as they in turn had a deficit on their invisibles account with Yugoslavia. Net credits from tourism, investment abroad, and transport and communications in transactions with socialist countries were quite considerable for Yugoslavia. Over the last five years the deficit on the trade account with seven socialist countries had averaged US$600 million, while there was little imbalance for the full current account. Mr. Tyler suggested that there must be some lines of credit involved in financing the imbalances with certain socialist countries, particularly the U.S.S.R. Mr. Milošević replied that existing policies were to remove these imbalances. Some years ago a line of credit amounting to US$1.5 billion was extended by the U.S.S.R. for the import of capital equipment. However, details on these matters would be supplied to the staff next week. Negotiations on trade with the various socialist countries for the period 1981-85 had already been concluded with both sides being interested in balanced trade.

Mr. Tyler said that the moderation of domestic demand had led to the availability of goods for export. If domestic demand was increased at a higher rate would exports be affected adversely by supply difficulties? Mr. Milošević noted that 1980 had been a difficult year in that both a large increase in the volume of exports and a substantial decline in the volume of imports had to be effected in order to bring about the desired improvement in the trade balance. If import volume was held constant there would be no difficulties, but a decline created problems. In the first nine months of 1980 there had been a reduction in the trade deficit in constant price terms of about US$1.9 billion. However, the unfavorable movement in the terms of trade, caused in part by the sharp rise in oil prices, resulted in the deficit falling by only US$700 million. During the first nine months of 1980 import prices rose by 24 per cent, while export prices increased by 19 per cent compared with the corresponding period of 1979. The trade deficit in the first nine months of 1980 amounted to US$4,793 million which compared with US$5,456 million in the corresponding period of 1979. The year 1981 would be easier insofar as there would be some rise in the volume of imports and production capacity would come on stream to increase the volume of exportables and to replace imports. The increase in supply capacities would allow increased agricultural exports to Eastern Europe, higher textile, footwear and leather goods exports, together with larger exports of metal goods and equipment. Further information would be provided on new production capacities coming on stream. Demand and supply would be kept in balance and only in the event of extraordinary circumstances such as a bad harvest or a sharp rise in oil prices would difficulties be encountered.

With respect to changes in the commodity composition of trade, Mr. Milošević said imports of raw materials (SITC II) had increased by 25 per cent to US$1,131 million, and imports of fuels and lubricants (SITC III) by 63 per cent to US$2,551 million in the first nine months of 1980. A small increase had been recorded in imports of chemicals in the same period, while equipment imports had declined due to the cutback in fixed investment. Imports to other sectors had tended to stagnate. With respect to the rise in exports over the first nine months of 1980, footwear, clothing and furniture products (SITC VIII) had increased by 47 per cent, to US$977 million, chemical products (SITC V) by 60 per cent to US$688 million, and sugar and corn (SITC 0) by 56 per cent to US$629 million. Mr. Milošević said that a statistical release on trade results in the first nine months of 1980 would be given to the mission.

Mr. Tyler questioned whether press reports indicating that restraints on imports had led to supply bottlenecks which in turn had caused production difficulties were correct. Mr. Milošević said that this was a difficult question to answer. For certain individual cases misunderstandings between banks and communities of interest had led to supply problems. Enterprises experiencing internal difficulties often cited a shortage of imported materials as an excuse for their problem. The Annual Resolution for 1980 had provided for an increase in raw material imports and Mr. Milošević thought that inventories of raw materials were adequate. In short, while some individual enterprises complained about the lack of materials it was not a general phenomenon. Mr. Tyler observed that the good export performance for industrial products did not suggest a shortage of raw materials. Mr. Milošević agreed, noting the rapid rise in exports of textiles based on wool and cotton imports. He added that the Federal Secretariat for Foreign Trade had the power to raise quotas if there was a shortage of particular imports for industry. At present there were unutilized quotas. For 1980 it had been planned to increase the volume of raw material imports by 4 per cent. To date, the increase was 9 percentage points less than planned.

In response to Mr. Bery's question on export targets, Mr. Milošević replied that the expected results not only depended on the outcome in the trade account. In addition, developments in invisibles had to be taken into consideration. In principle, the projected results in the trade account depended on the surplus in services and a reasonable level of net capital inflows. The coverage ratio for 1980 had been projected initially to reach 60 per cent, a value considered sustainable over the medium term by the Institute of Foreign Trade. Although it was unlikely that the target would be achieved, a sharp improvement had been observed, from 47 per cent in 1979 to 57 per cent in 1980. For 1981, the authorities intended to continue their policies to increase the average ratio, but it was difficult to expect an improvement of the magnitude observed in 1980.

Mr. Bery inquired also about which restrictions imposed by importing countries had been most harmful to Yugoslav exports, and whether the import quota limits, in particular within the multi-fiber arrangements had been fulfilled. Mr. Milošević indicated that some problems had emerged in response to temporary measures by EEC countries, that reflected an increasing protectionist attitude by developed countries, although they had been solved in part by the conclusion of the agreement with the EEC earlier during the year which was expected to correct previous policies.

Mr. Tyler inquired if changes had occurred in the import list in 1980 and whether further changes were expected in 1981. Mr. Milošević replied that no changes had taken place in the RK and DK quota listings. But the 1981 Resolution envisaged the development of a new quota policy, to provide for a further liberalization of the import system. The general attitude was that quotas were to be used for protective and not balance of payments reasons. The study of the reform had been already initiated but the results would not be completed prior to the end of 1980. In any event, the policies for 1981 were to be viewed as transitional to the new system, and not as the final guidelines. He also indicated that a description of previous and expected changes in the system through 1985 were to be presented to the mission by another representative of the Federal Secretariat for Foreign Trade.

Mr. Tyler requested confirmation to his understanding that the 10 per cent surcharge applied to dutiable imports had been abolished at the time of the devaluation of June. Mr. Milošević said this understanding was correct and also indicated that the level of export subsidies and incentives had been reduced at the same time.

Mr. Tyler thanked the Yugoslav representatives for the useful discussions on trade, and congratulated them on the excellent trade performance observed during 1980.

## II. Exchange Rate Policy and Effects

Mr. Tyler inquired about the effects of the June 6 depreciation of the dinar on the performance of the current account, in particular on commodity exports and receipts for services. Mr. Dragomanović replied that in view of the fairly short period since the adjustment had taken place, no accurate and exact estimates could be made. As background information he noted that after a sharp increase of exports in the first months of the year, a marked deceleration occurred in the two months prior to the devaluation. These developments led to the view among the authorities about the need to adjust the rate if balance of payments problems were to be avoided. In response to the adjustment of the rate, exports resumed their rapid rate of increase and over the first nine months of the year they had risen by 32 per cent compared with the same period of 1979. Moreover, the average monthly rate of growth for the period July-September was considerably higher than that for the first six months of the year.

Mr. Tyler indicated that since the June adjustment, the exchange rate had not changed significantly vis-a-vis the U.S. dollar. He inquired whether the stability of the rate was an indication that there was no need for a further depreciation, notwithstanding the acceleration of price increases. Mr. Dragomanović pointed out that the effective rate had depreciated by about 4 per cent to 5 per cent since June, but that in general no major adjustment was envisaged for the near future. The sharp increase in prices was effectively the initial shock effect in response to the devaluation, but to a large extent the impact of the devaluation had been absorbed. However, the increase in import costs were not to be fully incorporated into domestic prices. During 1981 it was the intention of the authorities to keep the effective real exchange rate relatively constant through moderating price increases and making appropriate changes in the nominal exchange rate.

In general, the short-term impact of the devaluation on imports was expected to be small due to the relatively low price elasticity. Most of the reductions in imports had been the result of the agreement among enterprises to reduce imports, in response to the decline of domestic demand. Therefore, most of the initial effect had been felt in exports and services. In fact, the response of services had been very prompt. As an example, the monthly average of tourism receipts in the third quarter had been four times the level of the first half. By comparison, in 1979 the average level in the third quarter had been three times the average level attained in the first half. Similar trends could be observed in gross workers's remittances, although in this particular instance, the outcome in the first half of 1980 inflows had been relatively low due to extraordinary events of a noneconomic nature. Similarly, withdrawals had slowed down considerably in the third quarter, even after allowing for seasonal factors. The change in other services was also noticeable, although of less importance for the overall balance of payments outcome.

## III. Energy

Mr. Podunavać commenced the discussion on energy policies and developments, by indicating that the results observed to date had been considerably better than those projected at the time of the previous consultation with the Fund, early in 1980. Taking into account the nature of the Yugoslav economy as an

LDC, the reduction in oil consumption had been very satisfactory, as had been the increase in coal consumption. The results had not been fully in line with the expectations, but sharp declines had been observed in gasoline consumption. Notwithstanding an increase in the car fleet of 8 per cent, consumption had declined by 8 per cent, in particular after prices had been adjusted in 1979 and 1980. Fuel oil consumption (used for transportation) had remained at about the same level as in 1979, but in the long term any savings were to result mostly from investments in railroads and other gasoline saving projects. Moreover, the general use of fuel oil had been curtailed from 1,780,000 tons in 1979 to an expected 1,300,000 tons in 1980. Further reductions could be expected as a result of the adjustment in relative prices of coal and fuel oil to induce a greater use of coal. This was also expected to occur with respect to the substitution of coal for heavy oil, particularly for home heating. Consumption of the latter had declined by 14 per cent, to 1.2 million tons in response to prices and administrative measures (e.g., banning of use in new buildings). Although the demand for oil and gasoline as raw materials for petrochemicals had increased, the authorities did not intend to curtail the rise, as a significant part was directed to new capacities intended to enhance the export potential of Yugoslavia.

In response to a query by Mr. Tyler, Mr, Podunovać explained that the values shown in the table on energy and distributed during the meeting, did not include the imports for the filling of the pipeline and increases in stocks that totaled an additional 450,000 tons for all of 1980. Even including those values, imports were considerably below those originally envisaged. Mr. Tyler also inquired whether the current conflict between Iran and Iraq was expected to have a negative impact on oil availability to Yugoslavia. Mr. Podunavać indicated that although some oil had to be purchased in the spot market, there was sufficient oil provided by friendly nations and no drastic changes in quantities or prices could be envisaged for the near future. In general, Yugoslavia did not have the advantages of more developed countries that were involved in oil production in OPEC countries and, therefore, had to pay full prices for petroleum, which were close to the spot market prices. In general, major efforts had been undertaken by Yugoslavia to improve the efficiency in the use and for a more active conservation of fuel. The program had been adopted jointly by the Government and the Chamber of Commerce, and had been actively supported by the League of Communist Party and the Syndicates. According to the program, all OALs were required to analyze on a quarterly and annual basis the use of oil and other sources of energy to help reduce consumption. With regard to coal use, Yugoslavia confronted the problem that the demand for brown coal (lignite), which was easily obtainable, would not rise at a rapid pace. By contrast, production of black coal, obtained from underground mines, was more difficult to increase, but demand for home heating would absorb any rise in production. In any event, old mines had been reopened while existing ones were being expanded and modernized.

Mr. Tyler asked whether the import price in the table on oil consumption and imports (US$34.2 per barrel) represented the most recent quotation and not the average price for the year. This was confirmed by Mr. Podunavać.

Mr. Bery inquired about the results of the investment program in energy. In particular, he pointed out that the impact of recent investments had not been marked and this could have been caused by a lack of demand, lags in the completions of new capacities or underutilization of plants. Mr. Podunavač explained that the plan had not been fulfilled according to schedule, in particular for petrochemicals. Prior to 1979, the relative price structure did not induce a reduction of oil consumption and increases in the use of coal. After prices were corrected, it would take considerable time for the adjustment to take place. He also indicated that the total value of oil imports were not to exceed US$2.9 billion, but including derivatives, the filling of the pipeline and increases in stocks, the total could reach about US$3.5 billion. For 1981, it was expected that oil consumption would remain at the current low levels.

Mr. Tyler concluded the meeting by indicating that the great efforts undertaken by Yugoslavia in reducing consumption had been very successful and hoped that these efforts would continue to be pursued in the future.

The meeting adjourned at 1:30 p.m.

INTERNATIONAL MONETARY FUND

Yugoslavia

Minutes of Meeting No. 4
Held at the National Bank of Yugoslavia
on Monday, November 3, 1980, at 9:30 a.m.

Yugoslav representatives

Mr. Dimitrije Dimitrijević, National Bank of Yugoslavia, General Manager
Mr. Vladimir Dragomanović, National Bank of Yugoslavia, Deputy General Manager
Mr. Novica Smiljanić, National Bank of Yugoslavia, Director
Mr. Jovan Petrović, National Bank of Yugoslavia, Director
Mrs. Aneta Djermanović, Federal Secretariat for Foreign Trade, Advisor
Mr. Jevrem Godjevac, Federal Secretariat for Foreign Trade, Special Advisor
Mr. Toma Gudac, Federal Secretariat for Finance, Advisor
Mrs. G. Hofmann, National Bank of Yugoslavia, Director
Mr. Dusko Velicković, National Bank of Yugoslavia

IMF representatives

Mr. Tyler
Mr. Manison
Mr. Loser
Mr. Buyse

IBRD representative

Mr. Bery

I. Balance of Payments

Mr. Tyler opened the meeting by providing some reations to the balance of payments data and forecasts provided to the mission before the weekend. The mission had found it difficult to reconcile the forecast of imports for 1980 with data for the first nine months presented earlier by Mr. Milosević. That data showed the nominal growth in imports at 8.5 per cent over the corresponding period in 1979. The forecast, however, showed nominal growth for the year at 3.8 per cent, implying a decrease of 8.9 per cent for the fourth quarter as compared with the same period in 1979; this represented a volume decline in the last quarter of about 25 per cent, which did not appear likely. By contrast the forecast level of exports seemed reasonable. Mr. Tyler also noted that the import forecast when combined with the forecasts for exports and invisibles, resulted in a current account deficit of exactly US$2 billion. This suggested that the import figure for the year had in fact been residually calculated. Assuming that import growth was somewhat slower in the last quarter than in the first three, the current account deficit was likely to be between US$2.2 billion and US$2.4 billion. When compared with these figures, the preliminary 1981 forecast of US$1.8 billion for the current account deficit would represent a significant improvement. If the official forecast remained at US$2 billion for 1980 then a somewhat lower current account deficit would probably have to be targeted for 1981. Mr. Tyler stressed that, as far as the existing program was concerned, any current account deficit up to US$2.5 billion was acceptable. He wished though to clarify the assumptions behind the 1980 forecast and to indicate that a relationship existed between the forecast for 1980 and targets for 1981. He recognized that clarification of the 1980 import forecast would involve reference to the Secretariat of Foreign Trade and could not be provided immediately.

After discussion of a few administrative matters, discussion returned to the balance of payments tables provided for the mission (Table 11). Mr. Tyler remarked on the reduction in gross credits on account of workers' and emigrants' remittances compared to the 1980 projection. Mr. Dimitrijević responded that there had been a slowdown in the early part of the year for essentially political factors. While the flow had since been restored this had not fully compensated for the initial slowdown. Mr. Tyler also noted that estimates of consumers' and emigrants' remittances for 1979, both debits and credits, were less now than in estimates provided earlier in the year and asked if there was an explanation. Mr. Smiljanić, explained that the revised 1979 figures now excluded internal transactions between foreign exchange accounts of residents and, as such, were consistent with data for 1977 and 1978 earlier presented. This also provided an explanation for the high original forecasts for 1980, which had been based on the earlier, unrevised 1979 figures. On other invisibles, the forecast for 1980 of travel receipts was estimated on the basis of estimated tourist nights, average price of accommodation, and average expenditure outside hotels. Transportation credits reflected an estimated 3-4 per cent real increase and a 10 per cent increase in tariffs. The decrease in forecast interest credits in 1980 was because of lower reserve holdings, while the increase in other credits reflected substantial increases in investment works abroad. Turning next to debits on invisibles, Mr. Smiljanić repeated that withdrawals from foreign exchange deposit accounts had been high in the first half of the year, leading to the higher numbers for the year as a whole. The figure for transport reflected business travel only, which had been cut back under the stabilization program. The higher interest payments projected were due to the higher level of short-term indebtedness than originally estimated and rather higher interest rates.

Mr. Smiljanić then provided some explanations of the figures provided on long-term capital movements in Table 11. Before he did so, Mr. Tyler requested that additional detail be provided, giving gross drawings and repayments, and net lending by Yugoslavia, instead of the consolidated line currently presented. For 1980, Mr. Smiljanić provided the following details on medium-term and long-term capital movements.

| | (in millions of U.S. dollars) |
|---|---|
| Gross medium-term and long-term drawings (including gross use of IMF resources) | 4,613 |
| Less IMF (gross) | 413 |
| Medium-term and long-term less IMF | 4,200 |
| Of which: | |
| Financial credits borrowed by Yugoslav commercial banks | 650 |
| Suppliers' credits against capital goods | 1,600 |
| Suppliers' credits against raw materials | 360 |
| Anticipated borrowings by Yugoslav Government: | |
| (i) From IBRD | 250 |
| (ii) Financial credits borrowed by National Bank of Yugoslavia | 1,320 |
| Unallocated | 20 |

With regard to other capital account items, Mr. Smiljanić clarified that exceptional financing of US$250 million consisted of US$650 million (gross) borrowed by commercial banks on their own account, less US$400 million of repayments, while the improvement in short-term capital of US$338 million included an increase in commercial banks foreign exchange holdings of US$700 million and a decline in bilateral balances of US$350 million. Net use of Fund credit at US$343 million represented gross drawings of US$413 million and repurchases of US$70 million. Following upon Mr. Smiljanić's presentation, Mr. Tyler asked which sources of medium-term and long-term financing in 1980 were reasonably assured and which still in doubt. Mr. Smiljanić responded that suppliers' credits gross exceptional borrowing by commercial banks, and drawings from the IBRD were all relatively certain, and the major uncertainties lay with the borrowing program of the National Bank of Yugoslavia on its own account, amounting to US$1,320 million. Mr. Tyler remarked that earlier estimates for such borrowing, presented at Annual Meetings, had been of the order of US$1,700 million. As such, the current estimate seemed conservative. Mr. Dimitrijević added that, even if all negotiations underway were successfully concluded, there was still the issue of whether they could all be drawn upon in 1980.

The discussion then turned to forecasts of the balance of payments for 1981. Mr. Tyler indicated that the import forecasts inevitably depended on the final view taken on 1980 imports. Export growth seemed reasonable at 19.2 per cent; it was clarified that this consisted of an 8 per cent volume forecast and a 10 per cent price forecast. Mr. Tyler noted a slowdown in "other" invisible receipts; these were explained as reflecting weaker performance in investment works abroad in 1981. On the debit side, Mr. Smiljanić explained that withdrawals from foreign exchange accounts had been exceptionally high in 1980; as such, no further increase was projected for 1981 as a whole. On the capital account, Mr. Smiljanić provided a similar explanation to that provided for 1980; for medium-term and long-term borrowing the estimates were as follows:

| | (in millions of U.S. dollars) |
|---|---|
| Gross borrowing including IMF and exceptional financing | 4,100 |
| IMF gross | 195 |
| Exceptional financing gross | 750 |
| Gross medium-term and long-term borrowing excluding IMF and exceptional financing | 3,155 |
| Of which: | |
| Suppliers' credits against capital goods | 1,300 |
| Suppliers' credits against raw materials and intermediates | 400 |
| IBRD disbursements | 250 |
| Borrowings by National Bank of Yugoslavia | 1,200 |

Mr. Smiljanić also clarified that the exceptional financing figure of US$400 million consisted of US$750 million gross borrowings and US$300 million repayments, while the short-term capital figure of US$8 million outflow consisted of an estimated US$280 million to US$300 million drawdown of bilateral balances and a roughly offsetting increase in commercial bank foreign exchange holdings. On the short-term debt, Mr. Smiljanić stated that this took the form of lines of credit with commercial banks, at spreads between 2 1/2 per cent and 3 per cent above LIBOR. In response to questions from Mr. Tyler, Mr. Smiljanić said that in forecasting interest for next year it was hoped that trends in money markets would stabilize and that Yugoslavia would pay an average rate of 10-12 per cent on its medium-term and long-term floating rate debt. He estimated that roughly one-third of existing medium-term and long-term obligations were at floating rates.

## II. Exchange Rate Policy

Discussing exchange rate policy for 1980 and 1981, Mr. Dragomanović said that for this year policy had been not to continue frequent adjustments in the rate, but rather to let the price shock engendered by the June 1980 devaluation be absorbed by the economy. Once this had occurred exchange rate policy would again become active, aiming to maintain the competitiveness of Yugoslav exports through gradual but timely exchange rate changes. He also remarked that the National Bank was working to improve the methodology for determining appropriate exchange rate adjustments, and was seeking indicators that reflected demand and supply of foreign exchange across the entire current account, rather than differential movements in prices alone. Mr. Tyler asked what the legal position was regarding the level of foreign exchange reserves to be held and what the implications of such requirements were for policy. Mr. Dragomanović responded that by a change in the law passed in 1979 the National Bank of Yugoslavia was now obliged to ensure that reserves with the National Bank of Yugoslavia and commercial banks were sufficient to cover two months' payments for imports of goods and services from the convertible currency area; previously it had been three months' payments. If untoward events caused a deviation from this amount, the National Bank of Yugoslavia was obliged to take remedial action. Currently, the legal minimum was US$2.8 billion to US$3.0 billion. The policy for reserves was specified each year in the decision on monetary policy for that year.

Mr. Dragomanović then went on to discuss the nature of the current foreign exchange market in Yugoslavia. It was currently inactive, and accounted for an insignificant volume of transactions. The authorities considered it important to revive the market and to restore it to its economic function. For this to be feasible it was important that there be approximate balance between the demand and supply of foreign exchange in the economy. Currently demand o exceeded supply that there was no role for the central bank to play in the market; the task of allocating foreign exchange had been assumed instead by the enterprises themselves, operating within the framework of self-managing communities of interest for foreign economic relations (CIFER). In response to questions from Mr. Tyler, Mr. Dragomanović stressed that the allocation of exchange within the framework of the CIFER was outside the control of the National Bank of Yugoslavia or of other government bodies. There had been rumors that, on occasion, inter-enterprise transactions had occurred at other than the official rate, but to the extent these had occurred it was clearly understood that they were illegal and were not condoned by the authorities.

Returning to policy on reserves for the year, Mr. Tyler asked what figure of reserves was anticipated for the end of the year. Mr. Dragomanović said that the reserves target for the year was still for two months convertible currency import payments.

III. Trade Measures

Mr. Godjevac started by saying that the Yugoslav trade system had experienced no substantial changes since the last discussion with the Fund earlier in 1980. Generally, existing trends had been pursued. During 1980 certain regulations with respect to the foreign exchange and trade quotas were introduced, but they did not constitute substantial changes with respect to previous years. The new regulations only provided a more detailed analysis of the process of quota determination within the self-management agreements of the OALS. In addition, a decision was approved that transferred the decision making with respect to the determination of quotas to the relevant self-management agreements. Certain specific decisions were also passed in articles for fair exhibition, trade with neighboring countries, and imports financed by IBRD loans. All these regulations were organizational in character. Minor changes were introduced to the import lists: coffee and specified chemical products were transferred from quotas to the liberalized list. Mr. Tyler thanked Mr. Gordonowitz for the list of new trade measures introduced and asked if it would be possible to review them in more detail. Mr. Godjevac said that this list consisted of a series of measures taken since May 1980 which were relatively unimportant but agreed to give more details. The first series of measures concerned the Yugoslav energy balance. It was an agreement on the global relationships concerned in the energy field but did not indicate specific import volumes. The decision was devoted to those items in the import lists. The second series of measures was related to the new basis for customs operations of the

June exchange rate changes. The third series referred to commodities which were transferred from the quota to the liberalized list. The decree on the performance of investment works abroad extended the previous law through 1980. The amendment on the regulation stipulating the conditions for the sale of imported motor vehicles to domestic customers and was only of procedural and organizational interest. It was not intended to make it more difficult for private citizens to import cars. The item under 6 liberalized the conditions and extended the period for temporary imports by economic organizations concerning, among others, transportation means, certain tools and machinery. The seventh item ensured that the necessary goods for the completion of projects financed by World Bank loans could be imported. The eighth decision concerned the establishment and allocation of commodity and foreign exchange quotas for the import of goods in local border traffic. Its aim was to facilitate, within reasonable limits, imports of OALS situated in lower developed regions.

Mr. Bery inquired whether the local Chambers of Economy had to approve imports for border regions within the limits of general quotas. Mr. Godjevac indicated that the Chambers of Commercedecided which items would be of greater interest for the local OALS, depending on total production and then extended authorization for imports in addition to other quotas. Mr. Bery also inquired about the linking requirements for machinery produced locally. If so, he wanted to know whether this was done at the republican or at the Federal level. Mr. Godjevac said that import licenses can only be dealt out by authorized Federal authorities and, only for goods which are on the license list. For commodities on the quota list the size of the quota was determined jointly by producers and consumers. Thereafter import authorization was given to those OALS that needed them most. At this stage the Chambers of Economy and the republics intervened in the decision making. Mr. Bery remarked that his question concerned specifically machinery. Mr. Godjevac replied that what matters was the import regime under which a certain commodity falls, not its economic use. Imported commodities necessarily belong to one of the three following import regimes: liberalized (CLB), foreign exchange quota (DK or RK), or license regime. In the case of quotas the self-management agreement decided both the size of the quota and its beneficiaries.

Mr. Bery asked if the self-management communities of interest for external reasons had a particular obligation to provide foreign exchange for goods on the liberalized list rather than for goods falling under the quota or license regime. Mr. Godjevac answered that the self-management communities of interest had no direct influence on import regimes. However, once an item fell under the quota regime, the self-management communities decided on the size and distribution of imports based on the payment possibilities and distribution of foreign exchange. Moreover, regardless of the import regime of the commodity in question, the self-managed communities of interest decided on the allocation of foreign exchange. Mr. Tyler remarked that even goods on the liberalized list (LB) could only be bought with the authorization of self-managed communities of interest. This fact tended to result in LB lists not having any meaning and eliminating the distinction between the different import regimes. Mr. Godjevac said that within the self-management agreements foreign exchange belonged to those who earned it independently of the import regime. There was also a link between the earning and the disposal of foreign exchange. There was no distribution at the Federal level of foreign exchange, earned at the level of social communities of interest. They determined, between users and producers, the use of the foreign exchange within the various lists of imports.

## IV. Monetary Measures

Discussion then turned to an explanation of recent monetary and credit measures, a written list of which had been provided to the mission. Mr. Tyler asked whether the term "bank investments" in this list corresponded to bank credit. Mr. Dimitrijević said the term referred to bank-financed investments, and was similar to net domestic assets of the banks. In decisions prescribing the rate of increase in bank investments certain categories of investments were excluded from the limits. These included credit for investments in housing, and for special purposes such as for the development of the autonomous province of Kosovo. Excluded credits were equal to about 17-18 per cent of total bank credits. A list of the excluded investments would be given to the mission. Credits for the excluded categories of investment were included, however, under the definition of credit for the current stand-by arrangement. Mr. Dimitrijević added that the first stage of formulating the credit program consisted of estimating global credit needs. Then the amounts planned for the excluded or special categories would be deducted from the global figure. The residual would be available as credit for other purposes.

Mr. Tyler asked whether the measure containing new provisions on the calculation of the reserve ratio applicable to the increase in dinar value of foreign currency deposits was a sterilization measure. This was indeed the case. Mr. Tyler remarked that most of the other decisions seemed to indicate a move to more expansionary monetary policies. Mr. Petrović agreed and said that there had been liquidity problems during the first part of the year. These measures included the reduction in the bank's obligatory reserve ratio to the present level of a 15.5 per cent of bank sight deposits. It was possible that reserve requirements could be further lowered in 1981. Mr. Tyler also inquired about the decision referring to the charges banks have to pay for the use of their obligatory reserves to meet liquidity requirements. Mr. Petrović said that the interest rate had not changed but that now the obligatory reserves are defined as an average amount of reserves required during an accounting period. Occasional falls in reserves below this level are allowed as long as the average during a certain period is observed.

Mr. Tyler asked for more details about the decision concerning the financing of wheat. Mr. Petrović said that this measure was taken to enable the purchase of a maximum amount of wheat by the private sector to avoid wheat being used as fodder.

Mr. Tyler said that the decision passed in October concerning the volume and rate of bank investments between October 1 and December 31, 1980 was important and had been discussed with Governor Bogoev. While this decision was consistent with an increase in the money stock of 26 per cent during 1980, in the letter asking for a modification of the stand-by arrangement an increase in net domestic assets of the banking system would be proposed, which was consistent with a 24 per cent increase in the money supply to December 1980 and the change in net foreign assets forecast by the National Bank of Yugoslavia in Table 6. Mr. Tyler said that in future stand-by arrangements it might be possible to define net domestic assets of banks in terms of a constant exchange rate.

Mr. Tyler inquired also about the decision extending the time limit for subscriptions to Treasury bills. Mr. Petrović replied that this was done as an alternative to a further issue in the final quarter of 1980. The name of these bills was misleading since the ultimate issuer was not the Federation but the National Bank.

In conclusion, Mr. Tyler stated that it was encouraging to see the Yuboslav authorities making more flexible use of the instruments of monetary policy in managing their economy in 1980.

The meeting adjourned at 1:30 p.m.

INTERNATIONAL MONETARY FUND

Yugoslavia

Minutes of Meeting No. 5
Held at the National Bank of Yugoslavia
on Tuesday, November 4, 1980, at 9:45 a.m.

Yugoslav representatives

Mr. D. Dimitrijevic, National Bank of Yugoslavia
Mrs. G. Hofmann, Director, National Bank of Yugoslavia
Mr. J. Veljkovic, Assistant Director, General Planning Office
Mr. Prica, Advisor, Federal Bureau for Social Planning
Mr. J. Petrović, National Bank of Yugoslavia
Mr. T. Gudac, Gederal Secretariat for Finance
Miss G. Djerdjevic, Interpreter

IMF representatives

Mr. Tyler
Mr. Manison
Mr. Loser
Mr. Buyse

IBRD representative

Mr. Bery

Mr. Veljkovic commenced the meeting by explaining that the discussion would be devoted to the analysis of the Five-Year Program for 1981-85, currently in preparation and, also answers would be provided to a number of questions that had been presented by the mission on the subject of investment.

Mr. Tyler indicated the interest of the Fund staff in the prospective developments in the current account of the balance of payments. The size of the current deficit was of a magnitude that required adjustment over the medium term. Two alternative policies could be pursued to attain the objectives: (a) a curtailment of demand in the short run, as had been the case in 1980, or the implementation of policies that would help restructure the economy to increase exports and reduce imports over the medium term, and thereby help to improve the balance of payments. For the latter purpose it was of considerable interest to the Fund staff to obtain a good indication of the structure of investment, to achieve a larger export availability and import replacement, as well as the quantitative targets sought. If the basic documents were not yet finalized, due to the process of preparation and internal discussions, a general idea of investment policy, and the resulting prospects of the balance of payments in the medium term would be welcome.

Mr. Veljkovic described the framework of investment policy in 1981-85. The projections had to be seen in the light of the sharp adjustment in income distribution, personal consumption and investment, in 1980. There was a political consensus that investment policies be followed during the next five years had to be adapted to two main features: (1) priority-branches had to receive sufficient resources for investment. These priority areas were basically (i) food, (ii) energy, (iii) raw materials, (iv) export-oriented output, as well as (v) an integrated transportation system (intended to reduce transport costs in Yugoslavia to more competitive levels. (2) a political determination to reduce the ratio of investment to GSP over the period of the Plan. In part these two features were contradictory in principle; a change in the investment to more capital-intensive projects had to be made compatible with declines in the ratio of investment to GSP from 35 per cent in 1979 to a projected ratio of 33 per cent in 1980, 31 per cent in 1981, and a final ratio of 30 per cent in 1985. In order to achieve these objectives, the system of social compacts and self-management agreements had to provide for a successful reorientation of the process of accumulation to the priority sectors. In principle, the task was complicated by the degree of decentralization of the decision-making process, but there was a determination to achieve the stated goals. Moreover, the social compact for 1981-85 was to make investments in nonpriority sectors extremely difficult, by a continuation of fiscal and monetary measures, as well as direct administrative agreements within and between the republics were to establish special funds for the priority sectors. For example, self-management agreements had been concluded between enterprises in Bosnia-Herzegovina and Serbia for an investment equivalent to Din 100 million for an iron ore mine, and financial resources had been transferred between enterprises in the two republics to achieve that objective. Moreover, the restrictive financial policies would help attain the reorientation of investment. In general, it was intended by the Yugoslav authorities to direct investment to support projects in the form of pooled resources, by providing advantages like higher interest rates, to those enterprises that provided funds.

Mr. Tyler inquired whether enterprises could be directed to pool their resources. Mr. Veljkovic replied that several aspects had to be analyzed. On the one hand, a political initiative was important for the achievement of the objectives. In addition, increased credit opportunities, lower interest rates, and other measures would help provide the resources for the priority sectors. In general, interest rate policies were to become more active over the period. At the same time, republics and provinces were required to reach agreements to channel 80 per cent of the foreign funds obtained to priority sectors. Clearly, such trends of investments indicated a slowdown compared with the period 1976-80, but the structure of investment was expected to improve. All policies were to be supported by the sociopolitical organizations through three types of measures: (1) providing stable incomes for OALs in priority sectors, to improve their operating conditions. This objective was to be achieved by an improvement in the price relations for those OALs. (2) Reduction in import taxes, especially for items not produced in Yugoslavia, for priority sectors. Although equipment imports were to be reduced in general, it would not be the case for these activities. (3) Tax exemptions for priority sectors and increases in taxes for other sectors were to be implemented; in particular, taxes were to be increased to reduce incentives to activities with high import and low export components.

These policies were contained in several social compacts, that were in the process of being finalized. The basic compact between republics envisaged the harmonization and common direction of the process of production. It was currently being discussed and was expected to be approved by mid-November. A second social compact was directed at economic relations with foreign countries. It dealt with the balance of payments and external debt, and was also in the process of preparation at this time. The working document being currently discussed projected a rate of growth in exports of 8 per cent, that within five years was to increase the cover ratio to 70 per cent by 1985. Exports with the highest possible value added were to be promoted and were expected to be concentrated in agriculture, equipment, ships, and services. The target for the current account was a cumulative deficit of US$6.0 billion, in current dollars, to avoid an overly sharp increase in foreign indebtedness. This calculation assumed an annual average rate of price increase of 10 per cent from 1980 to 1985 for both exports and imports. The rate of growth of GSP was to be between 4-5 per cent, the minimum required to achieve the desired rate of growth of exports, and a reasonable growth in consumption. The growth of imports envisaged for the period would ,to an important extent, be dependent on the export performance. If a rate of growth of exports of 8 per cent materialized, imports could grow at a rate of 3-4 per cent. Imports were to be mostly concentrated on raw materials and intermediate goods. A slowdown was projected for consumer goods and equipment. Policies were to be geared to substitute imports of these commodities. Clearly, the shift of pressures to the priority areas, both domestically and for imports, was a difficult process to implement and there were lags but over time the direction of investment would be changed.

A third document was linked to the need for increased assistance to less developed provinces and republics (Kosovo, Macedonia, Montenegro, and Bosnia-Herzegovina). This document had created some controversy as to the recipients of aid. Kosovo clearly required further assistance--its per capita income was only one third of the average for Yugoslavia, while for the others per capita income amounted to two-thirds of the average for the country, and according to other indicators of wealth they were about in line with the rest of the regions. Therefore, at a technical level, other republics were not willing to contribute the envisaged amounts. In addition, Serbia was interested in reducing its contribution to the general fund because of its lower than average per capita income. But even if some conflicts existed, an agreement was to be reached at the political level within one month, with no major difficulties expected. In addition to the three previously mentioned documents, a social compact had also been prepared in relation to defense issues.

## II. Investment

Mr. Prica indicated that he would answer the supplementary questions on investment policies requested by the mission. With respect to the first question on the control of noneconomic investment in the past, the resolution for 1980 indicated that noneconomic investment would decline, except for housing and investment in the communal sectors that were to increase moderately. In 1979, noneconomic investment had increased by 7.5 per cent, and initially it was projected to increase by 3.7 per cent in 1980. By mid-year plans were modified, and the rate of growth was adjusted downward to 0.8 per cent for the year. In order to achieve these results two laws were passed. According to the first, sociopolitical communities were not allowed to obtain funds for construction of administrative buildings, while for other noneconomic projects, a 50 per cent ratio of self-financing was required. The second law also reduced expenditure for specified noneconomic investment expenditure in the field of culture, art, physical culture, and monuments. In addition restraints were introduced on investments for services of education, social security, and for other activities of the sociopolitical communities, although certain exceptions were granted. For the first nine months, payments for investment in noneconomic activities had remained constant in real terms and were expected to decline by 5 per cent for all the year. Mr. Veljkovic added that for

1981 a decline of 30 per cent in real terms was projected, except for housing, based on a policy of moderation of collective consumption. Moreover, there would be a restrictive granting of exemptions in these sectors. The importance of noneconomic investment was not to be discounted. In 1980 it constituted the equivalent of one third of total investment--22 per cent for housing and 12 per cent for other sectors.

With respect to question 2 on instruments to control investment to priority areas, Mr. Prica indicated that the Federal Government used mostly indirect instruments, like lower customs duties on imports and protective tariffs and tax exemptions. In addition selective credit policies were geared to favor the priority sectors. Currently selective credits on favorable terms were given to agriculture and exports of capital goods but it was now to be extended to other sectors. Where the Federation had power, price policies could also be utilized. Republics and autonomous provinces also provided tax rebates, a liberalization of income tax for services in priority areas and low interest rate credits, in particular for tourism and agriculture. Foreign credits could be directed to priority areas. In addition, reserves were transferred to underdeveloped regions, from the common Federal fund. In some republics, there was compulsory pooling of resources, mostly for the completion of energy projects. In addition banks had to channel resources to priority sectors, as a consequence of recently concluded agreements on priority sectors. In addition the sociopolitical communities also influenced other organizations to achieve a change in investment priorities.

With regard to question 3, on non-oil energy production and transportation a written response was being currently prepared. This was also the case with respect to question 5 on the growth and distribution of investment with respect to priority sectors. Question 4 on specific examples of agreements to implement the priorities of the 1981-85 Plan had been discussed previously during the meeting. Mr. Veljkovic indicated that an interesting agreement had been concluded among electronic firms of Slovenia, Croatia, and Serbia to build a cathode ray tube plant in Nis. A similar joint effort had taken place with respect to iron ore development.

Mr. Bery inquired as to the slow pace of implementation of investment projects in 1976-80. Mr. Veljkovic indicated that social compacts and agreements had been delayed. Currently there was a simultaneity in the preparation of plans and programs. All subjects in self-management agreements were to cooperate in the completion of programs, based on material balances in their sectors. Agreements based on the prescribed planning process had been concluded in the fields of agriculture and for some minerals. In general, participants of social compacts were to cooperate to achieve a better resource allocation based on the following principles: (a) improvement in the personal incomes of workers, increased yield of investment, and higher foreign exchange inflows and smaller outflows; (b) pooling of resources for the completion of projects in the fields of energy, raw materials, and intermediate goods; (c) increase in productivity as a result of better coordination and organization; (d) a more equitable distribution of regional development, and (e) adequate considerations with regard to the impact of the projects on the environment.

Mr. Prica added that the coordination between republics to attain the investment objectives in priority areas could be illustrated by the energy plan being currently discussed for Kosovo through the year 2000. A special social compact was to be signed determining the prospects for investment in energy in that province. Mr. Veljkovic mentioned that a new strategy of technological development was being proposed as a complement to the investment plan. New criteria had to be established and common agreements had to be determined in order to have a rational policy for the importation of new technology, which would be administered by the Federal Government.

With regard to question 6, on the mechanisms for appraisal and approval of investment proposals, Mr. Prica indicated that the need to analyze projects had been emphasized in recent agreements. There was a need for a social verification of the quality of new investment; the idea was central to the projects and was to be included in a new law on investment, currently under preparation. In a first instance, responsibility for preparation and appraisal of investment was to be given to experts, that had to be independent of the investing organization if the amounts of the new projects exceeded certain value limits. The planning authorities had to appraise the projects within the context of the priority lists. Even the banks were taking part in the exercise. For several years, investments had been appraised by a special institute in the Ljubljanska Banka and a new Serbian institute for project appraisal was to be constituted in Belgrade, financed by the Chamber of Commerce of Serbia, to analyze projects in that republic. The mechanism of appraisal was of major importance. If a project was rejected by the appraising agency, no financing would be extended, and therefore, the investment would not take place. In order to assess the viability of projects regular cost-benefit analysis was being applied. In part the overview was left to the banks, that use the appraisal methodology of the IBRD.

The meeting adjourned at 12:45 p.m.

INTERNATIONAL MONETARY FUND

Yugoslavia

Minutes of Meeting No. 6
Held at the National Bank of Yugoslavia
on Wednesday, November 5, 1980, at 9:30 a.m.

| Yugoslav representatives | IMF representatives |
| --- | --- |
| Mr. D. Dimitrijevic, General Manager National Bank | Mr. Tyler |
| Mrs. G. Hofmann, Director, National Bank | Mr. Manison |
| Mr. J. Petrovic, Director, National Bank | Mr. Loser |
| Mr. A. Jovanovic, Senior Advisor, Federal Secretary for Finances | Mr. Buyse |
| Mr. M. Kolundzija, Special Advisor, Federal Secretariat for Foreign Trade | **World Bank representative** |
| | Mr. Bery |

The meeting discussed preliminary plans for monetary policy in 1981, interest rate proposals, and developments in public sector expenditures and revenues.

## I. Monetary Policy in 1981

Mr. Petrovic said that monetary policy for 1981 would be geared toward supporting the continued implementation of the stabilization program. As in 1979 and 1980, the authorities would endeavor to keep the growth of the money supply below that of nominal GSP in 1981, although the gap in percentage points would not be as great as in the earlier years. Preliminary projections showed nominal GSP growing by 24 per cent and it was aimed at limiting the increase in the money supply to 22 per cent over the 12 months to December 1981. Mr. Petrovic said that the monetary projections for 1981 were based on an average exchange rate of Din 28 per U.S. dollar, an increase in prices of 15 per cent from end-1980 to end-1981, and an obligatory reserve ratio for banks of 15.5 per cent. Mr. Tyler said that the monetary projections seemed reasonable, although he considered the price assumptions on the optimistic side in part because of the probable need to effect a further depreciation in the foreign exchange value of the dinar in 1981.

In reply to a question by Mr. Tyler on whether there was a close direct relationship between quasi-money and domestic expenditures, Mr. Dimitrijevic said that increases in quasi-money had little impact on domestic spending. In fact, quasi-monetary deposits tended to absorb spending power. Mr. Tyler noted that since the encashment of foreign exchange deposits into dinars could be used as a basis for the extension of consumer credits, the accumulation of such deposits could boost domestic spending through this link. Mr. Dimitrijevic said that there was often a long delay (up to two years) before consumer credits could be obtained on the basis of foreign exchange deposits. Moreover, such credits were limited to loans for housing and productive economic activities and depended upon the credit capacity of the banks. Credit for housing at present constituted about 10 per cent of total bank credit.

Mr. Tyler enquired whether credits which were outside limits on "bank investments" could grow very rapidly and undermine the restrictive monetary policy. The Yugoslav representatives stated that many of the exempted credit categories were closely controlled, such as credits for the less-developed regions. Unless closely supervised, loans to housing could be a problem area. As in previous years, efforts would be made to eliminate the reliance of the federal government on the banking system in 1981. The planned sectoral distribution of credit would be similar to that recorded in 1980. Mr. Dimitrijevic observed that the household sector's demand for money was quite predictable, but that that enterprise sector's demand appeared to be quite unstable over the short run.

Mr. Dimitrijevic said that there was a very small lag between the primary money issue and changes in the money supply. In net terms, the primary money issue was projected to rise by Din 35 billion in 1981, compared with a forecast rise of Din 39 billion in 1980, the latter being based on a 26 per cent rise in the money supply. The main source of primary money expansion would be National Bank credits which were projected to rise by Din 53 billion in 1981 compared with an expected increase of Din 50 billion in 1980. It might be necessary to decrease the reserve requirement ratio in 1981.

## II. Fiscal Policy

Mr. Jovanovic began by discussing the results for 1979 in the public sector accounts. A list of the most important fiscal measures taken during the year would be handed out to the mission the next day. Total expenditures were 20 per cent higher in 1979 than in 1978 and total revenues increased by 22 per cent. The overall public sector showed a Din 2.4 billion surplus. Only the federal budget showed deficit which amounted to Din 3.8 billion. All other sectors had surpluses which, if greater than planned, had to be returned to the economy. Decisions for this purpose have already been taken for over 90 per cent of the 1979 surplus.

Fiscal policy for 1980 was determined by the Annual Resolutions and to date social security was the only sector for which the 1980 target has not yet been fixed. For the other sectors, the average growth rate is 16 per cent. Growth rates for social services, like education and culture, are close to the average but increases in contributions for natural disasters, such as earthquakes and floods, were likely to be above average.

Mr. Jovanovic stated that since increases for revenue are determined at the end of one year for the duration of the following year, there is generally a divergence between planned and actual revenue. As revenue is based on the personal incomes of citizens which in the past have been faster than expected, revenues have generally been higher than planned.

For the first nine months of 1980, some data are available. Assets for disability allowances went up by 28 per cent, while revenue to finance other kinds of general needs rose by 19 per cent. Revenue for collective consumption increased by 24 per cent, partly as a result of the sharp increase in collections by self-management communities of interest concerned with material production. Energy, railways and highways were considered public needs and are partly generally financed. Targets had to be modified frequently because about 50 per cent of the needs are satisfied at the level of the communes. The country consisted of about 450 communes which in turn have each about 10 self-managed communities of interest. There are thus nearly 5,000 bodies in the country which can decide to increase or decrease revenues and expenditures. Surpluses are allocated to different accounts on a quarterly basis so that they cannot be greater than planned. Data for separate accounts are not available yet but all decision-making bodies are planning to decrease revenue rates during the fourth quarter of the year, because revenues were greater than planned. Nevertheless, the increase in revenues will exceed the planned 16 per cent ratio because some items are excluded from the 16 per cent target and because there is self-contribution to local communities. There are 10-20 local communities in one commune and they contribute to the financing of local needs, such as highway repairs. In the self-management communities of interest, however, the 16 per cent target applies.

As far as the structure of revenue is concerned, the highest increase will take place in the economic sector because their incomes increased at the fastest rate (see item no. 126). For the same reason (item no. 121) revenues were increasing at a slower rate in the noneconomic sector.

Household expenditures decreased relatively as can be derived from the fact that revenues from the turnover tax have increased by only 22 per cent.

Overall for 1980 revenues for general and collective needs are projected to rise by less than that of nominal GSP. Collective consumption should increase selectively, depending on needs. In 1980 the total public sector will probably again show a small surplus. Consequently, tax rates are being lowered, except for the sectors where revenues and expenditures are balanced. In reply to Mr. Tyler's question Mr. Jovanovic said that expenditures on payment of personal incomes amounted to about 60 per cent of total public expenditures.

Mr. Kolundzija stated that in 1980 the original federal budget adopted by the National Assembly had both revenue and expenditure at Din 128 billion, including repayments of credits. The devaluation had an impact on the federal budget by increasing repayments of loans, and increasing expenditures for business travel abroad and for international organizations. The total increase of payments obligations due to the devaluation is estimated at Din 3,815 million. After adjustments were made in the budget the extra financing need is estimated at Din 2,445 million. In addition, pensions and disability allowances were increased by Din 3,999 million or 3.1 per cent of the total budget. The total budget increase due to the devaluation and these social allowances will be close to 6 per cent. On the revenue side, the tariff duties were not lowered but other customs charges were decreased. The average customs burden was 21.9 per cent in 1979 but after the devaluation it will amount to about 11 per cent. For the first nine months of 1980 the average customs burden was 16 per cent. The original customs revenue going to the budget was estimated at Din 30.6 billion, but this figure should now be lower. Substitutes for customs revenues will thus have to be found but where the funds will come from is still being discussed.

Mr. Tyler remarked that in the first nine months of the year, total revenue increased by less and expenditure by more than planned. Unless there is a change in trend during the last three months of the year, there would thus be a deficit. As the National Bank did not intend to finance this deficit, either taxes would have to be increased, or bonds would have to be issued. Of course, borrowing from commercial banks was another possibility but this would have the same monetary implications as borrowing from the National Bank.

Mr. Kolundzija replied that according to the law, the budget deficit must be financed by the Republics and Autonomous Provinces. At the moment, it was very difficult to say whether they would be able to do so or to indicate whether other sources of financing would be utilized. The Republics and Autonomous Provinces had not as yet expressed their opinion concerning these matters in the Federal Assembly.

For 1981 some projections had already been made. The estimate for the federal budget was Din 169.6 billion or 28 per cent more than revised budget for 1980. These figures were based on departmental requests rather than on finally agreed allocations. The contributions of the Republics to the underdeveloped regions and for expenditures for disability allowances and veterans benefits would account for 88 per cent of the budget. The remaining 12 per cent of their contributions would be to cover administrative expenditures or noneconomic investments. National defense will be financed by special agreements between the Republics and the Autonomous Provinces.

Mr. Marjanovic intervened to say that the basic orientation for next year is to reduce the share of collective consumption in GSP. The share of defense in total expenditure and in total GSP will be decided by the Republics and the Autonomous Provinces. This expenditure item was less flexible than others and as a share of GSP it was likely to rise. In 1981 the federal budget performance would be integrated with the stabilization program along the same lines as in 1980. Toward this end the National Bank would minimize or even eliminate its financing of the budget deficit in 1981.

## III. Interest Rate Policy

Mr. Tyler commenced the discussion on interest rates by indicating that the low interest rates that prevailed in Yugoslavia had encouraged increases in the level of investment and consumption that would have not occurred otherwise. The low interest rates resulted in an inefficient allocation of resources even within enterprises. In order to achieve greater efficiency in Yugoslavia's investment policy it was sensible to develop a financial market with realistic interest rates. Certainly, a program that included interest rate measures would be supported more favorably by the IMF.

Mr. Dimitrijevic agreed that in principle a more rational interest rate policy was required for the more efficient behavior of enterprises, and this was the general approach of the authorities. Recently, the National Bank had prepared a proposal that was being discussed by the Government of the Federation and the banking system: the main aspects that had to be taken into consideration for the proposals on interest rates were the following: (1) the present institutional framework consisted of free interest rates for lending purposes; maximum limits could be applied, although ceilings were not operational; (2) no financial markets existed currently, and therefore there was no single structure of market-determined rates; the structure consisted of various rates charged by different banks and for different credits; (3) over the previous two years interest rates had not been significantly negative in real terms, notwithstanding variable inflation rates. Interest rates to enterprises had ranged between 10 per cent and 12 per cent while the rate of inflation had averaged about 10 per cent per annum. Only in the recent two years had inflation increased sharply and real interest rates had become quite negative; (4) interest rates for deposits were currently fixed, while lending rates had been established freely by the interested parties. Under current conditions, the new proposal envisaged an increase in deposit rates by an average of about 4-5 percentage points. The increase in these rates were to stimulate the establishment of an agreement that contemplated higher rates paid by banks and would allow them to charge more for lending. The National Bank would not act directly on interest rates. Increases in deposit rates would not be across the board, but would be differentiated according to maturity. For example, banks could increase the rates on sight deposits by 1 per cent while for certain other longer-term deposits the rates could increase by 5 per cent. Lending rates could increase in line with the change in deposit rates. Some priority sectors would continue to be financed at a rate of 10 per cent while nonpriority sectors could be charged considerably higher rates. The proposed measures would not to result immediately in positive real interest rates, but in conjunction with a lowering of inflation would lead to more realistic rates. The differential interest rate structure would have a different effect for different banks, depending on their sources of financing, i.e., savings deposits, demand deposits, or foreign exchange borrowing, which carried a high foreign exchange risk.

Mr. Tyler commented that the changes were in the right direction, but if inflation continued at the current rates, real interest rates would continue to be negative. Therefore, more flexibility had to be built into the system, although the current reform did not envisage a marked change in the present structure. He also inquired about the interest policies to be pursued in the nonpriority sectors. Mr. Dimitrijevic indicated that although interest rates had affected the flow of funds and allocation of resources in Yugoslavia, other elements were also of considerable importance. However, with the abatement of inflation, interest rates for loans to nonpriority sectors would become positive in real terms and this could be expected to moderate investment in such sectors. He also explained that interest rates would be determined in individual agreements and by individual banks.

Mr. Tyler also commented that although no financial markets had been developed in Yugoslavia and the rates structure was not unified, the National Bank could influence rates by the discount and reserve requirement policies. Mr. Dimitrijevic explained that the National Bank could not directly affect rates in the priority sectors and, therefore, the best way to influence the market was to increase rates for deposits. In this regard, the authorities were contemplating the modification of the system of deposits in foreign exchange, that were currently receiving rates similar to those for deposits in domestic currency, to a structure that was related to the relevant country's interest rates for those currencies in which accounts were denominated. Mr. Bery noted that because of the mamor cutback in investment in nonproductive investment, the loans affected by the measures would be a relatively small proportion of the total. Mr. Dimitrijevic indicated that the higher interest rates were to affect both noneconomic and priority sector loans. With regard to the priority sectors, these would be established at a national and in some cases at the regional level, and therefore the structure of rates had to be established for each case.

Mr. Tyler commented that the experience with respect to systems with complex selective interest rates showed that great incentives existed for the enterprises to change the classifications of the loans in order to obrain less expensive financing. A more rational system would provide for direct subsidies to enterprises for priority projects. Mr. Dimitrijevic replied that the other members of the banks had to closely supervise the process of credit allocation and that this would help avoid abuses with respect to obtaining preferential interest rates. This was the case now when the financing originated from deferal and other special funds that were lent at preferential rates. But in any event, the very low interest rates were not expected to have any major impact on resource allocation as most of them were earmarked and would not affect the level of investment. Lower rates were granted on funds for priority sectors as a financial compensation that would help make those projects profitable, a necessary requirement for their success. Mr. Tyler indicated that the degree of distortion that was incorporated into the use of earmarked resources when a nominal rate was fixed, was not independent of the rate of inflation. In any event, it was not a rational policy to provide low-cost loans during periods of rapid inflation.

Mr. Tyler inquired whether the newly proposed system would become operational by the end of 1980. Mr. Dimitrijevic explained that the basic research by the banks would be concluded by the end of the year, but that the actual new system would only become operational in 1981. In any event the transition to the new system would be gradual as interest rates would not be changed for the outstanding debt, while they would be modified for all deposits. The implementation could take considerable time, but there was a clear determination to carry the policies through during 1981, although not at the beginning of the year.

The meeting adjourned at 12:45 p.m.

INTERNATIONAL MONETARY FUND

Yugoslavia

Minutes of Meeting No. 7
Held at the National Bank of Yugoslavia
on Wednesday, November 5, 1980, at 3:00 p.m.

<u>Yugoslav representatives</u>

Mr. I. Marjanovic, Deputy Governor, National Bank of Yugoslavia
Mr. D. Dimitrejevic, Director, National Bank of Yugoslavia
Mrs. G. Hofmann, Director, National Bank of Yugoslavia
Mr. Ante Zmigorevic, Deputy General Manager, Federal Bureau for Social Planning
Miss G. Djurdjevic, Interpreter

<u>IMF representatives</u>

Mr. Tyler
Mr. Manison
Mr. Loser
Mr. Buyse

The meeting discussed macro-economic forecasts for 1981, the negotiation of external financial credits for 1980 and 1981, and external reserves management policies.

## I. Macro-Economic Forecasts ror 1981

<u>Mr. Zmigorevic</u> said that the economic situation had improved in 1980 despite a number of difficulties. The external trade and current account deficits had been reduced even though there had been an unfavorable move in the terms of trade. In the first ten months of 1980 real exports had risen by 9 per cent and by 30 per cent in nominal terms, while the volume of imports had fallen by 10 per cent in spite of a 24 per cent increase in prices.

The rapid growth in personal incomes had been contained despite the sharp acceleration in domestic price increases. Indeed, real personal incomes had fallen by 8-9 per cent in the first part of 1980. As a result, real personal consumption had fallen. Although real fixed investment had been held relatively constant in 1980 there had been a considerable improvement in its structure insofar as there had been a marked rise in investments in priority projects, such as those designed to utilize domestic energy sources.

Economic policies in 1981 would be directed to achieving two basic targets in the form of attaining a further reduction in the current account deficit while at the same time moderating the tendencies which were causing a slowdown in the growth of production. Mr. Zmigorevic said that the forecasts for 1981 that he was providing to the mission reflected the preliminary thinking of the Yugoslav authorities. These figures would be finalized in December 1980. At this stage real GSP was projected to rise by 3 per cent in 1981, with the industrial and agricultural sectors expected to grow by 3.5 per cent and 4.0 per cent, respectively. There would be further slowdowns in the growth of the construction and some other sectors. Real exports were forecast to rise by 8 per cent resulting from rises of 7 per cent in merchandise exports and 9-10 per cent in services exports. The target for import growth was partly dependent on the level of imports realized in 1980, but at this stage real imports of goods and services were forecast to fall by about 2 per cent.

If the desired level of exports is achieved, the deficit in the current account of the balance of payments could be less than US$2 billion in 1981. As a working assumption it was expected that the current account deficit would not exceed US$1.8 billion, and US$1.5 billion with convertible currency countries.

Mr. Zmigorevic then discussed the policies that would be implemented to achieve the balance of payments objectives. Domestic demand would continue to be restrained in 1981 including keeping real personal consumption at the same level as that expected in 1980. For the current year partial indicators suggested that a small decline in personal consumption would be recorded. In 1981 it was aimed at constraining the growth of real personal incomes to 1 to 1 1/2 per cent which was in line with the expected rise in labor productivity.

Real fixed investment was forecast to fall by 1-2 per cent with non-economic investment targeted to decline by 30 per cent. The measures incorporated in the Annual Resolution for 1981 would aim at restructuring the economy toward the higher production of domestic energy, agricultural commodities, tourism, and transportation facilities, and industrial output based on domestic resources and oriented to the export market. A substantial increase in production capacity in the energy sector was planned in the years 1981 and 1982, especially for coal and hydroelectric production. Investment in the agricultural sector would be aimed at raising wheat, corn, and meat production. It was an objective to increase corn output to 11 million tons in 1981 compared with a level of 9.5 million tons in 1979. The main way in which corn production would be stimulated would be through raising guaranteed producer prices. In fact, producer prices for a number of agricultural commodities had been raised substantially in 1980 and information on such changes would be supplied to the mission. The main industries that would be encouraged with respect to export oriented production would be food processing, basic chemicals, petro-chemicals, and wood processing.

As to the growth of various import categories in 1981, Mr. Zmigorevic said that the increase in intermediate goods imports should be around 4-5 per cent, with goods for the textiles and metal processing industries given preference. The most productive use should be made of the US$10 billion expected to be allocated for intermediate goods imports in 1981. Imports of semi-finished steel products would be discouraged, while semi-finished goods such as rolled steel would be needed. Essential materials for the chemicals industry and for the transportation sector would also be given preferential treatment.

with the substitution of domestically produced capital equipment for foreign capital goods, equipment imports were expected to decline by 30 per cent. As most of this equipment came from industrialized western countries, the reduction in such imports would be a factor making for the decline in the trade deficit with these countries. For priority sectors equipment imports would remain considerable in 1981.

Mr. Zmigorev said that given the need to continue to compress imports in 1981 it was most probable that temporary administrative measures would be needed including import quotas and a possible temporary embargo on imports of certain types of equipment. Such a restriction would be applied across the board and not be confined to equipment imports from particular countries. The introduction of advance import deposits would be considered also.

Turning to policies to moderate inflationary pressures, Mr. Zmigorev noted that by September 1980 the 12-monthly rate of increase in the retail price index had reached over 30 per cent. The high price rises in 1980 would have a carryover effect into 1981 estimated at around 13-14 percentage points. This meant that if the GSP price deflator was to rise by 20 per cent in 1981, which was the preliminary target of the Federal Bureau of Planning, average prices could increase by only 6-7 per cent in 1981. A price freeze would be unlikely and administered price adjustments would be implemented selectively. The keeping of domestic demand in line with supply capabilities would help to curb inflationary pressures. Public consumption expenditures would basically be kept constant on real terms. Payments for pensions and disability allowances would be in accord with increases in personal incomes in the economic sector. Consumer credits would be reduced through tighter credit terms.

Mr. Tyler said that the strong inflationary pressures in 1980 did not seem to be attributable to excess domestic demand, but reflected largely higher import prices, the effects of the devlauation, and administered price adjustments. If these factors operated to a much lesser extent in 1981 and domestic demand was restrained the rate of inflation could be significantly reduced. However, given the carryover effect, a rate of increase of the GSP deflator of 20 per cent seemed optimistic. Mr. Zmigorevic agreed with this analysis noting that oil prices in October 1980 were 70-80 per cent above those of a year earlier. A major uncertainty relating to the inflation forecast for 1981 concerned the development in oil prices. The forecasts of the Planning Bureau were based on an increase in import prices, excluding oil, of 10-12 per cent and export prices of 10 per cent.

Mr. Zmigorevic stated that there would be a buildup in the stocks of oil in 1981 which would be approximately equal to the forecast decline in the consumption of oil or around 5 per cent. Reserves of foodstuffs would be increased in 1981 together with stocks of raw materials and intermediate goods for priority industries. Generally, Mr. Zmigorevic thought that stocks should record a modest rise in 1981.

Mr. Tyler in response to a question by Mr. Zmigorevic on the performance of the Yugoslav economy said that if the sound economic policies and good progress achieved in 1980 could be continued in 1981, this would constitute a sound basis for beginning of the next Five-Year Plan. The main problem area related to bringing the rate of inflation down to considerably lower levels. The main directions of policy appeared to be appropriate. The combination of market forces, social compacts, and self-management agreements, which had led to progress in particular areas such as incomes policies in 1980, should lead to further improvements in the economic situation in 1981.

Mr. Zmigorevic observed that the year 1981 would be difficult. Energy imports were quite large with crude oil, coking coal, and natural gas accounting for one quarter of total imports in the first nine months of 1980. However, there was a strong consensus between the Federal Government and the republics that the economic policies outlined above should be implemented in 1981, as there was no real alternative.

Mr. Marjanović indicated that the coordination of policies was sometimes very difficult. There was agreement among Yugoslav officials about the objectives but differences emerged with regard to the instruments of policies. In some instances opinions existed that the balance of payments problems of Yugoslavia could be solved in a simple manner, by banning certain transactions. But experience had shown that these direct controls did not operate within the Yugoslav economic system. For example, whenever imports had been controlled by licensing procedures or quotas, these controls had failed. The National Bank had difficulties in convincing other organizations about the need to avoid restrictive policies but he expected that their efforts would be successful in convincing others. Direct and indirect measures had to be adopted and there were clear ideas about how to go about them, so as to reduce the pressures on the balance of payments.

Mr. Tyler commented that with regard to the possible increase in imports from the U.S.S.R. there was no problem for a modification of the trade agreement with that country to increase imports of capital goods. But it would not be viewed as positive by the Fund Board if the measures that were introduced discriminated against specified countries.

## II. Foreign Borrowing by the National Bank

Mr. Marjanović explained that he would only describe the prospective borrowing by the National Bank, as the overall indebtedness policy had been discussed already in earlier meetings. He described the various arrangements with commercial banks that had been concluded or were to be concluded by the end of the year.

| Country | Amount 1980 | Amount 1981 |
| --- | --- | --- |
| | (in millions of U.S. dollars) | |
| 1. Concluded | 425 | ... |
| Kuwait | 250 | (250) not concluc |
| Austria (syndicated loan) | 100 | ... |
| Iraq | 75 | ... |
| 2. To be concluded | 875 | 425 |
| Libya | 75 | 75 |
| Italy | 200 | 200 |
| France | 150 | 150 |
| Germany | 350(to 400) | Similar to 1980 |
| Switzerland | 100 | ... |
| 3. Possible | 400 | ... |
| U.S., U.K., Canada, and Japan | 400 | ... |
| Total (excluding 3) | 1,300 | 425 |

Among those agreements to be concluded, the Italian authorities had confirmed that they would abide by the commitments of the previous Government, agreed during the summer of 1980. The banks were now ready to initiate discussions, as they had special incentives to enter into agreements due to the special mechanisms by which loans were directly subsidized by the Government. When the agreements were concluded, the loans would be disbursed in liras since Yugoslavia would otherwise have to convert dollars into lira. French banks were considering an amount equivalent to US$150 million but it was possible that larger amounts might be obtained. Negotiations would commence during the next few days and there was a possibility that similar amounts would be granted for 1981. The German banks were currently offering about DM 600-700 million, somewhat less than previously expected. It was interesting to note that German banks were not currently asking for a guarangee by the Government. They preferred to link the borrowing to the limits of lending by HERMES (the export insurance agancy). They preferred to proceed in that fashion as it helped develop relations with commercial banks in Yugoslavia. But the negotiations at this point were held with the National Bank and the relations with other banks was effectively a by-product of the agreement. Swiss banks had been approached as well, and they had initially offered SWF 100 million, but an amount of US$100 million was being discussed at the moment. This loan was to be granted at the most favorable terms.

The most complex situation related to negotiations with the American, British, Canadian, and Japanese banks. Ten banks were already willing to provide US$250 million, but the total amount could easily reach US$400 million.

The terms were in principle not unfavorable: the final maturity extended to seven years, while the grace period would be three years. The major problem was the interest rate spread. The banks had offered a 1 3/8 per cent over LIBOR, which was considerably higher than the spread previously offered to Yugoslav commercial banks, and those offered by Kuwait and Austrian banks. In addition, it placed Yugslavia at a disadvantage with respect to the rating of other important borrowers and for future loans Yugoslavia considered the issue of the spread more important than the amounts and had objected to the proposal, on the grounds that an acceptance of the terms offered would deteriorate the position of the country vis-á-vis other creditors. Currently a new meeting was scheduled to try to find an adequate solution. It was possible that the terms would not be accepted as some of the proposed changes were purely cosmetic; the spread was reduced but the utilization fee was increased. In any event, the outcome was not certain at this point. It was clear that the established borrowing goals were difficult to achieve, but significant amounts would be obtained and disbursed during 1980.

With regard to the access to financial assistance from the Soviet Union, Mr. Marjanović indicated that the bilateral payments agreement with the U.S.S.R. did not envisage financial credits. Currently lines of credit existed for the purchase of machinery for an amount of between US$520 million to US$750 million. But these suppliers' credits were slow in their disbursement pattern and only about 55 per cent of the total had been utilized. In addition, the trade balance had been negative for the last year and a half, and the situation had deteriorated as a result of the increase in the price of oil over the last year.

The balance in favor of the U.S.S.R. had amounted to a total of US$800 million in recent months.

With regard to the general prospects in the global balance of payments, Mr. Marjanović indicated that significant amounts of short-term credit had been utilized in the recent past, but that the prospective foreign exchange developments in the last months of the year would provide for an adequate coverage of expenditures until the end of the year. The increase in reserves would be lower than had been originally projected, because some short-term debt had to be repaid, but eventually reserves would be reconstituted to more appropriate levels. For the year as a whole, a small increase was projected in the reserves of the National Bank with somewhat smaller increases envisaged for the commercial banks. To a large extent the borrowing by the National Bank would not be channeled to the rest of the financial system. The commercial banks would, therefore, be forced to use part of their foreign exchange holdings, rather than those held by the National Bank. He estimated that gross reserves were to amount to about US$2.45 billion by the end of 1980.

Mr. Tyler inquired about the expected use of Fund resources in the near future and whether they would result in reserve increases. Mr. Marjanović explained that the authorities had the intention to channel most Fund resources to reserves, within the sovereign rights of Yugoslavia to use its assets.

After discussing the program of activities for the next two days, the meeting was adjourned at 5:45 p.m.

INTERNATIONAL MONETARY FUND

Yugoslavia

Minutes of Meeting No. 8
Held at the National Bank of Yugoslavia
on Thursday, November 6, at 9:30 a.m.

Yugoslav representatives

Mr. I. Marjanovic, Deputy Governor National Bank
Mr. N. Smiljanic, Director, National Bank
Mrs. G. Hofmann, Director, National Bank
Mr. T. Gudac, Special Advisor, Federal Secretariat for Finance
Miss Rankovic, Federal Secretariat for Finance
Miss G. Djurdjevic, Interpreter

IMF representatives

Mr. Tyler
Mr. Manison
Mr. Loser
Mr. Buyse

IBRD representative

Mr. Bery

The meeting discussed trade policy with respect to charges and taxes on imports, revised national accounts estimates, and the numbers on net foreign assets of the banking system and convertible external debt to be inserted in the letter of intent.

I. Trade Policy

An account of recent measures in the area of trade policy was provided by Miss Rankovic. She said that the occasion of the June devaluation had been used to eliminate a 10 per cent import surcharge previously in effect. Originally introduced as a "temporary" measure in the late sixties, it had survived at various rates through the seventies before its elimination this year. Following the abolition of the surcharge, procedures had been initiated to revoke the power of the Federal Assembly to impose the surcharge in the future as it was not considered a suitable instrument of balance of payments policy. These procedures would be completed by the end of the year. With the elimination of the import surcharge two sets of fiscal charges on imports remained, in addition to customs duties. These were a tax equalization charge of 6 per cent, intended to compensate for the burden of direct taxation borne by domestic producers, and a customs evidence tax of one per cent, intended to finance improvements in customs facilities. Both taxes were applied across the board to all dutiable goods. These levies were not regarded as "temporary" in nature and there was no immediate intention to eliminate them.

Following this first phase of trade measures, some modest revisions in the structure of tariffs were intended. These included reductions in tariff rates of about three percentage points for machines, instruments, etc. (Sections 16-18 of the Yugoslav Customs Tariff) to reduce the protection offered to such goods, and revisions in other sections to implement tariff revisions agreed to within GATT during the Tokyo round negotiations. The collective impact of these measures was not expected to be great, and would not lower the average effective duty rate appreciably. There was no intention to raise the duty rate on raw materials as a stimulative measure as had been done in 1976. In response to a question from Mr. Tyler, Miss Rankovic said that goods exempt from customs duty were of three sorts: First, there were goods exempted within the customs law itself, for various reasons. These included such items as books, certain noncompeting imports and equipment imported by workers employed abroad. Second, an estimate was made at the end of each year of the likely availability of certain raw materials and intermediates. If it seemed likely that domestic demand would exceed domestic supply, provision was usually made for the deficit amounts to be imported free of duty, and these exemptions were incorporated in the decision on trade policy for the forthcoming year. Third, waivers could be provided by an act of the Federal

Assembly for priority imports in particular cases. Mr. Tyler thanked Miss Rankovic for her presentation, and commended the measures taken this year, and the general orientation of import policy. The view of the authorities appeared to be that such protection as was sought for domestic production was better provided by neutral, undifferentiated tariffs and by appropriate exchange rate policies rather than by more selective intervention, and this was a view that he fully endorsed.

## II. National Accounts

Mr. Stamenkovic apologized for numerous errors that had arisen in a table on national accounts indicators given previously to the mission, and provided revised figures consistent with his earlier oral presentation. In response to questions he said that he did not fully agree with the 20 per cent estimate of the increase in the GDP deflator for 1981 currently being used in official forecasts. His own view was that it would be a minimum of 25 per cent and could be even higher. The draft resolution for 1981 submitted to the Assembly spoke only of a decrease in inflation compared to 1980 and did not mention a target rate. On inventories of imported goods, Mr. Stamenkovic said that he had no very accurate methodology for estimating these. Data collected by the Federal Institute of Statistics were in constant prices and available only for the end of 1978. At that time such stocks were sufficient for two months' production. He assumed that roughly the same relationship held for the end of 1979; given that total imports of raw materials and intermediates in 1979 were around US$9 billion, he estimated stocks at the end of 1979 to be US$1.5 billion. In the first eight months of this year, he estimated that these may have declined between US$150-200 million. His estimate was that the economy would enter 1981 with about 1 1/2 months of imports--an adequate level in his view. Indeed, he felt that inventories were still too high, and that a more active exchange rate policy could help further trim inventories. Mr. Tyler said he thought that the combination of devaluation with tight credit policies would produce some reduction in levels of stockholding. He asked Mr. Stamenkovic his views on the likely current account deficit for 1980, given trade figures for the first eight months; Mr. Stamenkovic estimated that the outturn could be anywhere between US$2 billion and US$2.5 billion depending in part on invisibles performance. The Federal Executive Council had not yet adopted a current account target for 1981 but it was likely to be in the US$1.5-2.0 billion range.

## III. Balance of Payments

The last part of the meeting was directed to the discussions of the letter of intent requesting the waiver and modification of specified ceilings for September 30 and December 31, 1980 in the current stand-by arrangement. In discussing the new estimated targets, Mr. Smiljanic provided details of the expected performance of the external debt and the net foreign assets position of the National Bank, as described in the following table:

Yugoslavia: Balance of Payments, 1980

(In millions of U.S. dollars)

| | Convertible Currencies | | Overall | |
|---|---|---|---|---|
| | Initial Projection | Revised Projection | Initial Projection | Revised Projection |
| A. Goods and services and unrequited transfers | -1,900 | -2,200 | -2,000 | -2,300 |
| Trade balance | (-5,250) | (-5,550) | (-5,700) | (-6,000) |
| Services (net) | (3,350) | (-3,350) | (3,700) | (3,700) |
| B. Long-term capital (net) | 1,269 | -289 | 1,707 | 157 |
| C. Total A + B | -631 | -2,481 | -293 | -2,143 |
| D. Short-term capital | -- | 850 | -338 | 512 |
| Allocation of SDRs | 38 | 38 | 38 | 38 |
| F. Exceptional financing | 250 | 250 | 250 | 250 |
| G. Total | -343 | -1,343 | -343 | -1,343 |
| H. Reserve movements (surplus -) | 343 | 1,343 | 343 | 1,343 |
| Use of Fund credit | (343) | (343) | (343) | (343) |
| Official foreign exchange | (--) | (-300) | (--) | (-300) |
| Foreign borrowing by National Bank of Yugoslavia | (--) | (1,300) | (--) | (1,300) |

The corrections resulted from a revised current account deficit in convertible currencies for 1980, higher by US$300 million relative to the projection provided to the Fund staff earlier during the discussions. The increased deficit was to be financed partly by US$150 million of increased long-term borrowing, while the rest was to be financed by short-term borrowing. The original levels of long-term borrowing had to be adjusted downward by the expected borrowing of the National Bank, to be included in the reserve movements and the more extensive use of short-term credit (US$850 million). Consequently, long-term credit had been adjusted downward by US$1,550 million, while short-term credit had been adjusted upward by US$850 million. Concurrently, the revised reserve movements reflected an increase of gross reserves of US$300 million and increased borrowing by the National Bank of US$1,300 million. Consequently, the net foreign assets position of the National Bank less exceptional financing by the commercial banks (US$250 million), the definition used in the stand-by arrangement, was to show a decrease of US$1,593 million in 1980 rounded to US$1.6 billion for the balance of payments test. The medium- and long-term convertible currency borrowing was expected to increase by no more than US$800 million, although it was expected that part of the amounts would effectively be contracted in the form of short-term debt, outside the ceilings.

The meeting adjourned at

INTERNATIONAL MONETARY FUND

Yugoslavia

Minutes of Meeting No. 9
Held at the National Bank of Yugoslavia
on Friday, November 7, 1980 at 8:30 a.m.

Yugoslav representatives

Mr. K. Bogoev, Governor
National Bank
Mr. I. Marjanovid, Deputu Governor
National Bank
Mr. D. Dimitrijevic, General Manager
National Bank
Mrs. G. Hofmann, Director
National Bank
Mr. J. Petrovic, Director,
National Bank
Mr. T. Gudac, Advisor, Federal
Secretariat for Finance
Miss G. Djurdjevic, Interpreter

IMF representatives

Mr. Tyler
Mr. Manison
Mr. Loser
Mr. Buyse

IBRD representative

Mr. Bery

The meeting consisted of an exchange of views about economic prospects and policies for Yugoslavia, together with a discussion of the possible use of Fund resources in 1981 and beyond. Some clarifications relating to the contents of the letter of intent were made also.

Governor Bogoev said that with the balance of payments still under pressure, the Government would continue with their present restrictive domestic demand management policies in 1981. It would be the aim of the authorities to limit the current account deficit of the balance of payments to no more than US$1.8 billion. With regard to balance of payments policies, Mr. Tyler emphasized three points. The Executive Board of the Fund would be interested in seeing a discernible improvement in the current account of the balance of payments between 1980 and 1981. A reduction in the current account deficit of about US$0.5 billion would in the mission's view be an appropriate target, in the absence of untoward events, such as a sharp rise in oil prices. If the deficit turned out to be about

US$2.2-2.3 billion in 1980, then a reduction in the deficit to US$1.8 billion in 1981 would represent good progress. Secondly, the year 1980 had been characterized by an unplanned increase in the amount of short-term borrowing at the expense of a large shortfall in medium- and long-term external borrowing by nonbank enterprises. A considerable amount of foreign borrowing that originally was intended to be undertaken by the enterprise sector was to be replaced by borrowing by the National Bank of Yugoslavia. The latter development did not cause any real problems, but the sharp buildup of short-term debt was a matter of concern. It was not only expensive to service, but could lead to a bunching of repayments in a particular year. Accordingly, to make the external debt burden more manageable every effort should be made to increase medium- and longer-term external market borrowing in 1981. Thirdly, Mr. Tyler said that resources should be used to build up gross official reserves rather than for financing the current account deficit or amortizing loans.

Mr. Tyler observed that monetary policies in 1980 had been sound. There would inevitably be pressures from the republican national banks to relax monetary policy in order to satisfy the requests of enterprises within their constituencies. However, it would be much easier for the authorities to reverse monetary policy in an expansionary direction rather to become to more restrictive as enterprises traditionally utilized very quickly any credit they received. Flexible use had been made of the instruments of monetary policy in 1980 and this could be repeated in 1981.

Turning to the conduct of fiscal policies in 1980, Mr. Tyler said that the lack of data rendered it difficult to make a judgment on their effectiveness. The Annual Resolution for 1980 had called for the limited growth of public expenditures, especially of noneconomic expenditures. To date during 1980 there had been little net borrowing by the public sector from the banking system. For 1981 a continuation of existing fiscal policies appeared appropriate.

Mr. Tyler stated that Yugoslav representatives had given the mission a broad outline of their policies for the medium term, including the investment strategy for restructuring the pattern of production. With the finalization of the Five-Year Plan 1981-85 these broad guidelines would be quantified into targets. Initial impressions were that the medium-term strategy seemed to be in the right direction for the generation of a sustained improvement in the balance of payments. However, the successful implementation of policies would depend crucially on the effectiveness of self-management agreements at the enterprise level and inter-republican accords. In 1981 social compacts appear to have been quite successful with respect to incomes and public sector policies. It was debatable whether the institutional arrangements would be effective over a longer-term period in gaining the consensus at all levels for the sound implementation of economic policies. It was hoped that 1980 was not just a crash program in response to a balance of payments crisis.

With respect to medium-term policies, Mr. Tyler emphasized that interest rates should play a more active role. They could help with monetary policies while at the same time contribute to the improved allocation of investable resources. The Executive Directors would be interested in seeing the prompt introduction of new interest rate policy.

Governor Bogoev said that he was in full agreement with the comments of Mr. Tyler. The policy orientation for 1981 would be basically the same as that pursued in 1980. Results of demand management policies in 1980 had been quite favorable despite both political and economic difficulties. The republics and the provinces had been more active in the implementation of balance of payments policies in 1980. With respect to demand management policies it was noteworthy that the rapid growth of both real personal incomes and consumption had been arrested in 1980. Income policies had been effective in 1980 because guidelines for personal income payments had been clearly specified and trade unions and local socio-political bodies had co-operated with the federal government authorities in insisting that such guidelines be respected. And for the first time the growth of public expenditures had lagged well behind that of nominal social product. The most embarrassing aspect of the Yugoslav economy's performance related to the sharp increase in domestic prices. Governor Bogoev noted that the acceleration of inflationary pressures to a considerable degree emanated from government decisions relating to the 22 per cent devaluation in dinar in June and major price adjustments to correct price distortions in a number of sectors including energy, transportation, and agriculture. Once-for-all price adjustments had been made to eliminate price disparities rather than gradual changes.

Governor Bogoev said that a definite decision had been made to change the level and structure of interest rates in Yugoslavia. Proposals prepared by the authorities were being discussed at present with the commercial banks and academic institutions. Yesterday, the banks had accepted the proposals.

By next month, the National Bank of Yugoslavia would submit their proposal on interest rates to the Government. It would be aimed at effecting a considerable reduction in negative real interest rates through raising nominal rates, and be the beginning of a more active interest rates' policy. Mr. Tyler said that it would be important from the viewpoint of the Executive Board that a decision on changing interest rates was indicated clearly as a first step in a more active policy on interest rates.

Governor Bogoev said that it would be difficult for the Yugoslav authorities to reduce the current account deficit below US$1.8 billion in 1981. Forecasts for exports of both merchandise and invisibles were on the optimistic side. In 1981 the authorities would begin major efforts to restructure their economy in line with the policy orientations of the 1981-85 Plan. Efforts would be made to promote export-oriented industries and produce agricultural surpluses for exports, in fields such as maize, fruits and vegetables, and meat production.

As to the financing of the current account deficit over the medium term, Governor Bogoev said that it was the intention of the authorities to use Fund resources to rebuild external reserves. It was the aim to increase National Bank of Yugoslavia and deposit money bank gross reserves to a level equivalent to two months of payments to convertible currency countries; at present such a level would be about US$2.7 billion. However, given the uncertainty of external market borrowings in late 1980 and in 1981 and the objective of not raising the external debt servicing ratio, Fund resources might have to be used to some extent to finance the current account deficit.

Governor Bogoev stated that the amounts that the authorities would wish to borrow from the Fund could be discussed more precisely in December. He enquired whether the 200 per cent of quota that could be made available to Yugoslavia in 1981 referred to the present quota or the new quota that would come into effect as a result of the Seventh Quota Review. Mr. Tyler said that it was not exactly clear whether the limit of borrowing up to 200 per cent of existing quota could be applied to the new quota. This would to a considerable degree depend on the Fund's liquidity position. However, for Yugoslavia the mission had been briefed by the Managing Director to make available to Yugoslavia up to 200 per cent of the existing quota at the time of mission's departure.

Governor Bogoev said that the amount of financial resources that Yugoslavia should seek from the Fund in 1981 and beyond would be discussed with the Government. Governor Bogoev and Mr. Marjanovic said that it was possible that Yugoslavia might seek an amount exceeding 200 per cent of the old quota due to their present high level of short-term external debt, the need for substantial funds to amortize debt, and the necessity of reconstituting external reserves to a much higher level. The authorities would aim to keep the current account deficit as low as possible while at the same time they would endeavor to maximize their external borrowings. Fund borrowing could not be treated as a residual component, but was a real component for covering imbalances. On the question of whether Yugoslavia should ask for an amount which would exceed 200 per cent of the old quota from the Fund, Mr. Tyler doubted whether it was in the Yugoslav interests to finance a higher proportion of the balance of payments deficit with Fund resources. With a further reduction in the current account deficit and increased market borrowings in 1981 purchases from the Fund equivalent to about US$700 million or 200 per cent of the old quota were likely to be sufficient. The Managing Director's view on making available an additional amount of funds to Yugoslavia would, however, be sought.

Governor Bogoev said that he fully agreed with the contents of the letter modifying the existing stand-by arrangement and that the letter would be signed by him and Mr. Kostic once it had been accepted by the Government. Mr. Tyler said that a staff paper requesting modification of the stand-by arrangement would be circulated to the Executive Board on the basis that the signed letter would be received.

The meeting adjourned at 10:30

INTERNATIONAL MONETARY FUND

Yugoslavia

Minutes of Meeting with Mr. Kostic,
Federal Secretary for Finance
Held at the Federal Secretariat for Finance
on November 4, 1980, at 1:00 p.m.

Yugoslav representatives

Mr. Petar Kostic, Federal Secretary for Finance
Mr. Popovic, Assistant Federal Secretary for Finance
Mr. Toma Gudac, Special Advisor to Secretary of Finance
Mrs. G. Hofmann, Director, National Bank

IMF representatives

Mr. Tyler
Mr. Manison
Mr. Loser
Mr. Buyse

IBRD representative

Mr. Bery

Mr. Tyler outlined initially the views of the staff team on the performance of the Yugoslav economy and the reasons for the mission. He said that the Fund was very pleased with the economic policies being implemented by the Yugoslav authorities. The stabilization program being undertaken by the authorities was essentially of their own volition and was consistent with the views of the Fund as to how the current economic problems should be corrected.

Mr. Tyler pointed out that the first task of the current mission was directed toward the modification of some of the performance criteria in the current stand-by arrangement program. The modifications were essentially of a technical nature since the basic objectives of the stand-by program were being achieved. Indeed, a substantial reduction was expected in the current account deficit of the balance of payments in 1980. The second task of the mission was to conduct preliminary discussions on the possible replacement of the present stand-by arrangement with a new one involving a larger amount of Fund resources and over a longer period of time. The Managing Director was sympathetic to the Yugoslav stabilization program, believing that a continuation of present policies would warrant a stand-by arrangement allowing purchases up to 200 per cent of existing quota (SDR 554 million), or the equivalent of about US$700 million, each year, for a period of up to three years. Mr. Tyler stated if a program went beyond 1981 economic policies would have to be directed toward generating a sustained improvement in the balance of payments. This could involve keeping the rate of growth of real GSP relatively low through continuous domestic demand restraint and/or restructuring the pattern of production toward replacing imports and promoting exports. As it would be quite difficult to keep the rate of growth at a very modest level in the years beyond 1981 the staff thought that a restructuring of the economy was the most appropriate strategy for effecting a medium-term improvement in the balance of payments. Accordingly, the staff were interested in the strategies and programs being prepared by the Yugoslav authorities for effecting structural adjustments in the economy. Although preparations for the next Five-Year Plan 1981-85 had not been finalized, at this point the policy orientation of the authorities appeared to be consistent with what the Executive Board would need to support a longer-term stand-by arrangement. The staff would return to Washington to report their findings and would come back in December to finalize the negotiations on the kind of stand-by arrangement Yugoslavia might wish to enter into.

Mr. Kostic questioned whether the entering into of a longer stand-by arrangement involving annual purchases equivalent to 200 per cent of quota or equivalent to about US$700 million would imply use of the fourth credit tranche and what this in turn meant for conditionality. Mr. Tyler replied that such purchases would take Yugoslavia well beyond the fourth credit tranche. However, use of the fourth credit tranche should now be viewed differently than was the case a few years ago, when such use was viewed as an indication that a country was experiencing extreme balance of payments problems. Up to recent years a country could not normally use Fund resources beyond the fourth credit tranche. With the event of the supplementary financing facility, countries could purchase amounts from the Fund more than double the amounts previously purchased. Indeed, it had become the policy of the Board of Governors of the Fund, which was strengthened at the recent Annual Meeting, that the Fund should play a greater role in recycling balance of payments surpluses to deficit countries. With the sharp rise in oil and other import prices larger amounts were now needed to support balance of payments adjustments. Appropriate use of Fund resources should be now viewed in terms of the amount of assistance needed to cope with a balance of payments problem and required during the adjustment process rather than as a percentage of quota. Moreover, Fund quotas had not kept pace with world financing needs and purchases from the Fund in terms of percentages of quota had less relevance today. Thus, Mr. Tyler suggested that the Yugoslav authorities should consider their balance of payments financing needs for 1981 and beyond and decide on how much of this financing should be provided by banks and how much by the Fund. The Managing Director had indicated that given a continuation of present Yugoslav policies he would be prepared to make available to Yugoslavia annual amounts up to 200 per cent of quota.

Mr. Kostic said that the Yugoslav authorities would like to continue to pursue policies that were actively supported by the IMF. The Government had not decided as yet whether to enter into a stand-by arrangement that would take it into the fourth credit tranche and beyond. Formal authority for the negotiation of a larger stand-by arrangement had not been given to the Federal Secretary for Finance and the Governor of the National Bank of Yugoslavia. A submission would be made to the Government stating what a Fund stand-by arrangement going up to and beyond the fourth tranche would imply in terms of conditionality, and the position of the Government would be finalized before the arrival of the staff mission in December.

Mr. Tyler said that Yugoslavia was satisfying Fund conditionality relating to its current use of resources in the second and third credit tranches. The same conditionality would apply to a stand-by arrangement in the fourth credit tranche and for all practical purposes Yugoslavia's present policies and performance would satisfy that conditionality. Under the existing stand-by arrangement, there would have to be agreement of the numbers to be entered as performance criteria for the implementation of the financial program for 1981. Such performance criteria could serve as the basis for a new and enlarged stand-by arrangement. For Yugoslavia it was not a question of additional conditionality with the greater use of Fund resources but essentially of continuing with the same conditionality.

Mr. Kostic said that economic policies for the next five years were currently being prepared. Measures to redress imbalances would be concentrated in the first two years of the Plan. He added that the high rate of inflation was a major problem and to a considerable degree was caused by factors of domestic origin. A reduction in the rate of domestic price increases and a further decrease in the current account deficit of the balance of payments were considered as the basic goals of economic policy. The annual rate of growth of real GSP would have to be kept at a relatively low level by Yugoslav historical standards, viz., 3 per cent, in order to achieve these objectives.

A higher rate of growth of real GSP would lead to an upsurge in imports of intermediate goods that would place undue pressures on the balance of payments. Mr. Kostic agreed that a restrictive monetary policy could be used to improve the balance of payments in the short fun, but that in the longer run a continuous improvement could be only sustained through a combination of sound demand management and policies operating on the supply side of the economy.

To reduce inflationary pressures, domestic demand had been restrained. A law had been passed to limit noneconomic investments while enterprises and socio-political bodies had been instructed to limit their nonproductive costs (administrative expenses and cultural outlays, etc.). Public expenditures had been curtailed and in 1980 it was expected that the federal budget outlays would grow at a rate well below that of nominal GSP. For 1981 the preliminary target was to keep the increase in federal budget 7 percentage points below that of projected GSP (23-24 per cent). While defense expenditures would show a considerable rise other public expenditures would be restricted. Real fixed investments would be cut back in 1981 through limiting funds for investment and ensuring that they flowed to priority projects, especially those related to the development of domestic energy sources and export-oriented industries.

Mr. Kostic said that for the medium term the investment strategy would be directed toward the achievement of three basic objectives. Firstly, decreasing the ratio of fixed investment to GSP since Yugoslavia had one of the highest ratios in the world. Secondly, restructuring the pattern of investments so as to increase the relative rate of capital formation in priority sectors. And, thirdly, raising the efficiency of or output returns on investments. The allocation of bank credits for investments would be an important policy instrument for attempting to attain such goals.

Mr. Kostic agreed with Mr. Tyler's view that Yugoslavia's use of Fund resources should depend on financing needs in absolute terms rather than measured as particular percentages of quota. With regard to borrowing from the Fund in 1981 and beyond, Mr. Kostic said that balance of payments financing projections for the coming years had not been finalized. In addition, at this stage it was very difficult to assess exactly what could be obtained from external market sources to finance balance of payments needs. The banking world appeared to be behaving in an inconsistent manner toward Yugoslavia. While Yugoslavia's economic policies would be jointly agreed upon with the Fund, the amount of financing sought from the overseas banks would not be linked with the negotiations with and the amount of financial resources committed by the Fund.

Mr. Kostic stated that the Yugoslav Government's strong support for the role of the Fund in helping with the international recycling process had been demonstrated at the recent Fund-Bank Annual Meeting. They had voted in favor of the seventh increase in quotas and supported the eighth quota review. The Federal Secretary asked Mr. Tyler to transmit his cordial regards to the Managing Director.

Mr. Tyler observed that the behavior of the banking world toward Yugoslavia was sometimes irrational and inconsistent. Generally, banks had tended to lend less and expect the Fund to provide more resources in meeting balance of payments financing needs. Indeed, it was the current view among bankers that the Fund would grant Yugoslavia a larger stand-by arrangement. However, he hoped that the good performance of the Yugoslav economy in the first part of 1980 would induce banks to take a more favorable stance toward lending to Yugoslavia.

Mr. Kostic concluded by saying that he appreciated very much the efforts of the Fund in directly and indirectly assisting Yugoslavia with its balance of payments financing needs and in supporting its policies. Yugoslavia was under no pressure from the Fund to adopt economic policies that differed from the thinking of the Yugoslav authorities about how the unfavorable aspects of the economic situation should be dealt with.

The meeting adjourned at 2:00 p.m.

CONFIDENTIAL
November 4, 1980

MEMORANDUM FOR FILES

Subject: Minutes of Meeting with Governor Bogoev, October 31, 1980

Mr. Tyler and myself met with Mr. Ksente Bogoev, Governor of the National Bank of Yugoslavia, on October 31, 1980 to discuss the monetary and credit program for the final quarter of 1980. Mr. Dimitrijevic and Mrs. Hofmann of the National Bank were present also.

Mr. Tyler outlined initially the mission's view on economic developments to date during 1980. The general impression based on trends this year was that considerable progress had been made in adjusting the Yugoslav economy to meet the objectives under the current stand-by arrangement. The deficit in the current account of the balance of payments had been substantially reduced and domestic demand management had been good. Prices had risen at a faster rate than projected, but such a divergence could be explained. However, there was one worrying aspect in that there had been a recent loosening in monetary policy. In the first half of the year, the stance of monetary policy had been very strict, while in the third quarter there had been some relaxation. Proposals for the fourth quarter, however, suggested very rapid increases in the money supply and domestic bank credit. The monetary policies in the first half of the year seemed to have produced good results, especially with respect to the balance of payments, but with the continual acceleration in domestic credit and money proposed for the second half of the year undesirable results could arise. A large increase in liquidity could lead to a higher-than-planned increase in real economic activity, which in turn could stimulate a rise in imports. As it was expected that the financial program for 1981 would be directed toward achieving a growth in monetary aggregates similar to that achieved in the first half of 1980, a sudden upsurge in monetary aggregates in the latter part of 1980 would prevent their smooth growth and thus give cause for concern to outside critics. In previous years, an abrupt rise in monetary aggregates in the final part of the year had often undermined the control exercised in containing monetary aggregates in the first part of the year, and had resulted in subsequent adverse balance of payments effects. In short, the staff team was of the view that the 26 per cent rates of increase for the money supply and adjusted domestic bank credit 1/ (29 per cent for unadjusted domestic bank credit) for the 12 months to December 1980, that were implied by the National Bank's projections for the fourth quarter, seemed too high. Accordingly, it would be desirable for Governor Bogoev to persuade fellow members of the Board of Governors not to proceed with the proposal to increase the money supply by 26 per cent.

Apart from the internal difficulties with the proposed rate of monetary and credit expansion, Mr. Tyler said there would be problems with respect to the external view of the program. Management, staff, and Executive Directors at the IMF, which would focus on the unadjusted definition of domestic credit, would probably view the 29 per cent rate proposed for the 12 months to

1/ Adjusted downward to take account of the effects of the devaluation on foreign currency credits to residents.

December 1980 as being excessive. In addition, while one could assure the authorities of other countries that the basic objectives of the current stand-by program had been met, one might have to express doubt to them about the wisdom of current domestic policies if the proposed loosening of monetary policies were implemented.

Governor Bogoev replied that he was very unhappy with the decision of the Board of Governors to adjust upward the proposed rate of monetary expansion to 26 per cent. There had been repeated and agonizing discussions over the extent to which the parameters of monetary policy should be changed for the final quarter of 1980. Personally, he said he would be very pleased to bring the 12-monthly rate of monetary expansion back to 23 to 24 per cent. The Government had also been very dissatisfied with the decision of the Board of Governors. At present the decision on the increase in money supply in the final quarter was being discussed by the committee for the monetary sector in the National Assembly. Governor Bogoev said that two possible courses of action could be pursued. Either the decision of the Board of Governors could be changed or authorizations could be given placing monthly ceilings on the increase in bank-financed investments so as to keep the expansion in the money supply to no more than 24 per cent. The Government could be expected to support the more restrictive stance of monetary policy.

Governor Bogoev then explained why a rate of monetary expansion above the originally programmed 22 per cent was necessary. He stated that costs and prices in 1980 had risen at faster rates than originally foreseen due largely to the devaluation of the dinar and discretionary price adjustments to correct distortions in relative prices. As a result of the higher than expected rate of inflation in 1980, nominal GSP was now forecast to rise by at least 32 per cent compared with the original forecast of 22 per cent. If the original monetary targets are adhered to the economy would be pushed into illiquidity and the normal flow of payments disturbed. Production was already being adversely affected by weak domestic demand. Consumer credit conditions had recently been tightened through increasing downpayments for credit financed purchases of consumer durables (from 37 1/2 to 75 per cent for cars, TVs, and refrigerators) and abolishing such credit for the buying of construction materials. As regards the extent to which the rate of monetary expansion should be adjusted upward compared with the original program, Governor Bogoev said that there were now sufficient arguments to persuade the Board of Governors to accept a 12-monthly rate of 24 per cent or less. He added that the increase in the money supply in 1981 should be at a lower rate.

Mr. Tyler said that the desired balance of payments and production objectives had been achieved in the first part of 1980 with a tight monetary policy. The income velocity of circulation of money had risen and secondary sources of credit had been utilized. If bank credit was increased sharply in the final quarter it could be substituted too quickly for inter-enterprise credits. The income velocity of money would most likely not show a significant decline and enterprises would use their improved liquidity position to raise investment expenditures and hence imports. Mr. Tyler added that there was no evidence showing that the economy was growing at an undesirably slow rate. It would be better to wait for such evidence before injecting a larger amount of credit and liquidity into the economy. Governor Bogoev agreed with the analysis of Mr. Tyler noting that the mistakes in monetary policy of previous years should not be repeated.

Mr. Dimitrijevic said that the fact that at the time of devaluation of the dinar, that part of the domestic bank credit outstanding was denominated in foreign currency terms, justified an increase in the level of credit permitted under the stand-by arrangement. Mr. Tyler agreed that account should be taken of the foreign exchange linked credits outstanding and the resultant effects from the devaluation in determining the credit ceiling for December 31, 1980. However, for the purposes of monitoring the stand-by arrangement, the definition used would be the net domestic assets of the banking system unadjusted for changes in dinar value of foreign exchange credits caused by the devaluation. He thought that the ceiling on net domestic assets of the banking system for December 31, 1980 under the stand-by arrangement should be modified so as to permit an increase in domestic credit over the 12 months to December 1980 that would bring about an increase in the money supply of no more than 24 per cent given the projection of the National Bank of Yugoslavia as to the change in net foreign assets of the banking system in the final quarter of 1980 viz. Din 26.8 billion. The increase in bank credit should be kept as low as possible so as to encourage the nonbank sector to borrow from abroad. Mr. Dimitrijevic suggested that if there was a shortfall in foreign borrowing by the nonbank sector an accommodating adjustment in domestic bank credit could be made. Mr. Tyler stressed that such a policy was dangerous in that it could lead to an adverse monetary impact on the balance of payments. External borrowing should be the aggregate that should be adjusted rather than domestic credit.

Mr. Tyler said that he assumed that the program for 1981 would be similar to that for the current year with the emphasis on short-term demand management. However, if the Yugoslav authorities wished the Fund to support a longer-term program there would have to be evidence that the authorities were implementing concrete policies to restructure the economy so as to bring about a sustainable adjustment in the balance of payments. It would be difficult to rely continually on restraining domestic demand to keep the balance of payments sound. Accordingly, there was a need for the staff to gain a better knowledge of the medium-term program designed for the period 1981-85 to restructure the economy. In this context, the staff would like to meet with the staff of the Federal Planning Office. Governor Bogoev agreed that the staff should make such a visit stating that it would be politically impossible to effect a sustained improvement in the balance of payments by maintaining a low growth rate of real GSP.

Mr. Tyler noted also that there seemed to be no specific policies that would ensure that the rate of inflation would be brought down from 30 per cent in 1980 to the preliminary forecast of 20 per cent in 1981. Governor Bogoev said that he was extremely optimistic about reducing the rate of inflation since price disparities had been corrected in 1980 and domestic demand would be kept low. However, this optimistic scenario could be disrupted by a sharp increase in oil prices and he wondered what the attitude of the Fund was to unforeseen outside disturbances. Mr. Tyler said that the Executive Board and the Managing Director were sympathetic to countries in the event of unforeseen changes outside the authorities' control and normally would give sympathetic consideration to appropriate adjustments in financial programs.

Mr. Tyler asked whether the Federal Government would have any problems in keeping with the ceiling of Din 77.9 billion in their borrowing from the National Bank through to end-1980. Governor Bogoev replied that there should be no problem as the Federal Government was aiming at cutting back its expenditures in order to reduce its deficit. At the same time they would try to finance their deficit by selling bonds.

Mr. Tyler agreed to supply a draft letter requesting the necessary changes in the performance criteria to the Yugoslav authorities by the following Tuesday.

L.G. Manison

cc: Mr. Tyler
Mr. Loser
Mr. Buyse