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EBS/83/46

CONFIDENTIAL

February 24, 1983

To: Members of the Executive Board

From: The Secretary

Subject: Yugoslavia - Staff Report for the 1982 Article IV Consultation and Review Under Stand-By Arrangement

Attached for consideration by the Executive Directors is the staff report for the 1982 Article IV consultation with Yugoslavia and a review of the stand-by arrangement for Yugoslavia. Draft decisions appear on pages 35 through 38.

This subject will be brought to the agenda for discussion on a date to be announced.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

YUGOSLAVIA

Staff Report for the 1982 Article IV Consultation and Review under Stand-By Arrangement

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

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

Approved by L. A. Whittome and Subimal Mookerjee

February 23, 1983

I. Introduction

The 1982 Article IV consultation and discussions on the stand-by program for the final year of the three-year stand-by arrangement with Yugoslavia were conducted in Belgrade during the period December 2 to 24, 1982 and February 11 to 17, 1983. 1/ The Yugoslav representatives included officials of the National Bank of Yugoslavia, and of various Federal Secretariats and agencies concerned with economic matters. The policy discussions were led by the Vice President of the Federal Executive Council, Mr. Dragan, and included Vice President Srebrić, the Federal Secretary for Finance, Mr. Florjancić, the Governor of the National Bank of Yugoslavia, Mr. Makić, the Deputy Governor of the National Bank of Yugoslavia, Mr. Veljković, and other officials. The staff participating at various times during the period were Mr. L.A. Whittome (EUR), Mrs. H.B. Junz (EUR), Ms. D. Ripley (EUR), Mr. M. Brimble (STAT), Mr. L.G. Manison (EUR), Mr. P.M. Keller (ETR), Ms. N. Kirmani (ETR), Mr. W. Lewis (EUR), and, as secretary, Miss M. Stuart (ETR), and Miss M. Owen (TRE). Mr. F. Kilby (IBRD) also joined the discussions in December.

On January 30, 1981, Executive Directors approved a three-year stand-by arrangement for Yugoslavia in an amount equivalent to SDR 1,662 million, or 400 per cent of quota. Two thirds of this amount was purchased during the first two years of the arrangement. The remaining one third, or SDR 554 million, may be purchased during the third year of the arrangement. According to paragraph 3(b) of the stand-by arrangement (EBS/81/5, 1/15/81) and paragraph 28 of the letter of the Federal Secretary for Finance and the Governor of the National Bank of Yugoslavia, dated January 15, 1981, requesting the stand-by arrangement,

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1/ The last consultation discussions were in December 1981. The staff report (SM/82/24, 2/2/82) and Review and Consultation under Stand-By Arrangement (EBS/82/20, 1/29/82) were discussed by Executive Directors on February 22, 1982. Yugoslavia continues to avail itself of the transitional arrangements under Article XIV.

the Yugoslav authorities are to consult with the Fund and reach understandings for the remaining period of the arrangement before the beginning of the third year of the stand-by arrangement. As mentioned above, consultations and discussions took place during December 1982 and February 1983. The prospects and policies for 1983 are described in the attached letter, dated December 30, 1982 and in the supplement to the letter dated February 18, 1983, signed by the Federal Secretary for Finance and the Governor of the National Bank of Yugoslavia.

Fund holdings of Yugoslav dinars on January 31, 1983 amounted to the equivalent of SDR 2,002.5 million, or 482.0 per cent of quota (Appendix I); excluding holdings relating to purchases under the oil and compensatory financing facilities, they were SDR 1,756.4 million, or 422.7 per cent of quota. It is proposed that the SDR 554 million that may be purchased during the year should be made available as follows: up to SDR 175 million until May 15, 1983, up to SDR 325 million until August 15, 1983, and up to SDR 425 million until November 15, 1983 (Table 1). If the full amount is purchased before the end of 1983, the Fund's holdings of Yugoslav dinars, excluding the oil and compensatory financing facilities, will rise to SDR 2,266.2 million by December 31, 1983, or 545.4 per cent of quota.

The performance criteria for the second year of the stand-by arrangement included ceilings on the level of domestic credit extended by the banking system, on the increase in credit extended by the National Bank to the budget of the Federation and on the increase in the outstanding amount of debt in convertible currency. They were met on March 31, June 30, and September 30, 1982.

The level of credit extended by the National Bank of Yugoslavia to the budget of the Federation and that of the stock of outstanding debt in convertible currencies on December 31, 1982 conformed to the performance criteria. However, the level of domestic credit outstanding on that date, according to preliminary data, exceeded the agreed ceiling by Din 9.2 billion or 0.4 per cent (Table 2). The authorities explained that the most important single factor accounting for this breach of the ceiling related to a considerably better than expected growth of agricultural output, in particular a more favorable harvest of corn. Credit extended for carrying of agricultural inventories is exempted from the ceilings imposed by the National Bank on domestic credit. The Bank now has reduced the limits for extension of nonagricultural credits in order to compensate for the larger-than-anticipated credit demand of the agricultural sector. The Bank fully expects that the limits on the stock of net domestic assets agreed for the first six months of 1983 will be observed.

Since 1949, the World Bank Group, including the International Finance Corporation, has approved loans and credits in Yugoslavia amounting to US$3.5 billion, of which about US$1.3 billion was extended to the transportation sector. In recent years World Bank projects have

Table 1. Yugoslavia: Purchases Under
the Stand-By Arrangement

	First year (Feb. 1981-Jan. 1982)	Second year (Feb. 1982-Jan. 1983)	Third year (Feb. 1983-Jan. 1984)	Total
1. Amount available				
In millions of SDRs	554	554	554	1,662
In per cent of quota	133	133	133	400
Amount drawn				
In millions of SDRs	554	554	--	1,108
In per cent of quota	133	133	--	267
Amount undrawn				
In millions of SDRs	--	--	554	554
In per cent of quota	--	--	133	133
2. Proposed phasing over third year				
Amount becoming available on:	1983			
	(March 16)	May 15	August 15	November 15
In millions of SDRs	175	150	100	129
In per cent of quota	42	36	24	31

Source: International Monetary Fund, European and Treasurer's Departments.

Table 2 . Yugoslavia: Quantitative Performance Criteria for Second Year of Stand-by Arrangement

	1982							
	March 31		June 30		Sept. 30		Dec. 31	
	Ceiling	Actual	Ceiling	Actual	Ceiling	Actual	Ceiling	Actual 1/
Domestic credit extended by banking system: stock on date shown (in billions of dinars)	1,996	1,996	2,076	2,076	2,159	2,159	2,247	2,256
Credit of the National Bank to the budget of the Federation: change from December 31, 1981 to date shown (in billions of dinars)	--	--	--	-0.4	--	-0.4	--	-0.4
Convertible currency debt outstanding 2/ change from December 31, 1981 to date shown (in billions of U.S. dollars)	0.7 3/	--	0.7 3/	0.2	...	0.3	0.5	-0.1

Sources: Yugoslav authorities; and staff estimates.

1/ Preliminary figure.
2/ External debt with original maturities of more than one year. Includes borrowing by the National Bank of Yugoslavia and commercial banks. Excludes net purchases from the Fund.
3/ This was the maximum increase permitted in the period up to June 30, 1982.

focused increasingly on the agricultural sector which has received 13 loans amounting to about US$772 million, or more than 20 per cent of total IBRD loans extended to Yugoslavia. In addition, IBRD lending has concentrated on industry, energy, telecommunications, water supply and sewerage, tourism, and the environment. During 1982, four loans totaling US$189 million were approved, of which two loans totaling US$115 million were to the agricultural sector. As of December 31, 1982, total disbursed IBRD loans outstanding to Yugoslavia amounted to US$1,682 million while undisbursed loans amounted to US$904 million. In recent years, disbursements of project loans have averaged US$275 million per year, and are expected to continue to average similar amounts over the next five years.

II. Background

1. Medium-term context

Developments in the Yugoslav economy have been reviewed frequently during the past two years and the information contained in EBS/82/181 (10/7/82) sets out in detail the background to the present difficult economic situation. The main causes underlying the severe external liquidity crisis that faced Yugoslavia by end-1982 are to be found in the policies pursued in the second half of the 1970s. As in many other countries, excessive optimism dominated that period. This led to a continuation of high-growth policies, despite the change in world economic conditions that argued for a basic shift in policy orientation.

Yugoslavia's growth-oriented policies relied heavily upon foreign, largely borrowed, capital resources. External indebtedness more than tripled, to almost US$20 billion between 1975 and 1981 and over that period, external debt in convertible currencies rose from less than US$6 billion to more than US$18 billion (Table 3). Since then, the level of indebtedness has stabilized, largely because lenders have been unwilling to extend further credit. The sharp increase in external debt in convertible currencies was accompanied by a very fast rise of the debt service ratio, which rose by almost two-thirds to over 25 per cent between 1980 and 1981 alone, as exports to the convertible currency area fell well below expectations, interest rates in international capital markets rose, and the average maturity of the outstanding debt shortened appreciably (Table 4).

The excessive economic expansion and the mortgaging of future output since the mid-1970s was compounded by a serious misallocation of resources. Expensive and increasingly scarce borrowed capital resources were channeled into projects that turned out neither to yield the foreign exchange earnings (or savings) needed for debt servicing, nor, more generally, to be financially viable. The ability of firms to earn convertible foreign exchange and their incentive to do so were hampered by

Table 3. Yugoslavia: External Debt Disbursed and Outstanding

(In millions of U.S. dollars; end of period)

	1975	1979	1980	1981	1982
Repayable in convertible currency	5,816	13,680	17,608	18,337	18,280
Medium and long term	5,613	12,812	15,558	16,025	16,470
Public or publicly guaranteed	2,294	3,530	4,697	5,957	6,380
IMF	182	456	760	1,252	1,754
IBRD	560	1,143	1,359	1,483	1,576
Other	1,552	1,931	2,578	3,222	3,050
Private	3,319	9,282	10,861	10,068	10,090
Commercial banks	1,230	5,120	6,110	6,350	6,040
Other	2,089	4,162	4,751	3,718	4,050
Short term	203	868	2,050	2,312	1,810
Repayable in bilateral currency	768	1,490	1,542	1,531	1,528
Total debt	6,584	15,170	19,150	19,868	19,808

Sources: Data provided by the Yugoslav authorities; and staff projections.

Table 4. Yugoslavia: Debt Service Payments on Medium- and Long-Term Debts 1/

(In millions of U.S. dollars)

	1980	1981	Prelim. 1982	Projections 2/ 1983	1984	1985
Repayable in convertible currencies, excluding IMF						
Amortization	1,844	1,695	1,690 3/	2,843 3/	2,576	2,509
Interest 4/	1,205	1,887	1,960	2,000	2,000	1,900
	3,049	3,582	3,650	4,843	4,576	4,409
Repayable in bilateral currencies						
Amortization	162	238	260	270	290	320
Interest	45	40	45	70	75	85
	207	278	305	340	365	405
Total	3,256	3,860	3,955	5,183	4,941	4,814
Memorandum items:						
Debt service to IMF 5/						
Repurchases	70	88	45	182	295	353
Charges	31	60	118	162	180	169
Total	101	148	163	344	475	522
Debt service/exports of goods and services (in per cent)						
Convertible currencies, excluding IMF	15.6	25.4	24.1	33.8	28.1	24.9

Sources: Data provided by the Yugoslav authorities; and staff projections.

1/ Debts with an original maturity of over one year, excluding IMF.
2/ Staff projections on debt service payments on estimated outstanding debt in 1982 and projected new borrowing in 1983.
3/ There were delays of scheduled payments in 1982 which are projected to be eliminated in 1983.
4/ Includes interest on short-term debt.
5/ On purchases outstanding at end-December 1982; SDR amounts converted to U.S. dollars at average exchange rates through 1982, thereafter at the rate of SDR 1 = US$1.095.

the existence of a fragmented foreign exchange market and by an exchange rate policy that only partly offset the effects of divergent domestic and foreign price trends. Accordingly, there was a marked decline in the share of exports going to the convertible currency area. However, the growth of aggregate demand associated with the expansion of investment activity allowed both employment and nominal wages to grow rapidly despite unfavorable developments in labor productivity and in the external balance. Accordingly, not only investment, but indirectly also consumption became increasingly dependent upon borrowed resources. At the same time, price, credit, and restrictive domestic trade policies shielded the economy from competition from within and without, so that distortions between domestic supply and demand became progressively embedded.

By 1979, in the wake of the second oil shock, the external current account deficit reached 6 per cent of gross social product. In response, the authorities embarked on an adjustment program that, however, turned out to be inadequate to the task of solving the problems that had arisen. Accordingly, the stabilization program for 1981 set out a medium-term strategy designed to secure adequate and sustainable external and internal adjustment. The growth of final domestic demand was to be curtailed so as to shift resources into the tradable goods and services sectors. Credit, interest rate, price, and exchange rate policies were to be used actively in support of the program.

These policies led to a decline in final domestic demand, in real terms, of over 7 per cent between 1980 and 1982, with fixed investment falling by 15 per cent, albeit from a high level (Table 5). In 1981 consumption demand fell for the first time in more than a decade, and this decline continued into 1982. These sharp adjustments, however, were accompanied by a disappointing price performance. Although the inflation rate was reduced from 46 per cent in 1981 to 30 per cent in 1982--approximately the same level that had been recorded in 1980--this improvement fell far short of policy aims.

A prime cause of the inflationary tendencies in the Yugoslav economy is to be found in the wage payments system. Enterprises traditionally base increases in personal income on prospective earnings, which continually tend to be overestimated, with enterprises subsequently attempting to validate the excessive wage awards by raising prices. Because of the inefficient internal distribution system and sheltered domestic markets, there has been relatively little resistance to price increases for other than basic consumer goods such as bread, housing, and transportation. Accordingly, the Yugoslav economy has been prone to repeated wage-price spirals, which have frustrated time and again initially successful attempts to control incomes. These inflationary tendencies, combined with an exchange rate policy that has tended to lag inflation differentials, have increased incentives to divert output from export to domestic markets.

Chart 1

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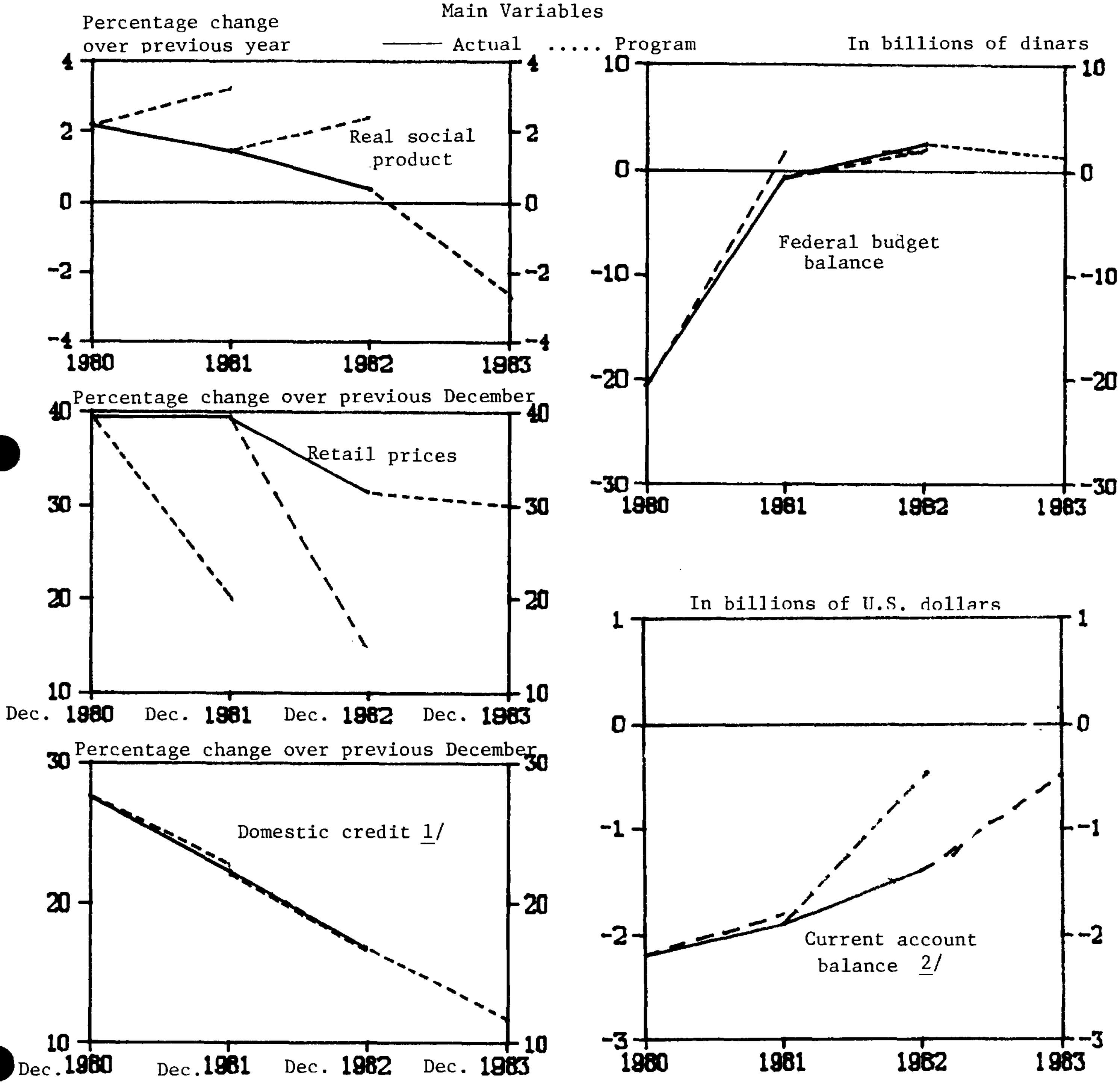
Main Variables



Source: Data provided by Yugoslav authorities; and staff estimates.
1/ Program variable for 1983 is net domestic assets of the banking system.
2/ Balance of payments with the convertible currency area.

Table 5. Yugoslavia: National Accounts, Incomes, and Prices

	1980	1981	1981	1980	1981	1982		1983	
	In billions of dinars at current prices		In per cent of GSP			Plan 1/	Prelim-inary estimate	Plan 1/	Staff forecast
				(In 1980 prices; per cent change)					
National accounts									
Private consumption	818.8	1,143.3	51.7	0.7	-1.0	--	-2.5	-6.0	-2.0
Public consumption	143.1	198.2	9.0	2.7	-0.5	-0.2	-1.8	-0.3	-5.0
Gross fixed investment	545.7	676.6	30.6	-1.7	-9.1	-6.0	-6.3	-20.0	-7.0
Final domestic demand	1,507.6	2,018.1	91.3	--	-3.9	-2.1	-3.7	-10.0	-4.0
Stockbuilding 2/	119.6	238.1	10.8	1.4	3.3	-0.8	-3.3	-0.7	--
Statistical discrepancy 2/3/	-5.6	-6.6	-0.3	--	-0.8	4.3	4.9	7.4	--
Total domestic demand	1,621.6	2,249.6	101.7	1.3	-0.9	-2.6	-1.8	-2.0	-3.5
Exports of goods and nonfactor services	350.0	546.6	24.7	8.9	8.7	8.5	-3.9	8.8	1.7
Imports of goods and nonfactor services	418.5	585.1	26.5	-9.9	-0.5	3.6	-11.7	-5.2	-2.3
Foreign balance 2/	-68.5	-38.5	-1.7	4.9	2.1	0.9	2.1	2.9	0.9
Gross social product	1,553.1	2,211.7	100.0	2.2	1.5	2.5	0.3	0.9	-2.6
				(Per cent change)					
Incomes									
Nominal gross social product				34.0	42.4	23.0	27.4	21.0	27.5
Nominal aggregate wages 4/				24.4	37.5	22.0	31.0	...	30.0
Average nominal wage 4/				20.5	33.6	20.0	28.5	...	27.5
Real wage 4/				-8.3	-5.1	--	-2.8	-7.0	-4.0
Prices									
GSP deflator				31.0	40.2	20.0	27.0	20.0	31.0
Retail prices				30.4	46.0	20.0	29.5	28.0	33.0
Retail prices (growth during year)				39.2	39.3	15.0	30.7	20.0	30.0

Sources: Federal Statistical Office, Indeks; data provided by the Yugoslav authorities; and staff estimates.

1/ Resolution for the Annual Plan for the year indicated.

2/ Changes in per cent of preceding year's GSP in constant prices.

3/ Changes for 1982-83 represent "unallocated consumption," the discrepancy between demand and production estimates (see RED for explanation).

4/ Aggregate wages are equivalent to the Yugoslav concept of total net personal income from employment; the average wage is equivalent to net personal income per worker. These wage data refer to the socialized sector, which includes "noneconomic" activities but excludes individual workers.

On the external side, some progress has been achieved. The current account deficit vis-à-vis the convertible currency area, which had peaked at US$3.3 billion in 1979, was reduced to US$1.8 billion in 1981 (Table 6). Policies for 1982 were intended to strengthen the rate of improvement achieved in preceding years, but the deficit for that year is now estimated to have declined only to US$1.4 billion. Furthermore, the reduction in the deficit, at least since 1981, cannot be regarded as a sustainable move toward internal or external balance, since it has been brought about mainly by a reduction of imports sufficiently large to begin to impede output. Imports from the convertible currency area have fallen continuously since 1979--from US$11.3 billion to an estimated US$9.6 billion in 1982. 1/ This decline in nominal terms reflects an estimated fall in real terms in excess of one quarter over the period.

The constraint on imports in part reflects the disappointing performance of exports of goods and services, which rose considerably less than anticipated. Exports of goods to the convertible currency area rose from US$4.8 billion in 1979 to US$5.7 billion in 1980, but subsequently have remained around that level. In addition, the surplus on the invisibles account fell from its peak level of US$3 1/2 billion in 1980 to under US$2 1/2 billion in 1982. Up to 1980, net capital inflows in excess of US$1 1/2 billion per annum (including errors and omissions) were considered normal and would thus have covered the current account deficit recorded in 1982. Since 1980, however, the capital account position has deteriorated rapidly and by 1982 capital transactions resulted in a small net financial drain.

In the three years since 1979 the balance on current account transactions in nonconvertible currencies has moved from sizable deficit to an estimated surplus of nearly US$1 billion. There was a substantial rise in the value of imports in nonconvertible currencies between 1979 and 1981, but the value of exports more than doubled over this period. As a result, the trade balance in nonconvertible currencies moved from a deficit of US$655 million in 1979 to a surplus of US$557 million in 1981. An improvement in the terms of trade and a reduction in the volume of imports from the U.S.S.R. led to a further rise in Yugoslavia's trade surplus in nonconvertible currencies in 1982 to almost US$700 million (see recent economic developments paper).

1/ The use of statistical exchange rates for the conversion of foreign currencies into dinars makes intertemporal comparisons of trade flows difficult, though balance calculations tend to be somewhat less distorted. The use of different sets of statistical rates in the calculation of projections and outturns make those discrepancies also difficult to interpret.

Table 6. Yugoslavia: Balance of Payments with the Convertible Currency Area

(In millions of U.S. dollars)

	1979	1980	1981 1/	Official estimates: Original projections 1982	Official estimates: Preliminary Outturn 2/ 1982	Official estimates: Preliminary outturn First half 1982	Official estimates: Preliminary outturn Second half 1982	Staff projections: Full year 1983	Staff projections: First half 1983	Staff projections: Second half 1983	Staff projections: First half 1984
A. Goods and services and unrequited transfers	-3,304	-2,203	-1,821	-500	-1,420	-1,543	123	-500	-1,100	600	-700
Exports, f.o.b.	4,766	5,656	5,720	7,730	5,858	2,746	3,112	6,300	2,970	3,330	3,300
Imports, c.i.f.	-11,336	-11,321	10,600	-12,885	-9,637	-4,997	-4,640	8,600	-4,275	-4,325	-4,450
Trade balance	-6,570	-5,665	-4,880	-5,155	-3,779	-2,251	-1,528	-2,300	-1,305	-995	-1,150
Services and unrequited transfers (net)	3,266	3,462	3,059	4,655	2,359	708	1,651	1,800	205	1,595	450
B. Long-term capital											
Long-term capital received (net)	1,335	2,065	818	460	114	128	-14	907	684	223	200
Drawings	2,903	3,909	2,513	2,650	1,804	989	815	3,750	2,270	1,480	1,350
Repayments	-1,568	-1,844	-1,695	-2,190	-1,690	-861	-829	-2,843 4/	-1,586 4/	-1,257	-1,150
Long-term loans extended (net)	-123	-235	-235	-250	-175	-51	-124	-200	-75	-125	-100
Total	1,212	1,830	583	210	-61	77	-138	707	609	98	100
C. Short-term capital (net)	218	739	167	-500	-506	-340	-166	--	--	--	--
D. Allocation of SDRs	37	37	38	--	--	--	--	--	--	--	--
E. Errors and omissions	491	-575	598	198	412	726	-314	--	--	--	--
F. Total (A through E)	-1,346	-172	-435	-592	-1,575	-1,080	-495	207	-491	698	-600
G. BIS - bridging loan									500	-500	
H. Reserve movements											
Use of Fund credit (net)	218	304	672	592	563	303	260	421	316	105	100
SDRs	-34	41	--)								
Reserve position in the Fund	81	--	--)								
Gold	-4	-5	--)								
Official foreign exchange (increase-)	1,085	-168	-237	--	1,012 3/	777 3/	235 3/	-628	-325	-303	500
Total	1,346	172	435	592	1,575	1,080	495	207	491	-698	600

Sources: National Bank of Yugoslavia; and staff estimates.

1/ Computed on the basis of statistical conversion rates of currencies (other than the dinar) to the U.S. dollar which also applied in 1982. For 1981, use of these rates tends to underestimate marginally balance of payments flows.

2/ The use of statistical exchange rates in 1982 resulted in a significant, but uneven, overestimation of most balance of payments flows in convertible currencies depending on currency composition. Staff calculations suggest that trade flows with the convertible currency area are overstated in 1982 by about 4 per cent, while services such as workers' remittances and tourist receipts are overstated in excess of 7 per cent.

3/ Including reserves reduction of commercial banks.

4/ Includes repayments related to the cleaning up of arrears.

2. The economy in 1982

The performance of the economy fell short of the adjustment objectives in several major respects as described in EBS/82/181. During the first half of the year, nominal personal incomes rose faster than anticipated, and part of the progress made earlier in reducing inflationary pressures was inevitably reversed. Consequently, the inflation rate for the year as a whole was expected to be at least twice that incorporated in the program. By late summer, it was evident that both domestic and external developments were diverging dangerously from those expected at the beginning of the year, and that the adjustment effort needed to be intensified.

Although expansion of domestic credit by the banking system remained within the agreed bounds through early fall, interenterprise credit--and with it accounts receivable--expanded rapidly. As a result, the liquidity constraints on enterprise behavior, and particularly on their ability to increase personal income, were significantly less than would have been expected from the slowing pace of activity and from the limitations on access to bank finance.

On the external side, imports from the convertible currency area were falling more rapidly than anticipated, partly as a result of curtailed access to foreign exchange following the introduction of the temporary law on foreign exchange and credit transactions with foreign countries in May 1982 (see forthcoming recent economic developments paper), which in turn was motivated in part by the rapid deterioration in the reserve position. Nonetheless, the projected US$1 1/4-1 1/2 billion improvement in the current account balance in convertible currencies looked increasingly unattainable. Export revenues, particularly from sales to the developed countries, were not rising as projected and the surplus on invisible transactions was declining. In addition, pressures on the capital account continued to increase. Although the outflow of short-term deposits was associated largely with the liquidity problems of one major bank in Zagreb, the external financial resources of the banking system as a whole also declined sharply, and there was little prospect that these developments could be reversed in the second half of 1982.

In response, the federal authorities decided to depart from the growth goals incorporated in the 1981-85 Plan, and, in order to achieve a sustainable balance in the economy, adopted additional measures to reduce both domestic demand and inflationary pressures and to increase exports. These measures included greater restraint on personal incomes, severe restrictions on the extension of credit for investment purposes, and a selective price freeze for a period of six months starting July 1982. They were subsequently buttressed by a rise in the level of interest rates, a 16.7 per cent devaluation of the dinar, steps designed to ensure that essential imported inputs were available for export-oriented industries, but to limit other imports, and administrative measures to conserve foreign exchange resources.

The administrative measures adopted in October 1982 included, in particular, limitations on the cash withdrawals from resident foreign exchange accounts to US$250 per account per month, although no limit was placed on the drawing of foreign currency checks against such accounts. For Yugoslav nationals going abroad, progressively rising noninterest-bearing deposits linked to the number of border crossings were introduced and the import of goods by private residents was limited to Din 1,500 per border crossing. Stringent rationing of gasoline (40 liters per automobile per month) was imposed, and other energy conservation measures were adopted. Expenditure ceilings on the federal budget were strictly maintained in the face of higher-than-expected inflation.

During the first nine months of 1982, prior to the decision to effect a step devaluation of the dinar in October, the exchange rate of the dinar vis-à-vis the U.S. dollar had depreciated by some 20 per cent (see Chart 2 and the forthcoming recent economic developments paper). In nominal effective terms, the depreciation of the dinar amounted to almost 15 per cent according to the payments-weighted currency basket of the Yugoslav authorities, but to less than 9 per cent according to a trade-weighted basket, which accords a smaller weight to the dollar. In real effective terms the rate remained roughly constant according to the payments basket, but appreciated by almost 5 per cent according to the trade-weighted basket. In view of the importance of West European markets for the Yugoslav economy, not only for merchandise exports but also for tourism, and the disappointing performance of Yugoslav exports on these markets, the authorities devalued the dinar by 16.7 per cent on October 21. From October 21 until the end of the year, the rate of the dinar depreciated slightly in terms of the official currency basket but remained virtually unchanged in real effective terms.

Partly under the impetus of the policy measures implemented in the second half of the year, and partly because of external constraints, real GSP for the year as a whole is estimated to have remained virtually unchanged. Domestic demand is estimated to have fallen 1.8 per cent below its 1981 level. Although the emergence of a large, positive statistical discrepancy between production and demand estimates throws some doubt on the estimated changes in the individual components of demand, it is clear that fixed investment continued to fall significantly, and that public and private consumption trended downward as well.

The preliminary outturn for the public sector accounts shows a small surplus in 1982 and the share of public sector expenditures in GSP is estimated to have fallen by about 1/2 percentage point, to 35.0 per cent, in 1982 compared with 1981. As regards credit policy, the National Bank found that the use of quarterly ceilings on the credit extended by the banking system had permitted significant intraquarter variations; it therefore, has imposed monthly ceilings. Although bank credit rose just fractionally more than had been programmed, the rise of money supply, M1, as well as that of quasi-money, appears to have exceeded that estimated as being consistent with the criteria incorporated in the 1982 stabilization plan by a considerable margin. M1, according to preliminary data, has risen by almost 27 per cent during the 12 months ending December 31, 1982, over 10 percentage points more than the 15.5 per cent planned, and just about 2 percentage points less than nominal GSP. The dinar component of quasi-money is estimated to have risen by 19.2 per cent over the same period (Tables 7 and 8).

The current account deficit with the convertible currency area in 1982 is estimated at US$1.4 billion, about US$ 1/2 billion below the outturn for 1981, but well above the US$ 1/2 billion that had been targeted. More sluggish than expected growth of export markets, the heavy concentration of Yugoslav exports in cyclically sensitive products, and the large proportion of Yugoslav exports affected by trade barriers in partner countries contributed to this outturn, but a lack of competitiveness certainly was also a major factor. The volume of exports to the convertible currency area fell by an estimated 2 1/2 per cent in 1982. 1/ Thus, the reduction in the trade deficit resulted solely from an unsustainable compression of imports. In 1982 merchandise imports, in volume terms, were estimated to have been about one ninth below their already low 1981 level. In addition, the surplus on services and transfers was reduced by about US$3/4 billion in 1982 as the net inflow of emigrants' remittances and net earnings from tourism fell by about US$1/2 billion and US$1/4 billion, respectively, and interest payments rose. As the need for stronger adjustment efforts became increasingly clear in a world climate in which domestic and international liquidity problems led to a reassessment of international credit risks generally, and of the position of some countries near to Yugoslavia in particular, the net capital position deteriorated, and in 1982 as a whole turned negative by an estimated US$150 million. 2/

III. Policies and Prospects for 1983

At the time the Yugoslav authorities fashioned their 1983 economic plan they were faced with a situation in which official reserves had approached minimal levels and large debt repayments were falling due. In addition, stocks of imported raw materials had been greatly depleted, and production, both for the domestic market and for exports, was being hampered by a lack of imported inputs. Finally, no new financial credits, which could have relieved the situation, were in the pipeline. Against this background, the authorities decided that their central aim of policy was to continue to meet all external payments obligations in an orderly manner.

1. Policies

The measures that have been adopted to help solve the current critical external situation were taken partly in the context of the medium-term policies which aim to bring about correction of the structural problems discussed in earlier papers, and in part with an eye to achieving

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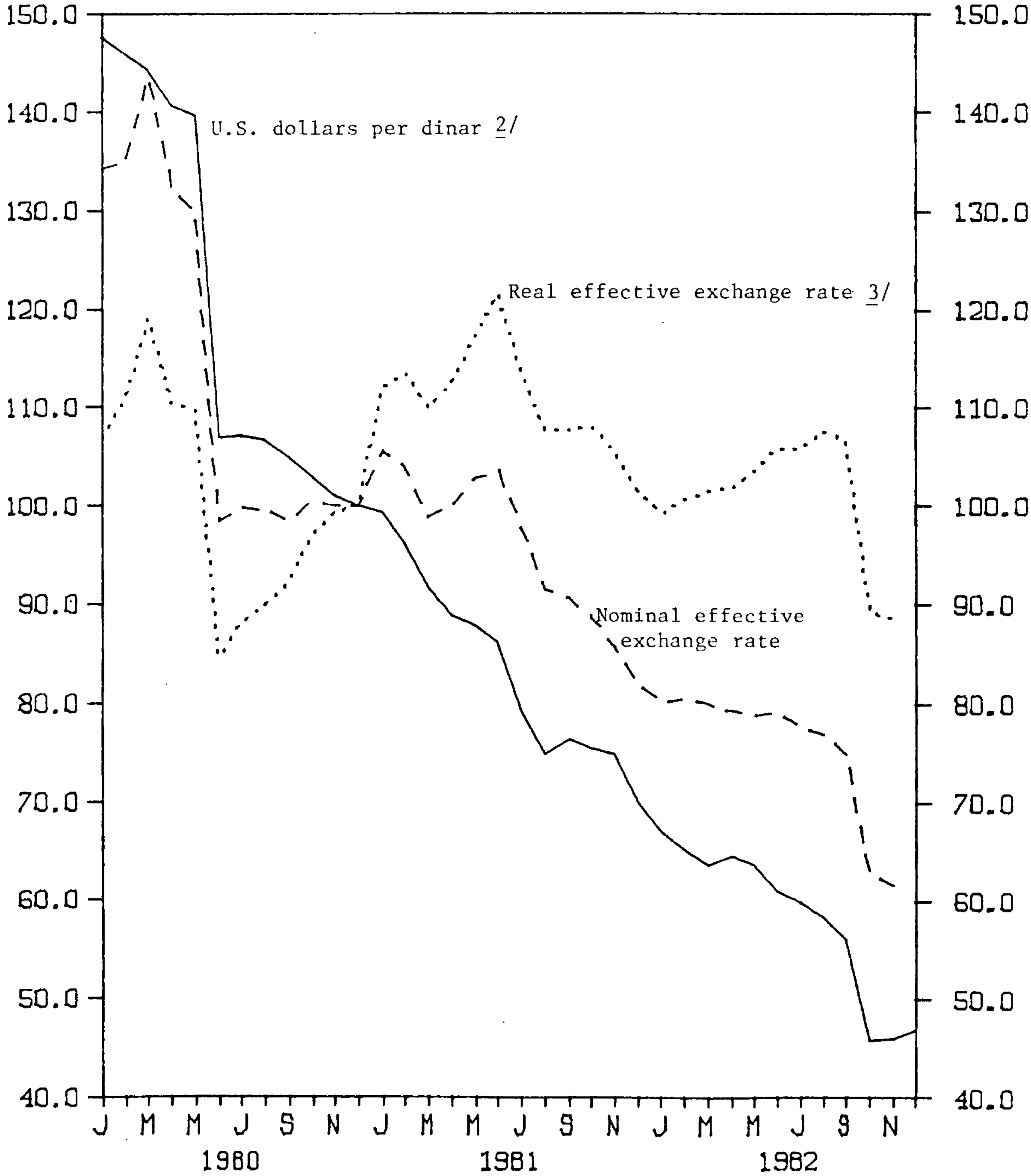
1/ On the basis of official estimates.
2/ Excluding use of Fund credit, but including errors and omissions.

Chart 2

Yugoslavia

Exchange Rate of the Dinar 1/

(End of December 1980 = 100)



Sources: IMF, International Financial Statistics; staff estimates; and data provided by the National Bank of Yugoslavia.

1/ Nominal and real effective exchange rate indices are based on the European Department's exchange rate indices (bilateral trade weights).

2/ End-of-period values.

3/ Adjusted for relative producer prices.

Table 7. Yugoslavia: Actual and Projected Net Domestic Assets of the Banking System

	1981 Dec. (1)	1982 June (2)	1982 Dec. a/ (3)	1983 June (4)	1983 Dec. (5)	(2)/ /(1) (6)	(3)/ /(1) (7)	(4)/ /(3) (8)	(5)/ /(3) (9)
	(Levels in billions of dinars)					(Percentage changes)			
1. Net foreign liabilities 1/	537.1	572.6	587.9	615.2	627.7	6.6	9.5	4.6	6.8
2. Money (M1)	584.3	616.3	739.8	784.5	828.3	5.6	26.6	6.0	12.0
3. = 4+5 Quasi-money	1,231.6	1,321.1	1,386.7	1,446.0	1,575.2	7.3	12.6	4.3	13.6
4. Foreign exchange deposits 1/	668.2	687.5	713.8	717.7	782.2	2.9	6.8	0.5	9.6
5. Other quasi-money	563.4	633.6	672.9	728.3	793.0	12.5	19.4	8.2	17.8
6. = 1+2+3 Net domestic assets	2,353.0	2,510.0	2,714.4	2,845.7	3,031.2	6.7	15.4	4.8	11.7
Nominal GSP 2/	2,534	2,789	3,254	3,684	4,178	21.2	28.4	28.1	28.4
Income velocity 2/						8.7	6.2	14.0	14.5

Sources: National Bank of Yugoslavia; and staff estimates.

a/ Preliminary.
1/ Adjusted for exchange rate changes.
2/ Percentage changes at annual rates.

EBS/83/46
Corrected: 3/9/83

EBS/83/46
Corrected: 3/9/83

Table 8. Yugoslavia: Monetary Survey, 1980-82

(In billions of dinars)

	1980	1981		1982		
	Dec.	June	Dec.	June	Sept.	Dec. 1/
Net foreign assets	-254.5	-329.3	-375.1	-436.1	-468.9	-587.9
Domestic credit	1,568.3	1,750.7	1,927.8	2,108.3	2,211.1	2,369.2
SBA definition 2/				2,076.3	2,159.4	2,256.0
Money supply	461.6	506.0	584.3	616.3	664.9	739.8
Quasi-money	768.7	851.4	1,030.0	1,157.1	1,210.0	1,386.7
Other items (net)	83.5	64.0	-61.6	-101.2	-132.7	-345.2

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

1/ Preliminary estimates.
2/ Excludes changes in the dinar valuation of foreign currency denominated loans arising from changes in the exchange rate.

relatively quick results. In both respects, however, immediate policy action was limited to measures that could be effectively implemented in a federal state. These measures are described below.

a. Incomes policy

The Government considers its policy of restraining the growth of personal incomes to be a central element of its medium-term stabilization program. Steps have been taken to prevent renewed surges in personal income, such as occurred in the last quarter of 1981 and early 1982. Accordingly, the Yugoslav authorities have resolved that nominal personal income per worker should remain unchanged between the fourth quarter of 1982 and the first quarter of 1983, despite the fact that the rise in the fourth quarter, which is generally large on account of seasonal factors, appears to have been rather muted in 1982. For 1983 as a whole, the Government has adopted a target of reducing real personal income per worker 7 1/2 per cent below its 1982 level. Enterprises are to limit the growth in payments of personal incomes to that of current net enterprise income. The past practice of determining wage payments on the basis of prospective income streams of enterprises, which in turn were influenced by strong inflationary expectations, had been a major factor in fueling inflation. Therefore, any move toward a known base could strengthen the control mechanism significantly.

The growth of nominal incomes in the social (nonenterprise) sector is planned to be at least 7 percentage points lower than in the enterprise sector. For the federal administration, the differential is to be at least 9 percentage points. Personal incomes in the enterprise sector are paid in accordance with self-management agreements and social compacts and are not determined by the Federal Government. However, the Social Accounting Service (SDK), which executes virtually all payments made by enterprises, can monitor payments not in line with the incomes policy undertakings. Furthermore, if the results of the first quarter exceed the level registered in the fourth quarter of 1982, the Federal Government stated that it will activate its legal powers to enforce an adequate intervention mechanism so as to rectify the overruns and to prevent further breaches of the understanding.

b. Price policy

The Government has decided that over the next two years domestic prices will be brought broadly in line with international prices in order to reduce the price distortions that currently permeate the economic system and adversely affect the efficiency of production. In addition, prices are to reflect increasingly the balance of domestic demand and supply. As the first major step in this direction, prices of certain key commodities, such as electricity, coal, railway fares, live animals, and meat, have been raised by 25-35 per cent. Further, steps to increase prices of petroleum products by 25 per cent will be taken by the Federal Executive Council early in March 1983, and rents will rise by 30 per cent during the first half of 1983. New price distortions will not to be allowed to arise. The direct effects of these price increases on the cost of living index are officially estimated at 4 1/2 percentage points. Apart from these price increases, those associated with the depreciation of the dinar and those resulting from the earlier decontrol of prices of certain nonindustrial goods and services, the Government will maintain its current selective price freeze through June 1983.

c. Fiscal policy

Fiscal policy for 1983 aims, as in 1982, to achieve a further reduction of the share of public expenditures in GSP. The overall budgets of the Federation and the other public sector entities are traditionally in balance and, as in 1982, no net new credits are to be extended by the National Bank of Yugoslavia to finance the budget of the Federation. For 1983, both public sector revenues and expenditures are estimated to increase by 13 per cent. These estimates are based on an officially projected inflation rate of 20 per cent in 1983 and, therefore, imply a significant fall in real public sector expenditures. The rise in transfer payments, which is normally linked to the rate of growth of nominal personal incomes, is to be held to 18 per cent. Any revenues in excess of these expenditure ceilings will be returned concurrently to the economy at large.

The authorities have agreed that a breach of either one of the expenditure ceilings will trigger the legislative process enabling them to freeze excess revenues in a blocked account at the National Bank of Yugoslavia. Because expenditure data are not available in a timely fashion, the expenditure ceilings will be monitored through the relevant revenue data. Thus, any increase in either category of revenues for three consecutive months as compared with the same months a year ago in excess of the agreed ceilings, will be taken as a signal that the associated expenditure ceiling has been broken. In such a case, the Government will seek legislation that will result in monthly set-asides of accumulated and projected excess revenues, such set-asides to be frozen until at least 1985. Furthermore, any surpluses that materialize at the end of 1983, despite the monthly measures to redistribute them, will be placed in such a blocked account until at least 1985.

The expenditure ceilings the Government has adopted are quite tight compared both with the preceding year and with the projected growth in nominal GSP for 1983. As such they imply, inter alia, a large reduction in the real incomes of public sector employees. This fall is an important element in the Government's overall incomes policy and should help facilitate general compliance with the Government's target of a reduction in the real personal income per worker of 7 1/2 per cent in 1983 over 1982.

d. Credit policy

In the first two years of the stand-by program, monetary and credit policies proved not to be sufficiently restrictive, in large part because of unforeseen increases in the income velocity of circulation of narrow money. The sharp rise in the item "other domestic assets of the banking system" in 1982 also permitted domestic liquidity (M2 including foreign exchange deposits) to increase at a considerably faster rate than originally forecast. For 1983 the monetary authorities will revert to conducting their monetary policy on the basis of the change in the stock of net domestic assets of the banking system (NDA), thereby broadening their control mechanism compared with the previous mechanism of limiting domestic credit expansion only. The National Bank also formalized its recent steps to improve control over credit developments during each quarter by adopting ceilings expressed as the average of the three end-month data of each quarter, instead of using end-of-quarter ceilings. As noted above, no new credits are to be extended by the National Bank of Yugoslavia to the Federal Government during 1983.

The increase in the stock of net domestic assets over the 12 months to the end of December 1983 is to be limited to 11.7 per cent, and that for the 6 months to the end of June 1983 to 4.8 per cent (Table 7). This is consistent with an increase in money supply (M1) of 12 per cent during 1983 and implies a 14.5 per cent increase in the income velocity of narrow money. The rise in the dinar component of the broader monetary aggregates, estimated at 18 per cent, is substantially higher than that estimated for money, narrowly defined. This is in contrast with developments in 1982 and mainly reflects the increases in deposit rates, described below, which should encourage a shift from M1 to M2. The increase in quasi-money including foreign currency deposits, but after adjustment for exchange rate changes, is projected to be only slightly above that of M1. Since about one half of quasi-money consists of foreign exchange deposits of households with domestic banks, changes in these deposits materially affect the growth of quasi-money. For 1983, the limitations put on the use of these accounts in particular, and the continued external constraints generally, are likely to hold their growth below that experienced prior to 1982.

The change in quasi-money associated with the agreed exchange rate policy described below is excluded from the calculation of the ceiling on NDA. This approach is justified because these deposits are held primarily as a store of value, the more so now that domestic use of foreign exchange has been curtailed by administrative measures. Further, the differential rate of return in favor of foreign exchange deposits, taking into account exchange rate developments, remains large compared with that on dinar deposits, again limiting the expected conversion into dinars. Finally, projection of the change in the dinar value of the major currencies in which such deposits are held, and of any associated shifts in their currency composition, is extremely tenuous.

A major problem in the control of domestic credit has been the very large and growing amount of unsecured interenterprise credit. The Government has moved to speed up legislation that aims to bring such credits under control, and it is agreed that this legislation will be passed before the end of May 1983. The legislation will amend the law on the functions of the SDK and specifies the order in which enterprises must settle their various payment obligations. In doing so, the payments of personal incomes and of contributions to the communities of interest (for social consumption expenditures) are accorded the lowest priority. If an enterprise, after meeting its higher priority obligations, does not have sufficient liquid resources to meet its agreed personal incomes payment schedule, employees incomes will be reduced to the minimum guaranteed income prevailing in the republic or community in which the enterprise operates. Minimum guaranteed incomes are estimated to average about 55 per cent of personal incomes paid in the preceding 6-12 months according to regional regulations. This priority mechanism, if strictly enforced, would, together with the rise in interest rates, described below, contribute materially toward strengthening the financial discipline exercised by enterprises and, in particular, motivate creditors to start collecting outstanding bills and make debtors more cautious about borrowing on an unsecured basis.

The Government expects that implementation of this law will decrease the outstanding amount of unsecured bills by a minimum of Din 50 billion in 1983. The stock of such bills was estimated to be Din 169 billion in September 1982. The Government will include new measures in the law in order to strengthen the penalty mechanism and to ensure its effective implementation. However, if by September 1983 it appears that the projected reduction in the stock of outstanding unsecured bills is not being achieved, the Government will consult with the Fund on the efficacy of the sanction mechanism with a view to strengthening it further as needed.

e. Interest rates

The authorities have accepted the principle that interest rates should afford lenders a real positive rate of return in order to encourage savings in financial assets and to improve the efficiency and financial viability of investment. However, movement toward this goal has been very slow. Because of the past and current heavy subsidization of the cost of credit, full and immediate implementation of the Government's interest rate goals would necessitate so large an increase in interest costs that it would put most enterprises under great liquidity strains. Furthermore, the basic tenet underlying the Yugoslav economic system is that the employment of the population should be assured, and this implies that sufficient credit should be available to enterprises caught in a financial squeeze to allow production to be maintained. Finally, differing regional interests make interest rate policy a highly politicized subject, not least because subsidization of interest rates rather than outright grants has been a major instrument for the promotion of investments in less developed regions.

Accordingly, the authorities in the past have tended to take a passive attitude toward the attainment of positive real interest rates, hoping to bring inflation rates down to or below the level of interest rates rather than raise the latter. They now have agreed that substantial moves toward a more rational structure of interest rates can no longer be postponed. Accordingly, they have decided to raise the cost of funds to the banking system significantly. This rise is being achieved by increases in deposit rates and in the rates charged by the National Bank on discounts and on selective credits. In addition, two new deposit instruments, introducing three- and six-months maturities carrying interest rates of 12 and 15 per cent, respectively, have been made available to households (see Table 9).

The new rates of interest are calculated to increase the annual cost of funds to the banking system by some Din 53 billion. This will force an increase in interest charges on new nonpriority loans by at least 10 percentage points, from their current level of slightly more than 20 per cent to more than 30 per cent, on average. Depending upon the portfolio structure of individual banks, some nonpriority borrowers could be facing charges of over 40 per cent on new credits. Priority lending will, however, remain heavily subsidized. The adjustment of interest rates in early 1983 was agreed against the authorities' inflation target of 20 per cent for the year. If by the time of the midyear review with the Fund the inflation rate is not in line with this target, the need for further adjustment of interest rates (up or down) will be reviewed in relation to the authorities' medium-term objective of moving toward positive real rates of interest.

f. Exchange and trade policies

The authorities agree that a successful adjustment effort requires adequate incentives for a sustained expansion of export production, and that import decisions should be based on a realistic assessment of the cost of foreign exchange. To this end, they intend that the exchange rate of the dinar move toward a market-clearing rate. The difficulties caused by the present fragmentation of the foreign exchange market frustrate this aim. Further, the pressures on the balance of payments and the shortage of foreign exchange led to sharp cutbacks in imports in 1982. The de facto linking of imports to export earnings under Yugoslavia's system of exchange allocation by self-management agreements among enterprises underscored the problem.

The temporary law on foreign exchange and credit transactions with foreign countries, introduced in May 1982, placed priority on debt repayments in the use of foreign exchange. Self-management agreements concluded on the basis of this law set aside relatively high proportions of current foreign exchange earnings to meet payments for debt service and oil imports. This resulted in a significant reduction of the proportion of foreign exchange earnings that exporters could retain for their own use and, in turn, substantially reduced both their ability to import and existing export incentives. The restrictive stance on the allocation of

Table 9. Yugoslavia: Agreed Interest Rate Schedule

(Per cent per annum)

	Weights 1/	Interest Rates as of End-1981	End-1982	End-Feb. 1983
Deposit money of OALs 2/	0.22	--	1	4
National Bank credits				
Discounts and credits for liquidity	0.03	6-8	14	22 3/
Selective credits	0.20	1-6	4-9	8-12 3/4/
Household deposits with maturities of less than one year				
Sight	0.15	7.5	7.5	7.5
3 months	0.01	...	...	12
6 months	0.01	...	...	15
Restricted deposits of OALs 2/	0.06	--	1	4
Short-term deposits of OALs 2/	0.02	2	3	7-9 5/
Long-term deposits				
Households	0.06	9-10	13-20	18-28 6/
Housing	0.06	3-6	9	13
OALs and other	0.18	3-6	9	17-23 7/

Source: Data supplied by the Yugoslav authorities.

1/ Based on average amounts outstanding for 1983 as estimated by the National Bank of Yugoslavia.
2/ Organizations of Associated Labor.
3/ Effective end-January 1983.
4/ Rates on: credits for exports 8 per cent, agriculture 10 per cent, imports 12 per cent, other 12 per cent.
5/ Range from 7 per cent for deposits of 1-3 months' maturity to 9 per cent for deposits of 6-12 months' maturity.
6/ Rates on deposits for 1 year (18 per cent), 2 years (23 per cent), and 3 years (28 per cent).
7/ Range from 17 per cent for deposits of a maturity of 12 to 18 months to 23 per cent for a maturity of 36 months or more.

foreign exchange for imports was reinforced by a series of measures designed to conserve foreign exchange further and to stem the growth of the parallel foreign exchange market. These included measures to eliminate the use of foreign exchange in domestic transactions, limitations on cash withdrawals from foreign exchange accounts, and mandatory deposits on border crossings (see recent economic developments paper).

The Law on Foreign Exchange Operations and Credit Relations with Foreign Countries was further amended by the Decision on the Common Foreign Exchange Policy of Yugoslavia for 1983, which was promulgated on December 31, 1982. This decision made a number of the temporary regulations adopted in May 1982 permanent and added a number of new provisions. A major new element is an apparently considerable strengthening of the role of federal entities at the expense of the regional communities of interest. The emphasis on the balance of payments positions of individual Republics, that characterized the previous method of allocating foreign exchange, has been downgraded and replaced by a sectoral distribution system. Furthermore, the banking system is being accorded considerably greater responsibility in the allocative system. Commercial banks will be responsible for ascertaining that any foreign borrowing by enterprises will be for projects that generate a sufficient flow of convertible currency to meet repayment and interest schedules. The commercial banks will be required to issue a guarantee to the National Bank of Yugoslavia that each foreign credit is thus secured. In addition, Yugoslav enterprises borrowing foreign exchange from a domestic bank will be required to repay these banks at the market rate of exchange of the date of repayment rather than passing the exchange rate risk of foreign currency indebtedness to the banking system, as they were able to do in the past. In order to strengthen the authorities' supervisory capabilities, enterprises will be limited to one foreign exchange bank account and will have to consolidate all their accounts into a single account by July 1, 1983.

As in previous years, the Federal Executive Council continues to be responsible for exchange rate policy. But the National Bank of Yugoslavia is required to formulate guidelines for the maintenance of a realistic exchange rate for the dinar and set such a rate in regular consultations with the banking system. It will also establish the liquid foreign exchange requirements of domestic commercial banks and see to it that any bank's excess liquidity is sold into the market or lent on to other banks.

The law establishes a mandatory allocation system for the foreign exchange earnings of enterprises. The implementation of this transfer system has not been fully agreed as yet. The indications currently are that enterprises will be allowed first to meet their own debt and trade credit obligations and essential import needs. The remaining foreign currency receipts are allocated according to a strict order of priorities. First, 25 per cent will go to the Federal sector: 5 per cent for the Federal administration, 3 per cent into the reserves of the National Bank and 17 per cent for energy supplies. The allocation for energy supplies may be revised after the first quarter.

The next priority, for which percentages are yet to be established on the basis of self-management agreements under the aegis of the Community of Interest for Economic Relations with Foreign Countries, provides foreign exchange for imports by suppliers of export-oriented enterprises, for those whose production is based on established import needs, but who do not participate in export activities and for some other users in the productive sector. The third priority is to provide for the needs of the republican and communal governments. Although these percentages also have not been agreed at this time, it is fully expected that they will be well below the 5 per cent allocation for the Federal Administration. Finally, there is an allocation to infrastructure and miscellaneous other needs. Any remaining foreign exchange will need to be sold to authorized banks.

The net effect of these changes in the allocative system is difficult to assess. Clearly, there is some trade-off between the loss of the use of the retention quota--amounting to an estimated 20-30 per cent of export revenues in the second half of 1982--and some greater certainty of the ability to obtain necessary imported inputs for exports. Still some, currently not quantifiable, loss of export incentive appears certain. The extent of this loss depends also on the success, or otherwise, of the measures to reduce the fragmentation of the foreign exchange market and to increase the size of the interbank market for foreign exchange.

The priorities in the amended system of allocating foreign exchange are largely based on the size of hard currency return flows. An active exchange rate policy is considered an indispensable corollary to this system. The devaluation of the dinar by 16.7 per cent in October 1982 helped improve the international competitiveness of Yugoslav exports. But it was not sufficient to reverse the erosion of incentives for production of exports compared with those for production for the domestic market that had occurred since the devaluation of mid-1980. This erosion must also be seen against the urgent need for an improvement in the growth and the structure of Yugoslav exports to the convertible currency area. Against this background, the authorities let the dinar depreciate modestly from the end of December so that in nominal effective terms the value of the dinar at end-January was about 7 3/4 per cent below its level of October 21, 1982. Before mid-March, the exchange rate is to be depreciated by a further 6 per cent over and above the adjustment needed to bring about some additional improvement in the real incentives to the export sector. During the remainder of 1983, there will be steady adjustments, at least monthly, so as to assure a continuing gradual improvement in these incentives.

Restrictions on payments and transfers for current international transactions are maintained in accordance with the transitional arrangements under Article XIV, with the exception of the restriction on the availability of exchange for foreign travel which is maintained under Article VIII. This restriction arises from the limitation on the export and import of dinars to Din 1,500 per person for the first trip and

Din 200 per person for each subsequent trip during the year. This measure was introduced in July 1981 and liberalized in January 1982. Fund approval of this measure was extended in February 1982 until the next Article XIV consultation (EBD/7057-(82/23) adopted February 22, 1982). The authorities indicated that this measure had helped reduce illegal currency transactions and had not had a significant restrictive impact on current payments; they intend to remove the measure as soon as circumstances permit. Furthermore, external payments arrears have arisen in 1983. The authorities currently are in the process of determining the amount of such arrears. They have indicated that they intend to eliminate these arrears as soon as the proceeds of the financing package described on page 41 ff. are received and, in any event, before the August drawing under the stand-by arrangement.

g. Foreign debt

The mounting external debt servicing burden has underscored the need for the Yugoslav authorities to improve the monitoring and coordination of foreign borrowing and the Government intends to exercise strict control over foreign borrowing. The foreign exchange law introduced in May 1982 makes medium- and long-term foreign borrowing by Yugoslav commercial banks subject to the approval of the National Bank, and short-term borrowing subject to the approval of the Federal Executive Council. The amendments to the Law strengthen control over external borrowing further as discussed above.

The National Bank of Yugoslavia will provide to the Fund detailed information on the foreign activities of the Yugoslav banks on a regular and timely basis. Moreover, in 1983 the contracting of new loans with maturities of at least one and up to ten years will be limited to a maximum of US$1.5 billion, of which no more than US$500 million will be loans with maturities of between one and up to three years. The limits exclude borrowing either by the National Bank of Yugoslavia or under National Bank guarantee. Outstanding external debt that falls due during 1983 and that is rolled over, as well as new loans extended to replace maturing debt, will also be excluded from this requirement.

2. Prospects

The policies described above aim to depress domestic demand drastically and to shift resources to the export sector both in the short and medium term. Indeed, the 1983 Plan Resolution projects a fall in real final domestic demand of 10 per cent, with private consumption falling by 6 per cent and fixed investment by 20 per cent. This is intended to make room for a 20 per cent rise in the volume of merchandise exports to the convertible currency area.

The official estimates for 1983, however, are open to question. First, they incorporate an important component termed "unallocated consumption" that permits a large discrepancy--the contribution to growth of which amounts to about 7 per cent of GSP in 1983--to emerge between the output and demand projections (see forthcoming recent economic developments paper). Thus, it is uncertain whether the fall in demand for 1983 is being overestimated or whether output is likely to fall rather than to rise fractionally as planned. Second, given the reductions in demand that already have taken place, the staff believes that neither private consumption nor fixed investment are likely to fall as steeply as planned. The staff assumptions which underlie the program are for final domestic demand in 1983 to be some 4 per cent below its 1982 level, compared with the official projection of a drop of 10 per cent (Table 5). At the same time, the staff also projects the rise in merchandise exports and in tourism to fall substantially short of official expectations and, thus, forecasts a decline in GSP of between 2 and 3 per cent. Estimates of an absolute fall in output in 1983 are supported by the most recent economic indicators, which show the seasonally adjusted index of industrial production down in the fourth quarter of 1982, the volume of retail sales down in the second half of the year, and a small decrease in the volume of exports.

The official forecasts and policies are built around an inflation rate of 20 per cent for 1983 over 1982. However, because of the combined effects of the price and exchange rate decisions detailed above, the Government expects that its inflation forecast will be exceeded by at least 5 percentage points. The staff considers that even the amended official price projection is still too optimistic and expects the GSP deflator in 1983 to be at least 30 per cent or more above its 1982 level. In any event, because the Government is committed to the 13 and 18 per cent rates of growth of public expenditures and transfer payments, respectively, fiscal policy will turn out to be much more restrictive than originally planned.

The immediate purpose of the economic program of the Yugoslav Government is to bring about a further improvement in the balance on current account with the convertible currency area. The Yugoslav authorities postulate for 1983 a surplus with the convertible currency area of US$1 1/2 billion, stemming from a 20 per cent rise in the volume of merchandise exports, a further large fall in the volume of imports, and a substantial recovery of the balance on invisibles. For current account transactions with the nonconvertible currency area, the authorities will aim at a deficit of around US$250 million in 1983.

According to staff estimates the hoped-for surplus on current account with the convertible currency area is not likely to materialize in 1983. In fact, the staff forecasts a deficit of around US$1/2 billion. The cumulative effects of the depreciation of the dinar on the supply of of exportables and on the price competitiveness of Yugoslav goods in foreign markets are expected to become apparent during the course of 1983 and are estimated to contribute to an increase of perhaps 8 per cent in the volume of exports despite an expected near stagnation of export markets. Exports of agricultural products from the excellent 1982 harvest will contribute in 1983 to the looked for improvement. The forecast implies an increase in the dollar value of exports of 11 per cent, to

US$6.3 billion. 1/ Recent staff estimates put the growth of import demand in Yugoslavia's main markets at just over 1 per cent in real terms in 1983 compared with a growth rate of 0.2 per cent in 1982. The export growth projection thus implies a considerable increase in market shares in 1983 after a slight loss in 1982. It is clear, therefore, that even the staff's forecast must lie in the upper range of what is achievable. The growth in market shares also has to be seen in the context of the adjustment efforts made by other countries. Several of these countries are in a situation similar to that of Yugoslavia, namely, the sustainable adjustment that they are seeking depends largely on their ability to improve their export performance since imports have already been reduced severely. The export projection also depends on essential imported inputs being available in sufficient quantities to sustain export output. Merchandise imports from the convertible currency area accordingly could fall by some 10 per cent in nominal terms to US$8.6 billion in 1983 (and a similar magnitude in real terms), with imports of consumer and capital goods continuing to be cut back quite sharply. This assumption is reconcilable with the export assumption so long as it is possible to increase imports from the nonconvertible currency area.

The staff forecasts a reduced surplus of US$1.8 billion on account of invisible transactions in 1983, but there are major uncertainties relating to receipts from tourism and net workers' remittances from abroad. If tourists are not discouraged by real or purported shortages of gasoline and other items and by the measures that have restricted the use of foreign exchange in domestic transactions, the depreciation of the dinar should confer a significant advantage on the Yugoslav tourist trade. This advantage, however, will be much less marked with respect to certain competing tourist centers, such as Greece and Spain, where the exchange rate recently has been devalued. Under current circumstances, therefore, even the staff's forecast of a modest recovery in the foreign exchange value of tourist receipts from the depressed 1982 level may be optimistic. It is also difficult to predict both the extent to which the restrictions placed on withdrawals from foreign exchange accounts will adversely affect the inflow of remittances and the net effect of the high levels of unemployment in European industrial countries on such remittances.

Because of the strong seasonality of the Yugoslav external payments flows, the US$1/2 billion current account deficit on convertible currency transactions for the year as a whole implies a deficit of about US$1 1/4 billion in the first half of the year, partly offset by a surplus of about US$3/4 billion in the second half. As regards the capital

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1/ In 1982 exports and imports tended to be overvalued because of the use of accounting exchange rates. It was expected that market exchange rates will be used in the valuation of trade flows starting in 1983, in which case a comparison with 1982 trade data will, e.g., understate the increase in exports. Percentage changes for 1983 mentioned in this report correct for such bias.

balance, in the first half of the year maturing medium- and long-term debts amount to US$1 1/4 billion and other repayments falling due to US$1 billion. The clearing up of payments delays would add a little under US$1/2 billion to this repayment schedule. Gross financing needs, putting the current account deficit and credits due together, thus total around US$4 billion in the first half of 1983 (Table 10).

Given the low level of Yugoslavia's foreign exchange reserves at the end of 1982, these financing needs could not be met in a normal manner. The financing pattern consistent with the economic program set out in the Yugoslav Government's letter of intent and in the Supplement to that letter attached to this paper, therefore, contemplates a number of interdependent special financing elements.

(1) The National Bank of Yugoslavia has requested the Bank for International Settlements to provide a US$500 million short-term bridging credit contingent upon adequate financial resources becoming available from the international financial institutions and under the intergovernmental financial assistance package under (2).

(2) The representatives of the governments of 15 countries agreed on January 19, 1983 to provide Yugoslavia with new medium-term economic credits totaling about US$1.3-1.4 billion. Less than one fifth, about US$250 million, of this is in the form of financial credits, the remainder consisting of suppliers' credits. The division between financial and commodity credits, however, is somewhat artificial. A part of the financial credits consists of refinancing of maturing export credits, whereas a part of the new export credits will directly relieve cash flow problems by providing medium-term credit for essential imports normally financed by short-term credit or paid for in cash. The total subscribed so far excludes any credits that may be provided by Kuwait, whose representative had joined the 15 governments as an observer and who indicated that his Government, possibly joined by other Gulf States, was contemplating a parallel action.

(3) The governments participating in the cooperative action on behalf of Yugoslavia also decided in principle that official agencies providing credit or credit guarantees for exports to Yugoslavia would not take administrative measures curtailing their ability to continue to provide such funds or cover for such funds.

(4) Commercial banks accounting for up to 60 per cent of Yugoslav liabilities to foreign commercial banks agreed not to ask for payment on maturing debt for the 90 days starting January 18, 1983, providing that Yugoslav financial entities in one way or another co-opted nonparticipating banks into an identical agreement. This would provide a necessary breathing space while all banks with outstanding credits to Yugoslavia would seek agreement on a financing package, that would allow the orderly repayment of maturing debt, coverage of the expected current account deficit in 1983, and some buildup of reserves.

Table 10. Yugoslavia: External Financing Flows on Basis of Financing Package 1/

(In billions of dollars)

	1983			1984	1985
	Total	1st half	2nd half		
Use of funds					
Current account balance	-1/2	-1 1/4	3/4	--	1/2
Of which:					
Trade balance	(-2 1/4)	(-1 1/2)	(-1)	(-2)	(-1 1/2)
Medium- and long-term maturities	-2 1/2	-1 1/4	-1 1/4	-2 1/2	-2 1/2
Short-term maturities	-2	-1	-1	-2	-2
Other obligations	-1/2	-1/2	--	-1/4	-1/4
	-5 1/2	-4	-1 1/2	-4 3/4	-4 1/4
Sources of funds					
Suppliers' credits	1	1/2	1/2	1 1/2	1 1/4
World Bank, EIB	1/2	--	1/2	1/2	1/2
IMF (net)	1/2	1/4	--	1/4	1/4
Rollover of short-term debt	2	1	1	2	2
Government financial credits	1/4	--	1/4	1/4	1/4
BIS	--	1/2	-1/2	--	--
Bank financial credits	2	1 1/2	1/2	1/2	1/2
	6 1/2	4	2 1/4	5	4 3/4
Reserves change	3/4	--	3/4	1/4	1/2
Memorandum item:					
Interest payments	2	1	1	2	2

Sources: National Bank of Yugoslavia; and Fund staff estimates.

1/ Transactions with convertible currency area on a cash basis. Totals may not add because of rounding.

(5) The Managing Director would, if all the elements of the package were in place, be prepared to recommend to the Executive Board approval of the phased disbursement of the final tranche of the three-year stand-by arrangement (SDR 554 million) approved by the Executive Directors on January 30, 1981, under the conditions set out in the attached letter of intent and in the supplement to that letter. In addition, the Yugoslav Government stated that it will request further stand-by arrangements for 1984 and beyond. In fact, the agreements under (2) and (4) above are conditional upon such a continuation. The World Bank would move as expeditiously as possible to respond to the Yugoslav Government's request for a structural adjustment loan.

So long as all the elements of this interlinked financial package can be put in place, the staff projects that Yugoslavia will be able to meet the payments schedule set out in Table 10. The financing plan incorporates, on the basis of the small current account surpluses projected for 1984 and 1985, some recovery of reserves, which though remaining well below the levels registered on average in 1975-81, should be adequate to meet the seasonal needs in the first halves of 1984 and 1985.

The structure of the projected financial resource package could lead to some increase in net foreign liabilities of the Yugoslav banking system over and above the estimates in Table 7, which sets out the elements underlying the growth of net domestic assets in 1983. If the structure of foreign indebtedness shifts toward a greater proportion of credit provided through the banking system than in the past, foreign liabilities, as defined for purposes of the NDA ceiling, would increase without an offsetting rise in the reserves of the banking system. Under the program, such a change in net foreign liabilities, while leaving the money supply unaffected, would reduce the capability of the banking system to expand domestic credit commensurately.

5. Performance criteria and periodic reviews

Performance criteria for the final year of the stand-by arrangement include (1) limits on (a) the stock of net domestic assets of the banking system, (b) on credit from the National Bank of Yugoslavia to the budget of the Federation, (c) on the expenditures of the public sector and on transfer payments, and (d) on the increase in new medium- and long-term external convertible currency debt; (2) a monthly depreciation of the real effective exchange rate of the dinar; and (3) the reaching of agreement at the time of the midyear review on policies for the remainder of the stand-by period.

Changes in interest rates on bank deposits and on certain credits from the National Bank of Yugoslavia and some changes in domestic prices will have been implemented by the time the Executive Directors consider the request of the Yugoslav authorities for the use of Fund resources.

Most of these changes, in fact, were in place by February 20, 1983. The performance criterion relating to the more comprehensive aggregate net domestic assets replaces the ceilings on domestic bank credit used in the second year of the program.

The attached letter of intent provides for quarterly staff visits to review recent and prospective economic developments and to assess the effectiveness of policies being implemented. Also, soon after mid-year the Yugoslav authorities will review with the Fund developments in the balance of payments, prices, and incomes, and will in particular reassess the role of interest rates and credit policies. It has been explicitly stipulated that the increase in interest rates introduced in January-February 1983 against a target 20 per cent inflation rate during the calendar year will be reviewed in the light of the then-prevailing rates of price increase and that the exchange rate changes agreed upon will be assessed on the basis of actual against projected export performance in the markets of the convertible currency area. Finally, discussions of the credit ceilings for the second half of 1983 will proceed from a basis Din 9.2 billion below the amount shown for December 31, 1983 in Table 7. Such an adjustment was incorporated formally into the June 30, 1983 ceiling in February 1983.

IV. Amendment of Stand-by Period

Because of the unanticipated delay in placing the request for the stand-by arrangement on the Board agenda, the three-year period for which the stand-by arrangement was granted exceeds by one month the period for which the Yugoslav authorities requested a stand-by arrangement. In order to rectify this anomaly the decision proposed below amends the decision granting the stand-by arrangement to provide for an expiration date of December 31, 1983 instead of January 31, 1984. The Yugoslav authorities have been notified of this proposed action.

V. Staff Appraisal

The program proposed by the Yugoslav authorities on the policies to be pursued during the third year of the stand-by arrangement approved in January 1981 is designed to speed the process of structural adjustment in the economy and, thereby, bring about a sustained improvement in the external position of Yugoslavia. It focuses heavily on the reduction of distortions, overt or implicit, both on the investment and the consumption side. The shift in policies will inevitably result in an initial increase in the inflation rate as higher interest rates, adjustments of administered prices, and a more active exchange rate policy sharply change relative prices. Accordingly, the staff believes restraint on the growth of nominal wages to be of vital importance and strongly endorses the view of the Yugoslav authorities that steps must be taken to improve the control of the growth of nominal personal incomes. Incomes policy, for several years, has been a central element of the Yugoslav economic program, but has repeatedly fallen far short of its objectives largely because the mechanism for implementation has been weak. The steps taken by the Yugoslav authorities to improve that mechanism are important, but still do not necessarily eliminate the central weaknesses. The staff has agreed with the Government that it will activate its legal powers in this area if the recorded outcome for the first quarter of 1983 exceeds the fourth quarter, 1982 level. The staff will closely monitor developments in personal incomes during the quarterly visits, with a view to making specific recommendations, and if necessary incorporating them in the mid-year review with the Fund.

The staff recommends that a waiver be granted for the breach of the domestic credit ceiling in December 1982 because the excess was small, 0.4 per cent, because of the manner in which it came about and the steps taken to rectify it. For 1983, monetary and fiscal policies have, in the staff view, been designed in a way to make a greater contribution than in the past to the stabilization program. Fiscal policy is expected to be very tight, with expenditures falling very significantly in real terms. In addition, if, the Government is unable to observe either the 13 per cent limit on the growth of the expenditures of public authorities or the 18 per cent limit on the growth of transfer payments during any consecutive three-month period in 1983, legislation will be sought to freeze revenues in excess of obligations commensurate with the relevent expenditure ceiling until at least 1985. The staff places particular emphasis on this commitment which is expressed in the second paragraph of section III of the supplement to the letter of intent. The placing of what essentially is the "inflation dividend" of the public sector into a blocked account at the National Bank of Yugoslavia could contribute much to the enforcement of the expenditure ceilings and, thereby, make incomes policy more effective. Furthermore, by withdrawing liquidity from the economy at large, the change would automatically tighten monetary and credit conditions.

In the areas of monetary and credit policies, the most important elements are the change to a considerably more active interest rate policy, the steps toward control of the expansion of inter-enterprise credit, and a very tight limit on the growth of net domestic assets. Although the gap between nominal and real rates of interest remains considerable, it is being narrowed significantly. In addition, some, albeit very slow progress is being made in raising nominal interest rates charged for priority credits. In the staff's opinion, it is most important that considerable further progress be made on the occasion of the mid-year review. At that time, it should also begin to be apparent whether the aim to reduce the outstanding amount of unsecured inter-enterprise credit substantially can reasonably be met. If chances appear to be low, the staff will be prepared to suggest measures that can help strengthen the enforcement mechanism. Both, the policies regarding the cost of credit and curtailing the extension of credit outside banking channels represent, in the staff's view, crucially important structural improvements in the Yugoslav financial system.

The staff also supports the determination of the Yugoslav Government to continue to meet external payment obligations in an orderly manner, and its view that the maintenance of such payments is crucial to secure the political and social support essential for the success of the economic stabilization policies that have been adopted, and that are indicated for 1984 and 1985 as well. To be able to meet these obligations in the medium term it is vital that Yugoslav producers be assured adequate incentives to produce goods that are competitive in foreign markets and that can compete with imported goods on the domestic market. The steps already taken to bring about a shift of resources to the tradable goods sector through exchange rate adjustments are useful as is the further strengthening foreseen on a monthly basis for the remainder of the stand-by period. The adjustment in real terms during the period as a whole is estimated to be approximately 24 percent. However, it must be recognized that the effects of these measures will not be fully felt in 1983 or even 1984.

The financing plan set out above and in Table 10 is expected to provide adequate support for the stabilization efforts in the near term. However, there is extremely little margin for error and the injection of net new funds is minimal even under reasonably favorable assumptions regarding the success of Yugoslav exporters of goods and services in taking advantage of increased export profitability in 1983. Conversely, so long as substantial and sustainable improvements can be made in the current account vis-à-vis the convertible currency area, there is a reasonable possibility that spontaneous capital inflows could resume to a greater extent than has been projected. It is also uncertain whether the official target of achieving a deficit in current account transactions in nonconvertible currencies will be reached. But even if Yugoslav exports for nonconvertible currencies could be reduced significantly, there would be great problems in redirecting such exports to the convertible currency because of quality and design difficulties. On the import side, difficulties may be experienced in securing additional oil and other required raw materials from CMEA suppliers, whereas importables currently in good supply could not be absorbed given the Yugoslav policy to reduce investment and upgrade the efficiency of those investments that are being put in place.

The staff hopes that the amended law on foreign exchange will be implemented in a manner that ensures the existence of adequate export incentives and a liberal trade and payments regime. With regard to exchange restrictions under Article VIII, the authorities continue to maintain the restriction on the availability of exchange for foreign travel arising from the limitation on the export of Yugoslav dinars. The staff recommends extension of approval of the travel restriction until February 28, 1984 or the next Article IV consultation, whichever is earlier. External payments arrears have arisen in 1983 and a waiver for the arrears is proposed under the stand-by arrangement. The authorities currently are in the process of determining the amount of existing arrears. The proposed waiver would enable Yugoslavia to make purchases in March and May. The authorities intend to eliminate the arrears by the time the August drawing can be made. The staff recommends that the existence of arrears be approved until August 14, 1983.

The staff is of the strong view that the analysis of developments in and the management of the Yugoslav economy would be much enhanced by the provision of better and more current economic statistics. The official undertaking to prepare balance of payments statistics for 1983 on the basis of current rather than statistical exchange rates, together with the understanding that the National Bank of Yugoslavia will provide the Fund with detailed information on external debt on a regular and timely basis, are important in this respect. There is also a need to improve the statistical base for analyzing and monitoring the financial behavior of the enterprise sector, especially in the area of trade credits.

The staff believes that, with a continuation and, if necessary, a strengthening of the policies outlined in the attached letter of intent and in the supplement to that letter, the balance of risk is positive. The program, while focused first on relieving the immediate liquidity pressures on the Yugoslav external position, is intended to foster the medium-term improvement essential for internal and external balance. For these reasons, the staff recommends Fund support. Accordingly, the following draft decisions are proposed for adoption by the Executive Board:

I. 1982 Article IV Consultation

1. The Fund takes this decision in relation to Yugoslavia's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1982 Article IV consultation with Yugoslavia conducted under Decision No. 5392-(77/63) adopted April 29, 1977 (Surveillance Over Exchange Rate Policies).

2. Yugoslavia continues to maintain the restriction on the availability of foreign exchange for travel as described in EBS/83/46 (2/24/83). In the circumstances of Yugoslavia, the Fund grants approval for the retention of this exchange restriction until the completion of the next Article IV consultation or February 28, 1984, whichever is earlier. The Fund notes the existence of external payments arrears and the intention of the authorities to eliminate them at an early date. In the circumstances, the Fund grants approval of maintenance of external payments arrears until August 14, 1983.

II. Stand-by Arrangement Review

1. The Government of Yugoslavia has consulted in accordance with paragraph 3(b) of the stand-by arrangement for Yugoslavia (EBS/81/5, Supplement 2 (2/2/81) in order to establish performance criteria subject to which purchases may be made by Yugoslavia during the third year of the stand-by arrangement.

2. The letter from the Governor of the National Bank of Yugoslavia and the Federal Secretary for Finance of Yugoslavia, dated December 30, 1982, and the Supplement to that letter dated February 18, 1983, setting forth the policies and measures which the authorities of Yugoslavia will pursue for the third year of the stand-by arrangement, shall be annexed to the stand-by arrangement for Yugoslavia, and the letter of January 15, 1981, annexed to the stand-by arrangement, as supplemented by the letter of January 25, 1982, shall be read as supplemented by the letter of December 30, 1982 and the Supplement dated February 18, 1983.

3. Yugoslavia will not make any purchase under the stand-by arrangement that would increase the Fund's holdings of its currency in the credit tranches to more than 25 per cent of quota or increase the Fund's holdings of its currency resulting from purchases of supplementary financing to more than 12.5 per cent of quota

a. during any period in which:

(i) the intention as regards the exchange rate expressed in the last sentence of paragraph 3 of the annexed letter and in section II of the supplement dated February 18, 1983, is not being carried out;

(ii) the intentions as regards interest rates expressed in paragraph 8, sentences 1 through 4, and paragraph 9, sentences 2 through 4, of the annexed letter have not been carried out; or

b. during any period in which:

(i) the data for the preceding period indicates that the limit on outstanding net domestic assets of the banking system described in sentence 4 of paragraph 6 of the annexed letter and as specified in the attached Memorandum of Understanding, Annex 2, as amended by section I of the supplement, has been exceeded; or

(ii) there has been an increase in credit by the National Bank of Yugoslavia to the budget of the Federation, as referred to in sentence 8 of paragraph 6 of the annexed letter; or

(iii) the limit on foreign debt mentioned in paragraph 10, sentences 5 through 7, of the annexed letter and described in the attached Memorandum of Understanding, Annex 4, is not being observed;

(iv) the intentions relating to public sector expenditures stated in sentences 3, 4, and 5 in the first paragraph of Section III of the Supplement are not being observed; or

c. After May 14, 1983, if the progress toward the provision of external bank financing for Yugoslavia, as regards amount and timing, is not sufficient; or

d. After August 14, 1983, if suitable performance criteria have not been established in consultation with the Fund as contemplated in paragraph 12 of the annexed letter or while such criteria, having been established, are not being observed.

4. Purchases under this stand-by arrangement shall not without the consent of the Fund, exceed the equivalent of SDR 1,283 million until May 15, 1983, the equivalent of SDR 1,433 million until August 15, 1983, and the equivalent of SDR 1,533 million until November 15, 1983.

5. The Fund waives the application of the performance criterion in the first subparagraph of paragraph 3 of Decision No. 7058-(82/23) (Review and Consultation under Stand-by Arrangment, adopted February 22, 1982) and waives until August 14, 1983 the application of the performance criterion in paragraph 3(c)(i) of the stand-by arrangement in EBS/81/5, Supplement 2, (February 2, 1981) in respect of the arrears existing during 1983.

6. In paragraph 1 of the stand-by arrangement for Yugoslavia (EBS/81/5, Sup. 2, 2/2/81), the phrase "For a period of three years from January 30, 1981" shall be replaced by "For the period from January 30, 1981 to December 31, 1983."

Fund Relations with Yugoslavia 1/

Membership:	Yugoslavia is an original member of the Fund. It continues to avail itself of the transitional arrangements under Article XIV.
Quota:	SDR 415.5 million.
Use of Fund credit:	Total outstanding purchases of SDR 1,590.3 million, including SDR 242.4 million under the compensatory financing facility, SDR 3.8 million under the oil facilities, SDR 415.5 under the credit tranche, and SDR 928.7 million under the supplementary financing facility.
Fund holdings of dinars:	SDR 2,002.5 million, or 482.0 per cent of quota; 199 per cent of quota, excluding holdings related to the compensatory financing facility, oil facilities, and the supplementary financing facility.
Current arrangement:	Stand-by program covering a period of three years from January 30, 1981 in the amount of SDR 1,662 million (400 per cent of quota), of which SDR 1,357.8 million is being provided under the supplementary financing facility. (SDR 1,108 million had been purchased by end-January 1983.)
SDR position:	Net cumulative allocations amount to SDR 155.2 million. Holdings amount to SDR 1.509 million.
Gold distribution:	Received 177,144 fine ounces of gold in the four phases. Received profits amounting to SDR 32.9 million in the three distributions; US$11.0 million has been transferred to the Trust Fund.
Last consultation:	The staff report for the 1981 Article IV consultation with Yugoslavia (SM/82/24, 2/2/82) was considered by the Executive Board at EBM/82/23/23 (2/22/82). The Executive Board's decision on the 1981 consultation with Yugoslavia (Decision No. 7057-(82/23), adopted June 6, 1980) was as follows: 1. The Fund takes this decision in concluding the 1981 Article XIV consultation with Yugoslavia in the light of the 1981 Article IV consultation with Yugoslavia conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance Over Exchange Rate Policies.

1/ Position as of January 31, 1983.

2. The Fund welcomes the relaxation as of January 1, 1982 of the restriction on the availability of foreign exchange for travel as described in EBS/82/20 (1/29/82), and, in the circumstances of Yugoslavia, the Fund grants approval for the retention of this exchange restriction until the conclusion of the next Article IV consultation with Yugoslavia.

Exchange rate system:

The currency of Yugoslavia is the Yugoslav dinar. The authorities do not maintain the exchange rate of the dinar within announced margins and, therefore, all transactions, with the exception of those effected under the procedures set forth for certain countries with which Yugoslavia has bilateral payments agreements, take place at a fluctuating exchange rate. However, the authorities intervene in the foreign exchange markets, when necessary, to ensure orderly conditions and to smooth out fluctuations in exchange rates. The buying and selling rates for the U.S. dollar in the foreign exchange market in Belgrade on January 31, 1983 were Din 67.6278 and Din 67.8310 per U.S. dollar, respectively. Rates are quoted for certain other currencies.

Table 1. Yugoslavia: Selected Economic and Financial Indicators. 1980-83

	Actual 1980	Program 1981	Actual 1981	Program 1982	Latest Estimates 1982	Plan 1983	Staff Forecast 1983
	(Annual per cent changes, unless otherwise specified)						
National incomes, prices, and cost:							
GSP at constant prices	2	2	1 1/2	2 1/2	1/2	1	-2 1/2
Final domestic demand	--	--	-4	-2	-4	-10	-4
GSP deflator	31	20	40	20	27	20	31
Retail prices 1/	39	20	39	15	31	20	30
Real wages in socialized sector							
External sector (with convertible currency area)							
Export volume	2 1/2	7	2	12	-2 1/2	20	8
Import volume	-14 1/2	-3	-5	1	-11	-10	-9
Terms of trade (deterioration -)	-1	-5	-5	--	2	--	--
Nominal effective change rate (depreciation -) 2/	-30	3/	-23	3/	-30	...	...
Real effective exchange rate (depreciation -) 2/	-10	3/	-2	3/	-15	...	-24
Federal government							
Total revenue	17	50	51	24	20	24	24
Total expenditure	33	28	29	21	17	25	25
Money and credit							
Domestic bank credit 1/ 4/	28	22	23	16 1/2	17	11 3/4	11 3/4
Central bank credit to Central Government 1/	10	5	4	--	-0.5	--	--
Money (M1) 1/	23	22	27	17	26 1/2	12	12
Velocity (GSP relative to M1)	6	--	11	2	6	4	14 1/2
Interest rate (annual rate, one year savings deposit)	9	...	9	5/	6/	18 7/	18 7/
	(In per cent of GSP)						
Public sector expenditure	39	37	35	35	35	33	34
Federal government expenditure	8	9	7	7	7	7	7
Federal government deficit	1.3	-0.1	0.1	-0.1	-0.1	--	--
Gross fixed investment	34	32	31	28	29	23	28
Money (M1); end of period	30	30	26	26	26	24	24
Current account balance	-4	-2 1/2	-1 1/2	-1	-2 1/2	2 1/2	-1
External convertible currency debt; end of period	23	...	25	...	26	...	...
	(Other ratios and data)						
External debt service ratio on convertible currencies (in per cent of exports of goods and non-factor services)	16	19	25	23	24	27	34
Interest payments in convertible currencies (in per cent of exports of goods and non-factor services)	5	7	14	12	14	12	13
Gross official reserves (weeks of total merchandise imports)	5	6	6	5	3	4	5
Overall balance of payments with convertible currency area (in millions of U.S. dollars)	-172	-350	-435	-592	-1,575	-171	207

Sources: Yugoslav authorities; and staff estimates.

1/ Twelve-monthly change to end of period.
2/ End of year over end of preceding year; Yugoslav payments-weighted currency basket.
3/ The nominal exchange rate was to be adjusted in line with the differential between the change in Yugoslav prices and costs relative to those in trading partner countries.
4/ Stand-by definition; for 1983 refers to net domestic assets of the banking system.
5/ The interest rate on bank deposits of households of one year's maturity was increased to 11 per cent in March 1982. Interest rates were to be reviewed against the background of price developments and prospects in mid-1982.
6/ The interest rate on one-year saving deposits was increased further to 13 per cent on October 1, 1982.
7/ The interest rate on one-year deposits of households were raised to 18 per cent in February but are to be reviewed against the background of price developments and prospects in mid-1983.

Yugoslavia: Review Under Stand-By Arrangement

1. Attached hereto are a letter of the Federal Secretary of Finance and the Governor of the National Bank of Yugoslavia, dated December 30, and a supplementary letter dated February 18, 1983 in accordance with paragraph 3(b) of the Stand-By Arrangement (EBS/81/5, 1/15/81) and paragraph 28 of the letter of the Federal Secretary for Finance and the Governor of the National Bank of Yugoslavia, dated January 15, 1981, setting forth

(a) the objectives and policies that the Yugoslav authorities intend to pursue for the remainder of the stand-by period; and

(b) the understanding of Yugoslavia and the Fund regarding reviews that will be made of progress in realizing the objectives of the program.

2. To support these objectives and policies, the International Monetary Fund will make available SDR 554 million that may be purchased during the year as follows: up to SDR 175 million until May 15, 1983; up to SDR 325 million until August 15, 1983; and up to SDR 425 million until November 15, 1983 subject to the conditions noted below.

3. The letter from the Governor of the National Bank of Yugoslavia and the Federal Secretary for Finance of Yugoslavia, dated December 30, 1982, and the Supplement to that letter dated February 18, 1983, shall be annexed to the stand-by arrangement for Yugoslavia, and the letter of January 15, 1981, annexed to the stand-by arrangement, as supplemented by the letter of January 25, 1982, shall be read as supplemented by the letter of December 30, 1982 and the Supplement dated February 18, 1983.

4. Yugoslavia will not make any purchase under the stand-by arrangement

a. during any period in which:

(i) the intention as regards the exchange rate expressed in the last sentence of paragraph 3 of the annexed letter and described in Annex I of the Memorandum of Understanding, attached to that letter, as amended by Section II of the Supplement dated February 18, 1983, is not being carried out;

(ii) the intentions as regards interest rates expressed in paragraph 8, sentences 1 through 4, and paragraph 9, sentences 2 through 4, of the annexed letter have not been carried out; or

b. during any period in which:

(i) the data for the preceding period indicates that the limit on outstanding net domestic assets of the banking system described in sentence 4 of paragraph 6 of the annexed letter and as specified in the attached Memorandum of Understanding, Annex 2, as amended by Section I of the Supplement, has been exceeded; or

(ii) there has been an increase in credit by the National Bank of Yugoslavia to the budget of the Federation, as referred to in sentence 8 of paragraph 6 of the annexed letter; or

(iii) the limit on foreign debt mentioned in paragraph 10, sentences 5 through 7, of the annexed letter and described in the attached Memorandum of Understanding, Annex 4, is not being observed;

(iv) the intentions relating to public sector expenditures stated in sentences 3, 4, and 5 in the first paragraph of Section III of the Supplement are not being observed; or

c. After August 14, 1983, if suitable performance criteria have not been established in consultation with the Fund as contemplated in paragraph 12 of the annexed letter or while such criteria, having been established, are not being observed.

December 30, 1982

Dear Mr. de Larosière:

As stated in our letter of January 15, 1981, we are writing to you to describe the policies and measures to be adopted during the third year of the stand-by arrangement for Yugoslavia approved by the Fund on January 30, 1981.

Policies in 1981 were designed to restore internal and external balance to the Yugoslav economy, and our economic program for 1982 was intended to build on the progress achieved in 1981. In the event, however, personal incomes and enterprise incomes rose considerably faster than anticipated during the first half of the year and, inevitably, part of the progress that had been made in reducing the rate of inflation was reversed. The combination of more buoyant domestic demand than expected and a worsening world economic climate resulted in a disappointing export performance. By mid-year, the Federal Executive Council (the Government) faced the need to strengthen its stabilization program.

Accordingly, the Yugoslav Government took additional measures to contain both domestic demand and inflationary pressures and to increase exports so as to permit the rise in imports necessary to allow production to grow once more. These measures included restraint on personal incomes so as to keep their growth in line with that of net incomes of enterprises and this policy was reinforced by arrangements to roll back any excess payments; severe restrictions on the extension of credit for investment purposes; a significant rise in the level of interest rates and a 20 per cent devaluation of the dinar. In addition, public sector expenditures are being held to their original estimates, despite a higher than expected rate of inflation, and several measures were taken to improve the invisibles account of the current account of the balance of payments.

Partly as a result of these measures, final domestic demand in real terms will fall by 3 3/4 per cent in 1982, substantially more than foreseen in the 1982 Plan Resolution. Personal incomes are expected to fall by 2 1/2 per cent in real terms and the inflation rate, though still too high, has begun to moderate. The current account position has improved significantly in 1982, as the deficit vis-à-vis the convertible currency area narrowed from $1.8 billion in 1981 to less than $1 billion in 1982. The extent of the improvement is, however, inadequate. Exports increased considerably less than expected, in part because of the worsening international demand situation and the associated rise in protectionism. At the same time, service receipts fell and debt servicing payments rose rapidly. The main element in the improved current account situation was a fall in imports so large that it has already begun to impede output.

The Plan Resolution for 1983 gives the highest priority to improving the external liquidity position of Yugoslavia so as to ensure that the Government can meet its international financial obligations. In order to meet these obligations and to rebuild the presently inadequate level of reserves, it has been decided that in 1983 the achievement of a substantial surplus on the current account with the convertible currency area is essential. This objective is ambitious--it implies an improvement in the current account position of at least 4-5 per cent of GSP over the period of the stand-by arrangement. To achieve such a result, it will be necessary to ensure a decline of domestic demand even larger than the declines of the preceding two years. Nominal personal incomes growth will be restrained severely and real personal income per worker is to fall by 7 per cent. No new investment will be authorized except in priority sectors such as exports and energy. Public sector consumption will continue to be restrained as well. The fall in domestic demand is expected to ease price pressures, but to ensure a further decline in the rate of inflation, the measures limiting price increases will be continued into 1983. The policy program is designed to obtain the necessary improvement in the external financial situation in both 1983 and over the medium term. To these ends policies that should show quick results will need to be bolstered by policies that lead to a shift of resources into the export sector, that increase productivity, enhance savings and ensure an efficient allocation of capital resources.

1. For the purpose of supporting its major objectives of increase in exports and production in 1983, the Government considers its policy of restraining incomes as one of the central elements of its medium-term stabilization policy. It is therefore determined to ensure that the experience of the past, when the effectiveness of such policies was eroded over relatively short periods of time, is not repeated. This policy will again be rigorously enforced as regards the personal incomes of those who work for the Federal Government. If the social consensus now achieved regarding restraint on the growth of nominal personal incomes proves less successful than intended, then by midyear the Government will activate the Federation's legal powers to enforce an adequate penalty mechanism.

2. The Government is determined to reduce existing distortions in relative prices, not to allow new ones to arise and to adjust domestic prices in line with world prices. These changes will be made in 1983 and 1984. As the first major step in January 1983, the price of electricity will rise by about 25 per cent; the price of coal by about 25 per cent; prices of live animals and meat by about 29 per cent and railway fares by about 35 per cent (taking into account the increase for this type of transport made in the second half of December 1982). It is expected that retail prices of oil derivatives will increase by about 25 per cent during the first half of 1983. In addition the Government will recommend to the competent regional authorities that they ensure that rents will rise by about 30 per cent during the first half of 1983.

3. To secure a fundamental improvement in the current account, the dinar was devalued by 17 per cent from the end of 1981 to October 21, 1982, by 20 per cent on October 21, 1982, and by a further 8.1 per cent between October 21, 1982 and January 31, 1983. Subsequent to January 31, 1983, the exchange rate will be adjusted steadily to promote a continuing incentive for enterprises to export.

4. Fiscal policy in 1983 will continue to be restrictive and the share of public sector expenditure in GSP will decline further. The joint budgets of the Federation and the other parts of the public sector are

projected to be in balance. Public sector expenditures will be held to a rise of 13 per cent; in the budget plan revenues are estimated to rise by the same amount. If for any reason revenues are higher than foreseen, the surpluses will be placed in blocked accounts at the National Bank of Yugoslavia until at least 1985, in accordance with the aims of the medium-term stabilization plan.

5. Credit policy in 1983 will continue to be restrictive, with the net domestic assets of the banking system being allowed to grow by an amount considerably less than that of the expected rise of nominal GSP. We are determined to ensure that monetary policy fully supports our intention of securing a further reduction in domestic demand and we expect that it also will help control the rise in inflation that will be fueled by the depreciation of the dinar and the rise in prices of specific commodities referred to under paragraph 2.

6. During the last two years we set our monetary targets in the form of limits on the outstanding domestic credit of the commercial banks. However, in order to introduce greater flexibility into this system of control and to reduce some of the uncertainties inherent in it, we have decided to express our monetary targets for 1983 in terms of the growth of the net domestic assets of the banking system, and to base these targets on the average of the figures for three successive end-of-month periods. For the twelve months ending 31st December 1983 we intend to limit the increase in the stock of net domestic assets to 11.7 per cent. In accordance with this intention and on the assumption that the outstanding stock of net domestic assets on December 31, 1982 was Din 2,708.7 billion, we shall ensure that the average stock of net domestic assets for 31st January, 28th February, and 31st March, will not exceed Din 2,755.7 billion and that for 30th April, 31st May, and 30th June 1983, will not exceed Din 2,826.1 billion. The increase in the stock of domestic assets of 5.2 per cent between December 31st, 1982, and June 30th, 1983, is commensurate with a growth in the money supply (narrow definition) of 18.2 per cent (at an annual rate) between these two dates. The Government, however, will seek within the framework of the projected economic developments to remain below the established ceiling for net domestic assets. Dinar counterpart deposits of the Government at the National Bank of Yugoslavia originating from external financial credits will be sterilized. *Finally, in 1983, as in 1982, we intend to ensure that no increase in* credit will be granted by the National Bank of Yugoslavia to the Federal Government.

7. At the time of the midyear review with the Fund, the appropriateness of the credit ceilings will be reviewed in the light of the developments in the economy, paying particular attention to the external position and the situation in the productive sector. In addition, if at the time of the quarterly review in the spring with the staff of the Fund the position is exessively tight, then we shall reserve our right to request formally an earlier revision of the ceilings.

8. The Yugoslav Government will ensure that the costs of funds to the banking system will be increased by about Din 53 billion in 1983. This increase will be achieved through the rises in interest rates listed in

the attached schedule. The rates of interest directly subject to the control of the National Bank of Yugoslavia (as specified in the attached schedule) will be raised as shown in that schedule during the course of January 1983. The other rates of interest specified in the attached schedule will be raised as shown in that schedule by the 28th of February 1983. As a result of these actions the banks will be forced to raise their lending rates sharply. We estimate that the cost of new credits for nonpriority lending in 1983 will rise to over 30 per cent from a present rate of around 21 per cent. For some banks this rise will be larger.

9. The Yugoslav Government believes that this sharp and unprecedented rise in interest rates, coming on top of significant increases in October 1982, represents the extreme of what can be borne by the economy. However, if by the time of the midyear review with the Fund, the data available show that during 1983 prices have been rising at an annual rate in excess of 20 per cent, which is the Government's target rate, then the Yugoslav authorities will review with the Fund their medium-term objective of moving toward a real rate of interest, with a view to implementing a change in nominal interest rates adequate to ensure that real interest rates develop according to the medium-term policy intentions. The change in interest rates would relate to the schedule of rates and the associated weights used in this letter of intent and attached hereto. It is understood that the Government will in no way change its present price policy as described in the Plan Resolution for 1983. In addition, we shall continue our efforts to promote a more efficient functioning of the Yugoslav financial market and to enhance the role of interest rates in that respect.

10. Because of the deterioration of the maturity profile of our outstanding external debt and continued high interest rates in international markets, which directly affect over one half of our external debt outstanding, debt service has absorbed an increasing share of our convertible foreign exchange earnings in recent years. Debt service payments will amount to about $5 billion in 1983. It is, therefore, the firm intention of the Government to exercise strict control over foreign borrowing by Yugoslav banks. The National Bank of Yugoslavia will provide to the Fund detailed information on the foreign activities of the banks on a regular and timely basis. Moreover, in 1983 the contracting of new loans with maturities between one and up to ten years will be limited to a maximum of $1.5 billion, of which no more than $500 million will be loans with maturities of between one year and up to three years. The limits exclude borrowing by the National Bank of Yugoslavia. Outstanding external debt that falls due during 1983 and that is rolled over will also be excluded from this requirement.

11. Due to the difficult foreign exchange situation in 1982, it was not possible to continue our stated policy of liberalizing the foreign exchange system and of relaxing restrictions on imports. On the contrary, we were forced to take a number of measures to discourage foreign travel and to limit imports by private individuals. It is our intention to resume our policy of import and exchange liberalization as soon as the balance of payments situation permits. In particular, we plan to enhance

the efficiency with which the foreign exchange holdings of the commercial banks are utilized by reducing the present segmentation of the foreign exchange market. In this respect, the exchange rate and interest rate measures described above should prove helpful.

12. We intend to review economic developments in 1983 with the staff of the Fund on a quarterly basis, giving particular attention to developments in the balance of payments, prices and incomes, and taking into account projected developments. The effectiveness of the policies being implemented will be reviewed on these occasions with a view to ascertaining whether changes are called for. In addition, we shall review the developments of the first half of 1983 with the Fund as soon as is practicable after the middle of the year and in any case not later than September 15, 1983. At that time, we shall agree with the Fund performance criteria that are to be established for the second half of 1983.

13. We fully realize that the targets we have are very ambitious, both on the domestic and on the external side. The standard of living will again decline significantly in 1983 and we are looking for a very high level of performance from the export sector. Nonetheless, there is widespread and very strong support throughout our country for our efforts to strengthen the external account, to avoid any disruption in debt servicing, and to reduce external indebtedness, so that the restrictive policies we have adopted will be fully effective. We hope that our efforts will invoke the support of the international community.

Radovan Makič	Joze Florjancic
Governor, National Bank of Yugoslavia	Federal Secretary for Finance

December 30, 1982

AGREED MEMORANDUM OF UNDERSTANDING

Subject: Technical Note on the Calculation of the Index of the Real Exchange Rate

For the purpose of adjusting the real exchange rate, it is understood that, consistent with the National Bank of Yugoslavia's methodology for calculating the real exchange rate:

(i) The real exchange rate index of the dinar is expressed as 0.48 (U.S. dollars per dinar) plus 0.303 (deutsche mark per dinar) plus 0.047 (Swiss francs per dinar) plus 0.045 (Italian lire per dinar) plus 0.043 (Austrian schillings per dinar), plus 0.027 (French francs per dinar) plus 0.021 (pounds sterling per dinar) plus 0.012 (Swedish kronor per dinar) plus 0.012 (Dutch guilders per dinar), plus 0.007 (Belgian francs per dinar) plus 0.003 (Japanese yen per dinar), with a base of January 31, 1983 equal to 100 for each bilateral exchange rate of the dinar, multiplied by the ratio of an index of the movement in Yugoslavia's industrial producer prices to a weighted index of the movements in industrial prices in the foregoing 11 countries as specified in section (iii) below.

(ii) The index of Yugoslavia's industrial producer prices is the ratio of the price index for the most recent month that is available as of the 15th of each month to the index in the base period which is chosen so as to make the price change cover the same number of months as will have elapsed since January 31, 1983.

(iii) The weighted index of industrial prices in the foregoing 11 countries is defined as 0.48 (index of U.S. wholesale prices for industrial goods) plus 0.303 (index of German prices for industrial products) plus 0.047 (index of Swiss prices for home goods) plus 0.045 (index of Italian wholesale prices) plus 0.043 (index of Austrian wholesale prices) plus 0.027 (index of French prices of industrial goods) plus 0.021 (index of U.K. prices of industrial output) plus 0.012 (index of Swedish prices for domestic supply) plus 0.012 (index of Dutch prices of final products) plus 0.007 (index of Belgian wholesale prices for home goods) plus 0.003 (index of Japanese wholesale prices) with the index for each country expressed as the ratio of the price index for the most recent month that is available as of the 15th of each month to the price index in the base period which is chosen so as to make the price change cover the same number of months as will have elapsed since January 31, 1983.

(iv) Exchange rate and price data used in the calculation of the index of the real exchange rate will be consistent with those published in IMF, International Financial Statistics.

December 30, 1982

AGREED MEMORANDUM OF UNDERSTANDING

Subject: Technical Note on Net Domestic Assets Ceiling of the Yugoslav Banking System

The banking system for purposes of this ceiling is defined as the consolidated accounts of the national banks and the basic and associated banks. The net domestic assets (NDA) of the above-mentioned banks are calculated to equal the sum of the following items in the monetary survey:

	End-December 1981 (In billions of dinar)
Net foreign liabilities	375.1
Money	584.3
Quasi-money	1,030.0
	1,989.4

In setting the ceiling for NDA the effects of changes in the exchange rate on net foreign liabilities of the banking system and on foreign currency liabilities to residents (the latter are included in quasi-money) are eliminated by applying valuation adjustments to the relevant data.

It is understood that the foreign exchange proceeds of any special financial assistance will be shown both as an asset and a foreign exchange liability on the balance sheet of the National Bank of Yugoslavia.

The NDA level for December 1982 has been estimated to be Din 2,708.7 billion. To the extent that the actual level deviates from that estimated, the NDA ceilings for March 31, 1983 and June 30, 1983 will be adjusted accordingly.

December 30, 1982

Yugoslavia: Interest Rate Schedule

(Per cent per annum)

	Weights 1/	Interest rates as of End-Dec. 1982	Interest rates as of End-Feb. 1983	Effects
Deposit money				
OALS 2/	0.22	1	3	5.6
National Bank credits 3/				
Discounts and credits for liquidity	0.03	14	22	3.0
Selective credits	0.20	4-9	8-12 4/	10.4
Household deposits with maturities of less than one year				
Sight	0.15	7.5	7.5	--
3 months	0.01	--	12	1.4
6 months	0.01	--	15	2.3
Restricted deposits of OALs	0.06	1	4	2.2
Short-term deposits of OALs	0.02	3	7	1.2
Long-term deposits				
Households				
Time	0.06	13-20	18-28 5/	5.0
Housing	0.06	9	13	2.9
OALs and other	0.18	9	17	19.0
Total	1.00			53.0

1/ Based on average amounts outstanding for 1983 as estimated by the National Bank of Yugoslavia.

2/ Organizations of Associated Labor.

3/ Effective end-January, 1983.

4/ Rates on: credits for exports 8 per cent, agriculture 10 per cent, imports 12 per cent, other 12 per cent.

5/ Rates on deposits for 1 year 18 per cent, 2 years 23 per cent, 3 years 28 per cent.

December 30, 1982

AGREED MEMORANDUM OF UNDERSTANDING

Subject: Technical Note on External Borrowing by the Banking System

It is understood that for purposes of this arrangement the exclusion of borrowing by the National Bank from the agreed limits also includes borrowing by other entities under the guarantee of the National Bank. In addition, the exclusion of debt rolled over also would include debt newly contracted in order to provide resources to cover the repayment of maturing principal.

Supplement to Letter of Intent dated December 30, 1982

The understandings in this supplement, to the extent that they differ with the detail in the Letter of Intent supersede that detail.

I. Technical amendment to page 4, paragraph 6

Because domestic credit at the end of December 1982 had exceeded the credit ceiling by Din 9.2 billion and because monetary expansion generally appears greater than expected, the ceilings for the stock of net domestic assets for the subsequent six month period are adjusted downward by Din 9.2 billion. Accordingly, the limit for June 30 is Din 2,845.7 billion. The outstanding stock of net domestic assets on December 31, 1982 was Din 2,714.4 billion and the average stock of net domestic assets for January 31st, February 28th, and March 31st, 1983 will not exceed Din 2,758.2 billion and that for April 30th, May 31st, and June 30th, 1983 will not exceed Din 2,823.8 billion.

II. Technical amendment to page 4, paragraph 3

Because the expected improvement in the international trading environment is lagging, because the current account deficit vis-a-vis the convertible currency area has turned out to be greater by US$0.5 billion than expected and, in particular, because export performance in recent months has been below expectation, the pace of adjustment as foreseen in December 1982 needs to be speeded up. This also is in line with the moves to rationalize the use of foreign exchange and to expand the foreign exchange market as foreseen in the Decision on the Common Foreign Exchange Policy in Yugoslavia for 1983. Therefore, the dinar was devalued by a further 6.3 per cent between February 15 and March 11, 1983.

III. Technical amendment to page 4, pararaph 4

In order to ensure achievement of the restrictive fiscal policy set out in the Plan Resolution for 1983, we will monitor the 12 monthly ceiling rate of growth of 13 per cent for public sector expenditures and of 18 per cent for collective consumption expenditures. The monitoring will be based on the revenue data that is available monthly. If revenue collections for the public sector on the basis of these data exceed the year-on-year growth of 18 per cent, they are to be adjusted downward through rate cuts in the subsequent months. Therefore, any trend increase in public sector revenues or in revenues for collective consumption for any period of three successive months will be taken as not commensurate with the program agreed in the Letter of Intent. A deviation of 2 percentage points will be acceptable.

If developments in final domestic demand at the time of the review with the Fund have not been in line with the Government's goal set out on page 2 of the Letter of Intent, the Government will seek ways and means not to return revenue surpluses accruing to the individual public sector entities to the economic sector and the population, but to agree that such surpluses will be placed monthly in a blocked account at the National Bank of Yugoslavia until at least 1985. In any event, any surpluses that materialize by the end of the year despite the current monthly measures to redistribute them, will be placed in such a blocked account until at least 1985.

IV. Technical amendment to page 3, paragraph 1

In order to ensure that the overall objective laid down in the Plan Resolution for 1983 is met, it is crucial that the restraints on domestic demand incorporated in the Resolution be realized. Therefore, the Government, on the basis of the data on nominal personal incomes for the first quarter of 1983, which will become available by the end of April 1983, *will determine whether the Federation's legal powers to enforce an adequate* intervention mechanism should be activated as soon as possible. Such a basis will be deemed to exist if personal nominal incomes per worker in the first quarter of 1983 exceed their level of the fourth quarter of 1982.

The control of domestic credit and of interprise incomes depends crucially on the disciplined behaviour of the enterprise sector. The stock of outstanding credit that has accumulated outside the banking system has reached very high levels. To correct this situation, the Government has already started the procedure to pass amendments to the Law on the Public Auditing Service. The Government will do everything in its power to speed up this procedure with a view to passing the Law before the end of May 1983. The implementation of this Law will ensure that the amount of uncollected bills outstanding, not covered by instruments of payment, will decrease by a minimum of Din 50 billion in 1983.

The Government will include new mechanisms in this Law in order to strengthen the penalty mechanism so as to ensure effective implementation of the provisions of this Law. If by September 1983, it appears that the goal of reducing the outstanding stock of uncollected bills by Din 50 billion will not be achieved, the Government will consult with the Fund on the efficacy of the sanction mechanism with a view to strengthening it as needed.

Radovan Makic Governor, National Bank of Yugoslavia	Joze Florjancic Federal Secretary for Finance