FOR AGENDA

SM/86/176
Correction 1

CONTAINS CONFIDENTIAL INFORMATION

August 5, 1986

To: Members of the Executive Board

From: The Secretary

Subject: Yugoslavia - Staff Report for the 1986 Midyear Consultation Under Enhanced Surveillance

The following correction has been made in SM/86/176 (7/17/86):

Page 16, footnote 1: for "US$1.8 billion"
read "US$3.8 billion"

A corrected page is attached.

Att: (1)

Other Distribution:
Department Heads

A policy change which also had an effect analogous to an appreciation of the exchange rate was the introduction on January 1, 1986, of a new exchange and trade system. 1/ The new system provides that all foreign exchange be surrendered to the banking system at the official exchange rate. Access to foreign exchange for the payment of foreign debt obligations is not subject to any restrictions, while access to foreign exchange to pay for imports is restricted according to various categories. Exporters continue to benefit from preferential treatment over other enterprises in the determination of import rights, but net exporters no longer enjoy the foreign exchange premia from the sale to other enterprises of foreign exchange not used for their own account, as was possible under the previous system. The new system also adversely affects net importing enterprises that previously could buy foreign exchange from other enterprises. To alleviate this latter difficulty, the authorities plan to allocate foreign exchange made available through official foreign borrowing (e.g., from multilateral development institutions) to enterprises that would not otherwise qualify for import rights under the new system.

Owing to a shortage of foreign exchange, the authorities had to invoke Article 110 of the new foreign exchange law as of January 1, 1986. This Article, which had been intended as a transitory emergency measure, has remained in effect since that time; consequently, authorized banks have been required to submit daily to the NBY their intended payments in foreign exchange according to eight categories of priority, e.g., external debt service, imports of inputs by net exporters, priority federal needs, energy imports, etc. Based on information on the total availability of foreign reserves, the Federal Executive Council then decides on the categories of payments that can be made on a country-wide basis. One of the main objectives of the new foreign exchange allocation system is to ensure a more efficient transfer of reserves from surplus to deficit banks and regions. So far, interbank foreign exchange transactions have been quite limited, implying a failure of the system to generate an adequate transfer of reserves.

The continuous resort to Article 110 was attributed by the authorities to the strong import demand and three exceptional factors. First, because of seasonal factors, foreign exchange receipts were significantly lower than payments in the early part of the year. Second, commercial banks have been reluctant to utilize short-term foreign credits because in accordance with new regulations, they cannot pass on to borrowing enterprises the costs resulting from exchange and interest rate changes. A change in the relevant by-laws is being considered to deal with this latter difficulty. Third, there has been low utilization of available medium- and long-term foreign credits by

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1/ For a detailed description of the new exchange and trade system, see Appendix II of SM/86/39 (2/27/86).

enterprises because of new strict conditions applying to such borrowing. A rationalization of borrowing regulations is planned to alleviate this problem.

7. External debt management

Yugoslavia recently concluded debt refinancing arrangements with commercial and official creditors. On December 18, 1985 an agreement was signed with Yugoslavia's major commercial bank creditors on the refinancing of 100 percent of the principal falling due during 1985-88 1/ in respect of medium- and long-term debt contracted before January 17, 1983. The agreement went into effect on March 25, 1986. On April 17, 1986 an agreement was reached with official creditors within the framework of the Paris Club concerning medium- and long-term debt contracted before December 2, 1982 and falling due during May 16, 1986-December 31, 1988. 2/ In particular, it was agreed (i) to refinance 85 percent of the principal falling due between May 16, 1986 and May 15, 1987 with a grace period of four years and a maturity period of eight and one-half years; (ii) to refinance with similar repayment terms a smaller percentage of principal falling due between May 16, 1987 and March 31, 1988, the precise percentage to be decided at a subsequent meeting; and (iii) concerning amounts falling due in the last three quarters of 1988, participating official creditors expressed their willingness to remain involved in the process of medium-term adjustment provided that various conditions are met, including continuation of an appropriate relationship of Yugoslavia with the Fund (EBS/86/96, 4/25/86). The bilateral agreements for the first stage are to be concluded by end-February 1987.

IV. Stance of Policies and the 1986 Quantified Economic Program

The main objectives of the Government which took office in mid-May 1986 are to revive economic growth, to bring inflation under control, and to continue the process of external adjustment in order to reduce the external debt service burden. The Government recently announced a series of measures and other measures are still under preparation and will be announced later. The main macroeconomic targets of the authorities for 1986 are to increase the rate of economic growth to 3 percent, to reduce the rate of inflation to 65 percent by the end of the year, and to realize a current account surplus in convertible currencies of about US$900 million. The staff supports these objectives but its view is that while some of the measures announced go in the right direction, others are likely to exacerbate the country's economic difficulties, casting most serious doubts on the achievability of the authorities' targets.

1/ Estimated at US$3.8 billion.

2/ Principal falling due during this period is estimated at US$1.1 billion.