EBS/88/89
Correction 2

CONFIDENTIAL

May 31, 1988

To: Members of the Executive Board

From: The Secretary

Subject: Yugoslavia - Letter of Intent

The following correction has been made in EBS/88/89 (4/29/88):

Page 23, para. 1, line 6: for "five working days"
read "two working days"

A corrected page is attached.

Att: (1)

Subject: Technical Annex on the Understandings that have been Reached on the Liberalization and the Functioning of the Exchange and Trade Systems

1. The understandings reached with the Fund regarding the adoption of a flexible exchange rate policy before Executive Board discussion of the requested stand-by arrangement for Yugoslavia will require the revocation of both the emergency provisions of Article 110 of the Foreign Exchange Law and of the Bank Certificate Requirement at least two working days before that date; and that the revoked provisions will be replaced immediately by an arrangement whereby supply and demand for foreign exchange will have to be balanced without any other forms of administrative interference, relying only on frequent adjustment of the exchange rate supported by appropriately tight financial policies. This includes an intention not to intensify import restrictions for balance of payments purposes.

2. It is understood that the existing interbank market for foreign exchange can provide an appropriate setting for implementation of the flexible exchange rate policy, providing that the following agreed procedures are adhered to. Each enterprise presents its request for foreign exchange to its commercial bank which determines if the demand is bona fide as defined by the exchange and trade regulations. Apart from this controlling function, the bank will act as an intermediary only and is not empowered to refuse a bona fide request for foreign exchange. The banks transmit the demand for foreign exchange to the interbank market through the banks authorized to participate in this market. Aggregate demand in the interbank market on any given day must be fully satisfied, either through the foreign exchange available from banks that are net suppliers to the market on that day, or through drawing on the foreign exchange reserves of the NBY. The NBY can also acquire foreign exchange from the market to build up its reserve position. For the purpose of monitoring the operation of the interbank market for foreign exchange, the Fund will be provided with monthly information on the value of purchases and sales of foreign exchange between participants in the market. During the period of the stand-by arrangement, no major changes to the foreign exchange system will be implemented without prior consultation with Fund management.

3. The NBY will decide on the exchange rate each morning after the interbank meeting has taken place, taking into account prospective supply and demand as well as the binding requirement to meet the NFA target under the program. The new exchange rate is announced the same morning, and this is the rate at which banks must purchase foreign exchange from exporters during the day and the rate at which they accept to acquire foreign exchange from the interbank market meeting the

following morning. The commercial banks are allowed to hold prescribed working balances of foreign exchange, which can be used to satisfy bona fide demand for foreign exchange during the day and which can be replenished at the interbank session the next day.

4. The body competent for the exchange rate policy in Yugoslavia is the Federal Executive Council (FEC) and the responsibility for determination of the real effective exchange rate will remain with the FEC. To safeguard this competency but at the same time to enable the NBY to implement a flexible exchange rate policy on a day-to-day basis, the FEC will authorize the NBY to change the nominal exchange rate of the dinar in such a manner as to entail a significant real margin from the level established by the FEC. Before this margin is exhausted, however, the FEC will reestablish it so as to allow the continued implementation of a flexible exchange rate policy.

5. In order to prevent speculative pressures on the exchange rate from building up following the revocation of the emergency provision of Article 110 of Foreign Exchange Law and of the bank certificate requirement and following the liberalization of the import system, it has been decided to implement before the Board's discussion of the proposed SBA a flexible exchange rate policy, but it is also understood that the real effective exchange rate (on the basis of the retail price index and similarly on CPI indexes for partner countries) will not be allowed to appreciate from the level that will be reached at the start of the program. This policy is entirely consistent with the commitment to a flexible exchange rate policy, and it reflects the understanding that, given the low level of liquid reserves, unexpected favorable balance of payments developments should lead to an acceleration of the accumulation of external reserves rather than to pressures to appreciate on the real effective exchange rate.

6. As far as the liberalization of the import regime is concerned, the number of items that can be freely imported under the LB regime will be increased. Using 1987 import weights, the list of goods eligible for import under the LB regime will be expanded to the equivalent of 40 percent of total import and to 35 percent of convertible imports. This change will have been implemented before the above Board Meeting.

7. Understandings on a timetable for the completion of the liberalization process will have to be reached at the time of the midterm review, and will entail increasing the share of LB imports in total imports as defined above to at least 50 percent by January 1, 1989. The liberalization process will be completed in 1990. The final stages of the liberalization program will be built on production weights as well as import weights, and the authorities will make the necessary preparations in this regard.