FOR AGENDA

EBS/71/196

CONFIDENTIAL

July 16, 1971

To: Members of the Executive Board

From: The Secretary

Subject: Yugoslavia - Request for Stand-By Arrangement

Attached for consideration by the Executive Directors is a request by Yugoslavia for a stand-by arrangement, together with the staff's analysis and recommendation.

This subject is tentatively scheduled for discussion at a Board Meeting to be held on Friday, July 30, 1971.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

Yugoslavia--Request for Stand-By Arrangement[1/]

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

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

Approved by L.A. Whittome and Ernest Sturc

July 15, 1971

I. Introduction

In an attached letter dated June 24, 1971, Mr. Toma Granfil, member of the Executive Council, requests the cancellation of the stand-by arrangement in an amount equivalent to US$51.75 million which was approved by the Fund on February 19, 1971 and requests a new stand-by arrangement for one year under which, after making full use of any gold tranche position it may have, Yugoslavia will have the right to purchase from the Fund, currencies equivalent to US$83.50 million, equivalent to 40 per cent of Yugoslavia's quota. This total would be augmented by amounts equivalent to repurchases in respect of purchases under the stand-by arrangement unless, when any such repurchase is made, Yugoslavia informs the Fund that it does not wish the stand-by arrangement to be augmented by the amount of the repurchase. Purchases under the stand-by arrangement will not, without the consent of the Fund, exceed the equivalent of US$41.75 million prior to November 15, 1971, US$51.75 million prior to February 15, 1972, and US$68.50 million prior to April 15, 1972. Yugoslavia will consult with the Managing Director regarding the currencies to be purchased under the proposed stand-by arrangement prior to any request for a purchase. A waiver under Article V, Section 4 of the Articles of Agreement is required.

Yugoslavia is an original member of the Fund. Under the resolution of the Board of Governors on Increases in Quotas--Fifth General Review, Yugoslavia consented to a quota increase from US$150 million to US$207 million, effective from December 16, 1970. The par value is Din 15.0 per US$1 which became effective, with the Fund's concurrence, on January 23, 1971.

Yugoslavia has had stand-by arrangements approved by the Fund in 1961, 1965, 1967, and on February 19, 1971. The current stand-by arrangement is for the first credit tranche, viz., US$51.75 million.

1/ A staff team consisting of Messrs. Geoffrey Tyler, Hubert Neiss, Richard Williams, and Carl-Heinz Tretner, which visited Belgrade from May 18 to June 7, 1971 for the 1971 Article XIV consultation discussions, also conducted discussions which provided the basis for this report.

On April 14, 1970, Yugoslavia requested the rescheduling of three repurchases totaling US$45 million, which were due on May 23, June 14, and October 8, 1970, respectively. It was agreed that the repurchases should be made in nine quarterly installments of US$5 million each, beginning not later than July 15, 1970. Yugoslavia made purchases in the gold tranche equivalent to US$9.3 million on March 2, 1971, and US$5.25 million on April 7, 1971. On April 8, 1971 and June 28, 1971, purchases equivalent to US$10 million and US$20 million respectively, were made under the current stand-by arrangement, leaving US$21.75 million still available. Repurchases outstanding total US$69.50 million, of which US$5 million falls due not later than July 15, 1971, US$5 million not later than October 15, 1971, US$15 million in 1972, and US$44.6 million in 1974. After the repurchase of July 15, 1971, the Fund's holdings of dinars will be equivalent to US$227 million, or 109.7 per cent of quota, assuming no further purchases are made under the existing stand-by arrangement. If the requested stand-by arrangement is fully used and repurchases falling due in 1971 and 1972 are made, the Fund's holdings of dinars would reach a maximum of 142.8 per cent of quota. Table 1 shows what the Fund's holdings of Yugoslav dinars would be during the life of the proposed stand-by arrangement.

Table 1. Yugoslavia: Changes in Fund Holdings of Yugoslav Dinars During the Life of the Proposed Stand-by Arrangement

(In millions of U.S. dollars)

	Purchases 1/	Repurchases	Holdings	Holdings as percentage of quota
1971				
July 15	--	5.0	227.0	109.6
August	41.75	--	268.75	129.8
October 15	--	5.0	263.75	127.4
November 15	10.0	--	273.75	132.2
1972				
January 15	--	5.0	268.75	129.8
February 15	16.75	--	285.5	137.9
April 15	--	5.0	280.5	135.5
April 15	15.0	--	295.5	142.8

1/ Under the requested stand-by arrangement of US$83.5 million for a period of one year from July 30, 1971.

Yugoslavia is a participant in the Special Drawing Account and received allocations of SDR 25.2 million and SDR 22.1 million on January 1 of 1970 and 1971, respectively. In 1970, Yugoslavia used SDR 19.0 million mainly for repurchases. In January 1971, SDR 5.0 million were used for a repurchase from the General Account and SDR 10.5 million were used in transactions with other participants to acquire currency while in April 1971, SDR 5.0 million were used for a repurchase. On June 30, 1971, Yugoslavia's holdings amounted to SDR 7.2 million or 15.1 per cent of its net cumulative allocation.

II. Developments in 1970[1/] and Program for the Existing Stand-by Arrangement

In 1970, the Yugoslav economy continued to expand strongly in all sectors other than agriculture, where poor weather conditions led to a decline of 8 per cent in real output. In nonagricultural sectors, the increase in real social product was more than 9 per cent. The strong growth in real output was accompanied, however, by a continued sharp increase in costs and prices. Personal incomes per employee in industry in the final quarter of 1970 were 20 per cent higher than a year earlier and the increase in unit labor costs was about 14 per cent. Over the same period, producers' prices of industrial goods rose by 12 per cent and retail prices by 11 per cent.

Domestic expenditure, other than on inventories, rose in real terms by 10 per cent. By far the most buoyant element in demand was fixed investment which, in real terms, was 18 per cent higher in 1970 than in 1969, when the increase was 11 per cent. Both private and public consumption increased by around 7 per cent in real terms in 1970.

The domestic expansion had a strong impact on the balance of payments through an increase in imports. In addition, during the second half of 1970 there was an increasing anticipation of a devaluation. This added to the demand for imports, and led to some holding back of exports and a slowdown in December in workers' remittances. Thus, for the year as a whole, imports in 1970 were 35 per cent higher than in 1969 and the increase of 14 per cent in exports was less than that of 17 per cent recorded in 1969. The trade deficit rose from US$660 million in 1969 to US$1,194 million in 1970. For the year as a whole, receipts from services and transfers rose encouragingly, continuing the trend of recent years. Receipts of workers' remittances more than doubled to reach US$440 million and net receipts from services and transfers increased from US$552 million in 1969 to US$806 million in 1970. All of the deterioration on current account occurred with the convertible area; the current account with the bilateral area remained in approximate balance. On capital account, net inflow, including net errors and omissions, increased from US$186 million in 1969 to US$289 million in 1970. In net terms, the increase was due principally to a smaller

1/ For a more detailed discussion of developments and policies in 1970, see the Staff Report for the 1971 Article XIV Consultation and Recent Economic Developments.

outflow in respect of export credit and a larger inflow of short-term capital. Long-term loans received increased by more than US$100 million to US$636 million in 1970, but this increase was almost completely matched by higher repayments of long-term loans which rose from US$264 million to US$367 million.

The overall deficit, after including the allocation of SDR 25 million on January 1, 1970, was US$74 million, compared with a surplus of US$78 million in 1969. At the end of December 1970, convertible international reserves of the National Bank stood at only US$140 million, equivalent to less than one month's imports from the convertible area.

The sharp deterioration in both the domestic and external sectors of the economy became matters of increasing concern to the authorities during the course of the year. Monetary policy was tightened around mid-year by raising the compulsory reserve requirements and the free liquidity ratio that the banks are obliged to maintain. The overall rediscount ceiling of the National Bank was decreased and limits were put on the increase in short-term credit of the business banks. In the fiscal field, federal turnover taxes were raised in April 1970, and in July 1970 an import surcharge of 5 per cent was imposed.

By the last quarter of 1970, however, it had become evident that greater efforts were needed and the Government began introducing a comprehensive stabilization program in October 1970. The measures formed the basis on which Yugoslavia requested the current stand-by arrangement with the Fund and were described in detail in EBS/71/35 (2/5/71).

In October 1970, all producers' prices were frozen and price control was administered more strictly. Monetary policy was tightened further. The increase in short-term credits of the business banks between end-October and end-December 1970 was limited to 1.5 per cent, rediscount limits of the business banks at the National Bank were reduced, restrictions were placed on interbank lending, and consumer credit was tightened. A prior import deposit scheme was introduced under which importers had to deposit, with the National Bank, 50 per cent of the value of imports for three months, interest free.

It was decided that restrictive policies would be needed throughout 1971. The expansion in money supply during the first quarter of 1971 was limited to no more than 2 per cent above the end-December 1970 level and a ceiling was established for the expansion of short-term credit during 1971 that would allow a 10 per cent increase in money supply over the year as a whole. A limitation was placed on budgetary expenditure of all levels of government. Under the law, expenditure in 1971 was not to exceed revenue in 1970 by more than 10.8 per cent. In the field of personal incomes, a limitation was established for the first four months of 1971 under which they should not exceed the average level of 1970 by more than 11 per cent.

Subsequent to the request for a stand-by arrangement, Yugoslavia, with the concurrence of the Fund, devalued the dinar by 16.7 per cent from Din 12.5 = US$1 to Din 15.0 = US$1, effective January 23, 1971. Simultaneously, the import surcharge was reduced from 5 per cent to 2 per cent but its life was extended to the end of 1971. Also the prior import deposit scheme, which had been relaxed by reducing the amount of the deposit to 30 per cent and then 20 per cent, was abolished completely. On January 1, 1971, simplifications and liberalizations were made to the import regime by abolishing two restrictive categories and transferring many items to the liberalized list; also the scheme linking imports to export performance was reduced in scope.

These policies were expected to slow down the growth of domestic demand to more manageable proportions and so reduce the rate of cost and price increase. It was thought that they would allow balance of payments equilibrium over 1971 as a whole.

III. Developments in the First Half of 1971

In a number of respects, the policies introduced at the end of 1970 and the beginning of 1971 were slower to act than the authorities had hoped. The main reason for this seems to have been that the strength of the upward thrust of activity in 1970 was even greater than had been realized and the economic problems that the excessive expansion had brought were more deepseated than had been thought the case.

The continuing strength of the boom was evident in most areas of production and expenditure. In the first quarter, industrial production, compared with a year earlier, was 11 per cent higher, the same increase as had applied in the final quarter of 1970. Retail sales at current prices were 36 per cent higher than a year earlier, compared with an increase of 30 per cent in the final quarter of 1970. The corresponding increases in income per employee in the social sector were 19 per cent and 23 per cent, respectively, and in prices about 11-12 per cent in each quarter.

Imports in the first five months of 1971 were 36 per cent above the corresponding months of 1970. However, this increase gives a somewhat distorted picture of trends during the five months. In January 1971, the increase over January 1970 was no less than 82 per cent, and was, of course, explained by the intense speculation in what was effectively the last month prior to the devaluation. For the four months February to May 1971, i.e., after the devaluation, the increase over the corresponding months of 1970 was 26 per cent. This increase was, moreover, strongly affected by a large volume of agricultural imports in 1971, following the very poor harvest of 1970. Nonagricultural imports from the convertible area in the four months were only 7 per cent higher, which is noticeably less than the corresponding increase in industrial production, despite an increase in import prices. This suggests that producers were reacting to the devaluation and running down the excess of stocks of imports that were built up in the pre-devaluation period. Exports to the convertible area were slower to react to the devaluation and it was not until May 1971 that they rose above the levels of a year earlier. In that month, total exports were 9 per cent higher and export orders suggested that the months ahead would be good ones for exports. Convertible international reserves of the National Bank rose relatively slowly after the devaluation and at the end of May 1971 were only US$11 million higher than at the end of December 1970, after taking account of the allocation of SDR 22 million on January 1, 1971.

Monetary policy was kept tight in the first quarter of 1971. In that period, it had originally been decided, in December 1970, to allow an increase in money supply of 2 per cent. In the event, in the three months, money supply fell fractionally, and in March 1971 was only 10 per cent higher than a year earlier. The decline in the first quarter resulted from a substantial slowdown in the increase in short-term credit. Given that prices continued to increase strongly, the stability in money supply implied a substantial tightening of monetary conditions in the economy. It seems reasonable to assume that it contributed to the running down of import stocks that appears to have taken place after January 1971. Trends in investment balance sheets of the banking system were somewhat more expansionary. Investment credits increased by 4 per cent between December 1970 and March 1971, and on the latter date were 27 per cent higher than a year earlier.

With respect to fiscal policy, the limitation on the increase in budgetary expenditure in 1971 to no more than 10.8 per cent above the revenue levels of 1970 was operative in the first quarter. Data are not yet available to show whether or not this limitation was observed, although it is known that federal budget expenditure in the first quarter was only 9 per cent above the level of a year earlier. The indirect evidence of a continued high level of investment, however, suggest that public investment from extrabudgetary funds as a whole may not have reacted very quickly to the restraining policies during the first quarter.

Similarly, although full data are not available, it appears that the limitation in the increase in personal income payments during the four months to April 1971 was not fully effective. Here it is noteworthy that the limitation of an 11 per cent increase compared with the 1970 average was not completely carried over into the respective laws of the republics, which have the administrative responsibility in the field, since it would have meant no increase in personal incomes from April to December 1971. Important exceptions were made with respect to various categories of workers, such as those with incomes below the average.

Prices continued to rise strongly in 1971 and in the first five months of the year were 12-13 per cent higher than a year earlier. About one half of the increase of 7-8 per cent that occurred between

December 1970 and May 1971 was due either to higher import prices following the devaluation, or the deliberate adjustment of prices of a number of important basic commodities and resources, such as oil, electricity, coal, and transportation, which over a period of time had become increasingly out of line with other domestic prices. However, even after allowing for these factors, it appears that the price freeze has not been effective in preventing unwarranted price increases, although it is probably true that prices would have risen more quickly in the absence of the freeze.

In summary, the first months of 1971 showed two divergent trends. In some respects, for example, the trend in nonagricultural imports show there were signs that the stabilization policies were beginning to work. In some other respects, however, it was clear that excess expansionary forces were still present in the economy and could, if left unchecked, cause the policies as a whole to fail.

IV. Program for the Requested New Stand-By Arrangement

In the above context, the Government embarked on an examination of the economic situation in order to devise a set of measures that would slow down the rate of growth of expenditure to a level consistent with domestic and external equilibrium without, at the same time, causing a sharp reversal that would bring stagnation and high unemployment. The revised program is described below. On the basis of this new program, Yugoslavia has notified the Fund of its desire to cancel the existing stand-by arrangement and is requesting a new stand-by arrangement for a period of one year for the equivalent of US$83.5 million.

The stabilization program is expected to slow down the rate of increase of domestic expenditure during the second half of 1971. It envisages an increase in real terms in private consumption and gross fixed investment of about 7 per cent for 1971 as a whole compared with 1970. Real public consumption is expected to be virtually unchanged between the two years, while the addition to stocks will be higher than normal, mainly because the expected good harvest will augment agricultural stocks. On the output side, primary production in real terms is expected to increase by about 7 per cent, industrial output by 8-9 per cent, and real social product by about 8 per cent. Although the rate of increase of prices is expected to moderate in the second half of 1971, for the year as a whole the average price level should be 12-13 per cent above the 1970 average. However, the authorities anticipate an average increase of about 8 per cent in 1972 compared with 1971.

The balance of payments for 1971 is again expected to be substantially in deficit. The current account deficit is forecast at about US$300 million, of which about US$200 million is expected to be covered by net capital inflow. The overall deficit, after including the allocation of

SDR 22 million, is forecast to be US$67 million, or only fractionally less than in 1970. At the present stage, the Yugoslav authorities have not made a detailed balance of payments forecast for 1972. However, they believe that over the period of the stand-by arrangement, which is roughly the second half of 1971 and the first half of 1972, there will be no decline in net foreign assets of the banking system and that there will be an improving trend during the period. This would imply that, after allowing for seasonal factors, there would be a small deficit in the second half of 1971 followed by a surplus in the following half year. In this regard, it might be noted that if the expected excellent harvest is realized, agricultural imports should be much less in the first half of 1972 than they were in the first half of 1971, when the economy was suffering from the effects of the poor harvest of 1970.

In the course of the discussions, the staff team concluded that the forecast of the current account of the balance of payments is consistent with the forecast of domestic output and expenditure. It is implicit in this judgment that the devaluation, together with restrictive domestic policies, will cause a reversal of the anticipatory stock building of imports that occurred in 1970 and the beginning of 1971. It also assumes that there will be some reaction to the change in relative prices brought about by the devaluation. The success of the stabilization program is, of course, dependent on the policy measures described below being sufficient to reduce the existing excess demand. If resolutely implemented, the measures should gradually restore internal stability and consequently ease the balance of payments problem.

As for the measures themselves, which are described in the annexed letter from the Yugoslav Government, the policies with respect to prices and personal incomes are basically unchanged from the earlier program. The price freeze will continue. The authorities consider that this will help moderate the rate of price increase by preventing monopoly positions being used to raise prices, especially in situations where there is not free competition from imports. They recognize that the price freeze cannot itself be a solution for the basic economic problems and they hope that an improved balance of payments will allow greater competition in domestic markets and an easing of price control in the future.

The individual republics have by now passed laws that will govern economic organizations in the field of personal incomes during the remainder of 1971. The laws vary between republics but the main principle is that personal incomes should not increase faster than the net receipts of the organization. In some republics, personal income per employee is not to be more than 11 per cent higher in 1971 than in 1970. In all republics there are exemptions available to economic organizations in which personal income payments are not higher than specified levels. Under the new constitutional amendments, procedures are laid down in broad outline for the determination of personal incomes. Under new self-management agreements, economic organizations will be obliged to match income payments to the resources available to them after settling all nonlabor costs and after paying all necessary amounts into the various funds, and all taxes. There will be provisions for ensuring that organizations follow the agreements and there will be procedures for blocking personal income payments if the agreements are not followed. The authorities hope that the new procedures, combined with appropriate demand management policies, will adequately control the increase in personal incomes.

For 1971, expenditure in all budgets is by law to be no more than 10.8 per cent higher than revenue in 1970. Any additional revenue above this expenditure limit is to be frozen. As a result of this measure, it is expected that public consumption will be virtually unchanged in 1971. The extrabudgetary funds of the Federation are all being tranferred to the direct or indirect control of the republics. These funds will no longer have access to additional federal resources and will have to finance all expenditure from their own sources of revenue, and any borrowing they can make from the business banks. The authorities are convinced that the extrabudgetary funds will be squeezed financially and that as a result, they will not be able to increase their nominal expenditure in 1971 by more than 11 per cent above the 1970 level. This should be an important factor in reducing the increase in real fixed investment in the economy from 18 per cent in 1970 to an estimated 7 per cent in 1971.

A tight monetary policy will be necessary not only because of its general effect on expenditure, but also because other policies in the program would be ineffective if there is easy access to funds. In the first quarter of 1971 it had been decided that the original intention to restrict the increase in money supply during 1971 to 10 per cent was probably too restrictive and it had been decided to raise the target to 14 per cent. It has now, however, been concluded that a relaxation would not be wise at this time and the original target has been restored. As described in the annexed letter, a ceiling has been set on the increase in short-term credit for the remainder of 1971 consistent with an increase in money supply of 10 per cent during 1971 as a whole, with an intermediate ceiling for end-September 1971. Because the Government believes that the rate of increase of investment should slow down, it has decided that investment credit should be limited and for 1971 as a whole a target has been set of an increase of 15 per cent. Ceilings consistent with such an increase, including an intermediate ceiling for end-September 1971, have been established on investment credit. These ceilings, on short-term and investment credit, constitute performance criteria under the proposed stand-by arrangement.

In addition to the ceilings on investment credit, a law has been passed that prohibits investment being commenced before long-term financial resources have been obtained to finance it. Previously, a large amount of investment was begun on the basis of interim financing which led to a large volume of unpaid obligations. The existence of these in turn put pressure on the National Bank to create more liquidity. Under the new law, all economic organizations, republics, and local authorities must prove to the Social Accounting Service, by September 30, 1971, that they are observing the law.

In view of the sustained rise in the level of outstanding foreign indebtedness in recent years and the further increase that will be necessary in 1971, the Government has taken several measures in the field of foreign debt. The debt reporting and registration system is being overhauled by the National Bank so that a comprehensive picture of the amount and structure of debt is available promptly. The new procedures will be introduced progressively during the remainder of 1971. The increase in the ceiling on the outstanding level of foreign debt guaranteed by the business banks is to be raised by only US$105 million in 1971 to US$900 million, compared with increases of US$134 million and US$162 million, respectively, in 1969 and 1970. The ceiling will not be increased during the remainder of 1971; this is a performance criterion. The conditions under which the National Bank allows certain types of import credits, mainly short-term, have been tightened by raising the dinar counterpart payment that must be made at the time of importing, and shortening the period between the initial and final dinar counterpart payments. The outstanding level of this category of foreign debt is to be no higher at the end of 1971 than a year earlier. During 1970, it increased by US$150 million. The intention not to permit an increase in the level of these outstandings during 1971 is also a performance criterion.

The authorities are currently preparing a general program of trade and payments liberalization. Some measures will be introduced no later than the beginning of 1972. The liberalization will include commodities whose import value in 1970 totaled about US$120 million. The coverage of linkage arrangements will also be reduced substantially. As mentioned earlier, the import surcharge is to be eliminated at the end of 1972. It remains the intention of Yugoslavia to continue with the termination of the remaining bilateral payments agreements with Fund members.

A review of the economic situation will be carried out before December 31, 1971. On the basis of that review, understandings will be reached with the Fund with respect to ceilings on short-term and investment credit in 1972 and with respect to the increase in foreign indebtedness in 1972. The limits adopted pursuant to these understandings will constitute performance criteria.

V. Staff Appraisal and Proposed Decision

These comments supplement the appraisal in the staff report on the Article XIV consultation with Yugoslavia (SM/71/186).

Following a period in which costs and prices had risen strongly and the balance of payments had deteriorated markedly, Yugoslavia introduced a stabilization program in the final months of 1970, and devalued the dinar by 16.7 per cent in January 1971. Developments in the first half of 1971 indicate that the economic problems were more deepseated than earlier thought and the stabilization program has been rather slow to take effect, and difficult to implement in some areas, although there are indications that the tight monetary policy of the first quarter of 1971 and the devaluation are having an effect on import demand. The Yugoslav Government has reviewed its policies in the light of these developments, and has strengthened the program. It has decided to continue with restrictive monetary and fiscal policies and with the price freeze, and has introduced additional measures to prevent excessive investment expenditure, and to slow down the increase in personal incomes.

The program described in the letter of intent is designed to contain domestic spending within the limits of available resources from production and the inflow of capital that can reasonably be expected. In conjunction with the recent devaluation it should thus help to restore equilibrium in the balance of payments within the stand-by period. It should also help to moderate the rate of price increase and to ensure over the longer run the maintenance of sustained growth compatible with stability. To achieve these results, the program must be vigorously implemented.

The Yugoslav authorities are in the process of setting up a more speedy and comprehensive recording system for foreign debt. Moreover, they have acted to control the growth of important categories of short- and medium-term foreign debt. The staff welcomes these measures. Yugoslavia has continued to liberalize the trade and payments system and currently a full study of the system is being undertaken. On the assumption that the stabilization program leads to an improvement in the balance of payments, it should be possible to undertake a further liberalization of the system.

The proposed stand-by arrangement contains a number of safeguards. Thus it contains performance criteria relating to short-term and investment credit and certain categories of foreign debt during 1971, in addition to performance criteria in respect of the introduction of new restrictions on payments and transfers for current international transactions, the introduction of new multiple currency practices, and the conclusion of new bilateral payments agreements with Fund members. A review of the economic situation will be made before the end of 1971 and, on the basis of that review, understandings will be reached with the Fund with respect to limits on short-term and investment credit in 1972, and with respect to the increase in foreign indebtedness in 1972. These understandings will constitute performance criteria.

The following decision is submitted for the consideration of the Executive Directors:

> "The Government of Yugoslavia has notified the Fund of its desire to cancel the existing stand-by arrangement and has requested a new stand-by arrangement for a period of one year and for the equivalent of US$83.5 million. The Fund approves the stand-by arrangement attached to EBS/71/196 and grants any necessary waiver of the conditions of Article V, Section 3(a)(iii) of the Articles of Agreement."

ATTACHMENT

Yugoslavia--Stand-By Arrangement

1. Annexed hereto is a letter dated June 24, 1971 from Mr. Toma Granfil, a member of the Executive Council of Yugoslavia, setting forth the objectives and policies which the authorities of Yugoslavia will pursue.

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

3. Yugoslavia will remain in close consultation with the Fund during the period of the stand-by arrangement and, in particular, will consult the Fund in accordance with paragraph 15 of the annexed letter. These consultations may include correspondence and visits of officials of the Fund to Yugoslavia or of representatives of Yugoslavia to Washington, D.C. For the purposes of these consultations, Yugoslavia will keep the Fund informed of developments in the exchange, trade, credit, and fiscal situation through reports at intervals or dates requested by the Fund during the period the stand-by arrangement is in effect.

4. For a period of one year from July 30, 1971, Yugoslavia will have the right, after making full use of any gold tranche that it may have, to purchase from the Fund the currencies of other members in exchange for its own currency in an amount equivalent to US$83.5 million, provided that

(i) purchases under the stand-by arrangement shall not, without the consent of the Fund, exceed the equivalent of US$41.75 million prior to November 15, 1971, the equivalent of US$51.75 million prior to February 15, 1972, and the equivalent of US$68.5 million prior to April 15, 1972; and

(ii) the right of Yugoslavia to make purchases under this stand-by arrangement shall be subject to paragraph 14 of the annexed letter to the extent that such purchases would increase the Fund's holdings of Yugoslav currency beyond the first credit tranche. If at any time any limit in (i) above would prevent a purchase under the stand-by arrangement that would not increase the Fund's holdings of Yugoslav currency beyond the first credit tranche, the limit will not apply to that purchase.

The amounts available in accordance with this paragraph 4 shall be augmented by amounts equivalent to repurchases in respect of purchases under the stand-by arrangement, unless, when any such repurchase is made, Yugoslavia informs the Fund that it does not wish the stand-by arrangement to be augmented by the amount of that repurchase.

5. Yugoslavia will pay charges for this stand-by arrangement in accordance with Executive Board Decisions Nos. 270-(53/95), adopted December 23, 1953; 876-(59/15), adopted April 27, 1959; and 1345-(62/23), adopted May 23, 1962.

6. Subject to paragraph 4 above, Yugoslavia will have the right to engage in the transactions covered by this stand-by arrangement without further review by the Fund. This right can be suspended only with respect to requests received by the Fund after (a) a formal ineligibility, or (b) a decision of the Executive Board to suspend transactions, either generally (under Article XVI, Section 1(a)(ii)) or in order to consider a proposal, made by an Executive Director or the Managing Director, formally to suppress or to limit the eligibility of Yugoslavia. When notice of a decision of formal ineligibility or of a decision to consider a proposal is given pursuant to this paragraph 6, purchases under the stand-by arrangement will be resumed only after consultation has taken place between the Fund and Yugoslavia and understandings have been reached regarding the circumstances in which such purchases can be resumed.

7. Not later than three years after each purchase of exchange by Yugoslavia under this stand-by arrangement, Yugoslavia will repurchase an equivalent amount of Yugoslav currency from the Fund; provided that, if the Yugoslav currency held by the Fund as a result of transactions under this stand-by arrangement is reduced by repurchases under Article V, Section 7, or otherwise, such reductions shall be credited against the earliest amounts that become payable under this paragraph 7. Repurchases shall be made in gold, in convertible currencies acceptable to the Fund, or in special drawing rights, in accordance with the Fund's policies and practices at the time of repurchase.

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Socialist Federal Republic of
Yugoslavia

Belgrade, June 24, 1971

FEDERAL EXECUTIVE COUNCIL

Mr. Pierre-Paul Schweitzer
Managing Director
International Monetary Fund
WASHINGTON DC

Dear Mr. Schweitzer,

1. On the basis of a stabilization program which the Yugoslav Government began to introduce in October 1970, and which was outlined in the letter of January 14, 1971 from the former Federal Secretary for Finance, Mr. Smole, Yugoslavia requested a stand-by arrangement for one year under which, after making full use of any gold tranche it may have, Yugoslavia would have the right to purchase from the Fund currencies equivalent in total to $ 51.75 million. The Fund approved this request on February 19, 1971, and Yugoslavia purchased the equivalent of $ 10 million under the stand-by arrangement on April 8, 1971; further, Yugoslavia submitted a request for drawing of equivalent of $ 20 million on June 28, 1971. Subsequent to the request for a stand-by arrangement, the Yugoslav dinar was devalued by 16.7 per cent on January 23, 1971. It has become clear, however, that the economic problems of Yugoslavia were more deep-seated than was originally believed and will take correspondingly longer to slove. The Government is, therefore, introducing additional measures so that domestic and external equilibrium can be attained. Assistance from the Fund, over a longer period and in a greater amount than is currently available, would be of very substantial benefit to the Yugoslav Government in its stabilization efforts. Yugoslavia is, therefore, proposing that the current stand-by arrangement be cancelled and that a new stand-by arrangement for a period of one year be approved. Under the proposed stand-by arrangement, after making full use of any gold tranche position it may have, Yugoslavia will have the right to purchase from the Fund currencies equivalent to $ 83.5 million. This total would be augmented by amounts equivalent to repurchases in respect of purchases under the stand-by arrangement unless, when any such repurchase is made, Yugoslavia informs the Fund that it does not wish the stand-by arrangement to be augmented by the amount of the repurchase. Yugoslavia will consult with the Managing Director of the Fund regarding the currencies to be purchased under the proposed stand-by arrangement prior to any request for a purchase.

2. The letter of January 14, 1971 outlined economic developments in 1970 and the prospects for 1971. To recapitulate briefly, the economy was expanding strongly but was experiencing increasing difficulties in a number of areas. In the nonagricultural sectors, real social product increased by more than 9 per cent and it was only a very poor year in

agriculture that kept the increase in total real social product to 5 per cent. However, the rise in personal incomes, in costs, and in prices was substantial. Personal income per employee in industry was 21 per cent higher in the final quarter of 1970 than a year earlier. The corresponding increases in unit labor costs in industry and in prices were each about 12 per cent. As a result, and because of anticipation of a possible devaluation, imports rose strongly and receipts from exports and services were adversely affected. The trade deficit increased from \$ 660 million in 1969 to \$ 1,194 million in 1970. Most of the deterioration was with the convertible area, and the trade deficit with this area increased from \$ 578 million in 1969 to \$ 1,100 million in 1970. Despite an improvement of some \$ 250 million in net receipts from services and transfers, and an increase of about \$ 100 million in net capital inflow, the overall balance of payments deficit, not including the allocation of SDR 25 million, changed from a surplus of \$ 78 million in 1969 to a deficit of \$ 99 million in 1970. The gold and convertible foreign exchange reserves of the National Bank declined by more than \$ 100 million during 1970 and totaled \$ 139 million at the end of the year, including holdings of SDRs and the gold tranche position in the Fund. This represented an extremely low level of reserves, equivalent to less than one month's imports from the convertible area.

3. In response to these developments a wide range of policies was introduced. A price freeze was instituted, monetary policy was tightened significantly, and measures were taken to limit the increase in budgetary expenditures in 1971. A limit was placed on the permitted increase in personal incomes in the first four months of 1971 and steps were taken to introduce a more effective incomes policy after the above period. As mentioned earlier, in January 1971 the dinar was devalued by 16.7 per cent.

4. In some directions these measures were slower to take effect than had first been expected. Exports remained low until April 1971, although they recovered in May, but for the five months they were 1 per cent below the level of a year earlier. After a very bad month in January 1971, nonfood imports subsequently have shown a noticeable slower rate of increase, although the poor harvest of 1970 led to a substantial increase in agricultural imports in the months January to May 1971 and imports as a whole in the five months were 36 per cent above the corresponding level of a year earlier. However, recent trends in nonfood imports and a rising volume of export orders suggest that the devaluation is beginning to have an impact. Prices continued to increase strongly being still 12 per cent above the level of a year previously. Part of this increase was, of course, due to higher prices for imports following the devaluation and the increases in export prices in other countries; in additicn large adjustments were made in prices of a number of important basic commodities such as oil, electricity, coal and transportation, which over a period had become increasingly out of line with other domestic prices. Personal incomes continued to be substantially above the levels of 1970. Excessive

domestic expenditure remained a strong inflationary pressure. There were some signs by the beginning of the second quarter that the growth of expenditures had begun to moderate and, as described above, there were indications of a slowdown in the growth of imports, but in many respects the situation showed little sign of improvement.

5. The Government is therefore continuing and intensifying the stabilization program decided upon at the end of 1970. It is expected that the proposed policies, which are described below, will result in a real social product in 1971 about 8 per cent greater than in 1970. Although prices will rise by about 12 to 13 per cent during the course of 1971, the rate of increase should decline to about 8 per cent during 1972, as policies become increasingly more effective. For the balance of payments the objective is no change in net foreign assets of the banking system over the period of the stand-by arrangement. Given that there will be a substantial balance of payments deficit in the first half of 1971 and that the improvement in the balance of payments will be spread over 1972 as well as the second half of 1971, it is expected that there will be a decline in net foreign assets of around $ 70 million in 1971, after including the allocation of SDR 20 million on January 1, 1971, and an increase in net foreign assets in 1972.

6. In December 1970, a federal law was passed limiting the increase in personal incomes during the first four months of 1971 to no more than 11 per cent above the average for 1970. Complete data until the end of April 1971 are not available, but those already at hand indicate that this limit was broadly observed. For the remainder of 1971, the Republics have passed new laws governing permissible increases for 1971 as a whole. The provisions of the republican laws vary. The basic provision is that personal incomes in 1971 should not increase by more than the increase in net receipts per employee. Exceptions to the general rules are available to economic organizations in which personal income payments in 1970 were not higher than specified amounts, and to certain classes of organizations having limited financial means for granting increases in personal incomes. For some organizations having personal incomes substantially above their republican average, a limitation of 11 per cent applies. It is intended that a more lasting procedure for determining personal incomes will apply when new self management agreements come into force in all Republics. Under these agreements, enterprises will continue to determine the distribution of enterprise income but must observe certain guidelines. Basically enterprises should limit the increase in personal income payments to the increase in resources available after settling costs of nonlabor inputs and after paying amounts to the various funds, such as amortization and collective consumption funds, and certain taxes. The Government believes that by this means it will be possible, in conjunction with appropriate demand management policies, to obtain adequate control over personal income payments and, at the same time, maintain the basic principle of workers' self management.

7. The price freeze that was introduced in October 1970 as a temporary measure is to be continued for the present. As mentioned above, the rate of increase of prices has remained high for a number of reasons unconnected with the effectiveness of the price freeze. The Government believes, however, that a continuation and strong implementation of the price controls remains necessary until the domestic economy is more stable and further steps can be taken in the field of import liberalization.

8. In December 1970, it was decided to limit the increase in expenditure of all budgets and extrabudgetary funds in 1971 to 10.8 per cent of the level of revenue in 1970. This limit will be observed in respect of all budgets. As a result of this measure, it is estimated that there will be virtually no increase in real public consumption in 1971 compared with 1970. The federal extrabudgetary funds are in the process of being transferred to the Republics. The latter will no longer receive assistance from the Federation for extrabudgetary purposes and will be obliged to rely on their own resources to finance expenditure. This will force very restrictive expenditure decisions on the extrabudgetary funds and in total their expenditures are expected to be less than 11 per cent above the 1970 level. This will be an important element in the expected reduction in the rate of increase of real fixed investment from 18 per cent in 1970 to 7 per cent in 1971.

9. In view of the excessive increase in investment expenditures that occurred in 1970 and early 1971, the Government has taken steps to moderate this growth. In some sectors of the economy it had become increasingly common for investment to be undertaken without financial resources having been secured to pay for the investment. This resulted in an excessive expansion of investment on the one hand, and on the other rising a level of unpaid obligations. Laws have been passed prohibiting the undertaking of investment before financial resources have been secured to cover the investment. Economic organizations, Republics and Local Authorities must provide the Social Accounting Service by September 30, 1971, with full evidence proving that these laws are being observed. The Government believes that a strict administration of these laws will have an important impact on investment and bring a corresponding easing of the burden that has in the past been placed on monetary policy.

10. In December 1970, it was decided that monetary policy in 1971 should be such as to limit the increase in money supply to about 10 per cent. Although the precise size of the harvest for 1971 is not yet known, it will be larger than in 1970 and this will tend to tighten bank liquidity as currency in the hands of the large agricultural community will rise sharply. At this stage the Government believes that it is prudent to continue with an expansion of money of 10 per cent over 1971 as a whole. Accordingly, domestic credit of the banking system as currently defined for the purpose of <u>International Financial Statistics</u>, which, at the end of December 1970, stood at Din. 75.2 billion, will not exceed Din 81.0 by the end of September 1971 and Din 82.7 billion by the end of December 1971.

To keep the increase in domestic credit within the above limits, the "free" liquidity ratio is being increased from 3 per cent to 4 per cent and a later increase to 5 per cent will be considered. The minimum reserve requirement will be increased from 32 per cent to 34 per cent, when new credits are being granted for crop purchases and the types of deposits to which the requirement applies are being extended. The National Bank will also follow a more restrictive rediscount policy with respect to the business banks. The Government believes that it is equally important to contain the increase in investment credits during 1971. Accordingly, investment credits of the business banks, which at the end of December 1970 stood at Din 102.5 billion, will not exceed Din 114.2 billion by the end of September 1971, and Din 118.0 billion at the end of December 1971. The Government is currently considering possible changes in the credit system. Before any such changes affect the interpretation or operation of the above limits, the Government will consult the Fund and reach understandings with it regarding credit limits under the new system. A review of the economic situation will be carried out before December 31, 1971 and on the basis of that review understandings will be reached with the Fund by February 14, 1972 with respect to limits on domestic credit and investment credit for 1972.

11. The Government expressed in the letter of January 14, 1971, its concern about the increasing level of outstanding external debt and the concomitant increases in debt servicing obligations. In order that the trends in this area be fully known and to improve the control mechanism, the National Bank is currently introducing a comprehensive registration and reporting system. In addition, decisions have been implemented to limit the increase in important categories of foreign debt in 1971. With respect to foreign credits relating to certain classes of imports, and registered with the National Bank, the conditions governing dinar counterpart payments have been tightened. For certain categories of such debt, chiefly of less than 12 months maturity, 50 per cent must be paid immediately and the remaining 50 per cent within 3 months; previously the latter period was 6 months. For certain other categories, chiefly debt of longer maturity, 66 per cent must be paid immediately and 34 per cent after 6 months; previously the above ratios were 30 per cent and 70 per cent, respectively, and the second payment of dinar equivalent was not due until the final maturity of the credit. The outstanding amount of these registered credits will not be higher at the end of December 1971 than at the end of December 1970. With respect to foreign credits guaranteed by business banks either on their own or their clients' behalf, the limit within which they have been authorized to extend guarantees has been set at $ 900 million for 1971, compared with $ 795 million in 1970. The limit will not be increased above $ 900 million in 1971. To discourage external borrowing for the purpose of improving dinar liquidity, foreign financial credits guaranteed by business banks are subject during the life of the debt to a noninterest bearing reserve requirement in foreign exchange which has been increased from 10 per cent to 20 per cent. On the basis of the review referred to in paragraph 10, understandings will be reached with the Fund with respect to the increase in foreign indebtedness in 1972.

12. In the trade and payments field, the prior deposit scheme was abolished in January 1971. At the same time the import surcharge was reduced from 5 per cent to 2 per cent and it will be abolished entirely at the end of 1971. Some reduction was made in the coverage of linking arrangements for imports. The Government remains firmly committed to further liberalization of the trade and payments system, and is currently studying a further liberalization which will be introduced by the beginning of 1972 at the latest. In particular, quantitatively important transfers will be made to the liberalized list of imports and the scope of linking arrangements will be reduced substantially. The Government does not intend to introduce any new restrictions on payments and transfers for current international transactions, or introduce any new multiple currency practices.

13. In recent years substantial progress has been made in terminating bilateral payments agreements with both Fund members and with other countries. In the first four months of 1971 four such agreements with Fund members were terminated. Yugoslavia intends to terminate the remaining bilateral payments agreements with Fund members as early as possible. No new bilateral payments agreements will be concluded with Fund members.

14. During any period of the stand-by arrangement in which (1) the limits on domestic credit and investment credit as set forth in paragraph 10 have not been observed, or (2) the limits on foreign debt as set forth in the seventh and ninth sentences of paragraph 11 have not been observed, or (3) the intentions set forth in the respective final sentences of paragraphs 12 and 13 are not being observed, or (4) understandings have not been reached as provided for in paragraphs 10 and 11, or the limits adopted pursuant to such understandings are not observed, Yugoslavia will not request any purchase under the stand-by arrangement which would raise the Fund's holdings of its currency beyond the first credit tranche except after reaching understandings with the Fund regarding the circumstances in which such purchases may be made.

15. The Government believes that the policies set forth in this letter are adequate to achieve the objectives of the program but will take any further measures that may become appropriate for this purpose. During the period of the stand-by arrangement, Yugoslavia will consult the Fund on the adoption of any measures that may be appropriate at the initiative of Yugoslavia, or whenever the Managing Director requests consultations because of any criteria in paragraph 14 above are not being observed, or because the intentions stated in paragraph 8 are not being observed, or because he considers that consultation on the program is desirable. In addition, after the period of the stand-by arrangement, and while any Fund holdings of Yugoslavia's currency above the first credit tranche

include currency resulting from purchases under the stand-by arrangement, Yugoslavia will consult with the Fund from time to time, at the initiative of Yugoslavia or at the request of the Managing Director, concerning Yugoslavia's balance of payments policies.

(Toma Granfil)

Member of the
Federal Executive Council