

EBS/71/35
Supplement 1

CONFIDENTIAL

February 19, 1971

To: Members of the Executive Board
From: The Secretary
Subject: Yugoslavia - Stand-By Arrangement

Attached for the records of the Executive Directors is the text of the stand-by arrangement for Yugoslavia agreed at Meeting 71/13, February 19, 1971.

Att: (1)

Yugoslavia--Stand-By Arrangement

1. Annexed hereto is a letter dated January 14, 1971 from the Federal Secretary of Finance of Yugoslavia setting forth the objectives and policies which the authorities of Yugoslavia will pursue.

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

3. Yugoslavia will remain in close consultation with the Fund during the period of the stand-by arrangement and, in particular, will consult the Fund in accordance with paragraph 14 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.

4. For a period of one year from February 22, 1971, Yugoslavia will have the right, after making full use of any gold tranche that it may have, to make purchases from the Fund in the currencies of other members in exchange for its own currency in an amount equivalent to US\$51.75 million. 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. 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 this stand-by arrangement will be resumed only after consultation has taken place between the Fund and Yugoslavia and understandings have been reached regarding the circumstances in which such purchases can be resumed.

7. Not later than three years after each purchase of exchange by Yugoslavia under this arrangement, Yugoslavia shall 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 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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FEDERAL SECRETARIAT FOR FINANCE

Belgrade, January 14, 1971

Mr. Pierre-Paul Schweitzer
Managing Director
International Monetary Fund
Washington, D.C.

Dear Mr. Schweitzer,

1. As observed below, the Yugoslav economy has faced a number of difficulties in 1970 which reacted adversely on the balance of payments. The Government is taking steps to overcome these difficulties. Assistance from the Fund would be of substantial benefit to the Government in the period of readjustment. Yugoslavia is therefore proposing a stand-by arrangement for one year, under which, after making full use of any gold tranche that it may have, Yugoslavia will have the right to purchase from the Fund currencies equivalent in total to \$51.75 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 used in any drawing under the proposed stand-by arrangement.

2. Following a period of recession, the Yugoslav economy began to grow strongly from mid-1968. In 1968 real social product increased by 4 per cent, and in 1969 by 10 per cent. In 1970, the increase was about 9 per cent in the nonagricultural sector, although a very poor season in agriculture kept the increase in the total social product to about 5 per cent. Domestic expenditures also increased, with the highest rates of growth, on average, being in fixed investment. Throughout this period of expansion, nominal personal income payments increased at a rate that was higher than the Government would have wished. Until mid-1969, producers prices of industrial goods were stable, although retail prices and the cost of living rose at faster rates than in most industrial countries. The balance of payments in 1968 and 1969 showed a quite moderate deficit on current account, and, over the two years, the net foreign assets of the monetary sector showed a slight improvement.

3. In the second half of 1969 and in 1970, the economy experienced growing difficulties. Domestic prices began to rise sharply and there was a deterioration in the balance of payments. In October 1970, producers prices were 12 per cent higher than a year earlier and increases in retail prices and the cost of living were of the same order of magnitude. The strong rise in personal incomes continued. While exports performed well in 1970, imports are expected to be almost one third higher than in 1969. Despite a remarkable improvement in invisible receipts and a continued

capital inflow, the decline in net foreign assets of the monetary sector will approach \$100 million. The gross gold and convertible foreign exchange holdings of the banking system are currently less than \$300 million; and a continued decline in these reserves could not be permitted for long.

4. During the course of 1970, measures were taken to reduce excess demand. Monetary policy was tightened by a number of successive measures. Temporary ceilings on short-term credit of banks were imposed from May to July. Reserve requirements were raised from 30 to 32 per cent in July and August. In addition, the over-all rediscount ceiling was lowered, the minimum liquidity ratio of banks was raised, and the conditions for central bank borrowing by banks were more restrictively interpreted. In July, an import surcharge of 5 per cent was introduced. In the fiscal field, turnover taxes on a number of products were increased in April, and part of the increased revenue was blocked. However, these measures were not sufficient to halt the deterioration in the economic situation. In particular, imports continued at a very high level and the weakness in the balance of payments remained. Therefore, in the final months of 1970, the Government embarked on a stabilization program.

5. The program is being designed to halt the present inflationary trends and to eliminate the over-all deficit in the balance of payments, while allowing a rate of growth in the economy that will absorb the increase in the labor force. The stabilization effort consists of two stages. In the first, which is currently in effect, some measures have been taken, that are intended to have an immediate effect on the major symptoms of the current imbalance. These measures are essentially of a temporary character. In the second stage, which will be introduced during the first half of 1971, more fundamental adjustments will be made in the field of incomes, monetary and fiscal policy, as an integral part of the new five-year plan, 1971-75. In the external field, the Government is aiming at a level of gold and convertible currency reserves (including the Fund position and SDRs) of the National Bank that is not less at the end of the year than at the end of 1970.

6. The temporary measures referred to in the previous paragraph include the following. There is currently a freeze on all prices. Conditions governing consumer credits have been tightened. At the end of December 1970 outstanding short-term credits of the business banks are to be not more than 1.5 per cent greater than at the end of October 1970 and not more than one per cent higher than the October figure at the end of January 1971. During the first quarter of 1971, the increase in money supply will be limited to 2 per cent of the total at the end of December 1970. In the fiscal field, expenditure increases in all budgets and in all extrabudgetary funds in the first quarter of 1971 cannot exceed their level in the first quarter of 1970 by more than 10.8 per cent. Measures directly influencing foreign transactions include a prior deposit scheme for imports, increases in interest rates on deposits in foreign currency, and postponements in the allocation of import authorizations.

7. The Government believes that these measures will improve the economic position of Yugoslavia, particularly as regards the balance of payments. However, it considers that there are some problems that can be solved only by longer-term policies. It is, therefore, as mentioned above, in the process of instituting a series of more basic measures. Among them, it is proposed that a law will be passed that will govern the determination of personal incomes. The law will cover all personal incomes. It will involve compulsory negotiations between economic organizations, the Chambers of the economy, the trade unions, and the Government. The principles governing these negotiations will take account of productivity changes and differences between regions. Provision will be made for disciplining, by means of additional taxation, economic organizations that do not follow decisions made regarding permissible increases in personal incomes. As an immediate measure, the Government decided that minimum depreciation rates will be substantially increased. This will reduce the funds of economic organizations legally available for income distribution under the system of self-management. The Government firmly believes that, when instituted, these new policies will prove effective in preventing excessive increases in labor costs.

8. As mentioned above, steps have already been taken to reduce the growth of fiscal expenditure in the first quarter of 1971. The Government believes that it is essential that this restraint be continued and for the year as a whole fiscal policy will be significantly more restrictive than in 1970. The increase in budgetary and extrabudgetary expenditures for 1971 cannot exceed in total by more than 10.8 per cent, total expenditures in 1970. This will mean very little growth in real terms for about 30 per cent of total domestic expenditures. The law requires all budgets to be in balance, and in 1971 the Government also expects the extrabudgetary funds as a whole to be in balance. Budget surpluses which had been blocked in 1970 will not be released during 1971 except for a few very special categories of use. Any increases in revenue in 1971 over 1970 in excess of 10.8 per cent will also be blocked, and the use of special reserve funds will be further restricted.

9. The Government is in the process of deciding upon the division of fiscal responsibility between the Federation on the one hand, and the Republics and local authorities on the other. By placing more direct responsibility in the latter group, in terms of undertaking expenditures and being obliged to finance them, the Government believes that more effective fiscal discipline will follow.

10. The Government believes that, to ensure the success of the program, it will be necessary to pursue a tight monetary policy throughout 1971. A decision has been made to limit the growth of the money supply during the first quarter of 1971 to 2 per cent. This is equivalent to an annual rate of increase of around 10 per cent, which is less than the expected increase in nominal social product and which is believed to be appropriate for 1971 as a whole. An increase during 1971 of not more than Din 7.5 billion in domestic credit of the banking system as currently

defined in International Financial Statistics, would be consistent with the above monetary aims. On October 31, 1970, outstanding domestic credit of the banking system amounted to Din 74.0 billion. Efforts will be made to keep the expansion of other types of credit broadly in line with the monetary targets described above. This would imply that the expansion of total investment credits granted by the banking system and the social funds would not exceed Din 11.0 billion during 1971. On October 31, 1970, the outstanding amount of total investment credit was Din 113.0 billion.

11. The Government has become concerned about the increasing level of outstanding external debt and the concomitant increase in debt servicing obligations. Special attention will therefore be given to external borrowing, particularly short- and medium-term borrowing.

12. As mentioned above, a number of restrictive measures have been taken in the trade and payments field. These are of a temporary nature and the need for them will be reassessed in the light of the balance of payments developments. The Government remains firmly committed to further liberalization of the trade and payments system, and some simplification of the system will be introduced from January 1, 1971. The Government does not intend to introduce any new restrictions on payments and transfers for current international transactions or multiple currency practices.

13. In recent years, Yugoslavia has made substantial progress in terminating bilateral payments agreements both with Fund members and with other countries. Early dates have been set for the Termination of a further four agreements with Fund members. Yugoslavia intends to terminate the remainder of the bilateral payments agreements with Fund members as early as possible, and no new agreements will be concluded with Fund members.

14. 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 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 consultation because any of the criteria in paragraphs 10, 12, and 13 of this letter are not being observed or because he considers that consultation on the program is desirable.

Sincerely yours,

/s/

(Janko Smole)

Federal Secretary for Finance