

DOCUMENT OF INTERNATIONAL MONETARY FUND AND NOT FOR PUBLIC USE

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CONFIDENTIAL

July 30, 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 71/79, July 30, 1971.

Att: (1)



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.

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 solve. 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, non-food 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 addition 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 International Financial Statistics, 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.

/s/

(Toma Granfil)

Member of the  
Federal Executive Council