

EBS/80/114

CONFIDENTIAL

May 22, 1980

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 from Yugoslavia for a stand-by arrangement equivalent to SDR 339.325 million. A draft decision appears on page 11.

This subject, together with the staff report for the 1980 Article IV consultation with Yugoslavia (SM/80/119, 5/20/80), has been tentatively scheduled for discussion on Friday, June 6, 1980.

Att: (1)

INTERNATIONAL MONETARY FUND

YUGOSLAVIA

Request for Stand-by Arrangement with Supplementary Financing

Prepared by the European Department and the Exchange
and Trade Relations Department 1/

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

Approved by L.A. Whittome and S. Kanesa-Thanan

May 21, 1980

I. Introduction

In a letter dated May 16, 1980 (annexed), Yugoslavia requests a stand-by arrangement, with associated use of supplementary financing for the period up to December 31, 1981, in an amount equivalent to SDR 339.325 million, which is equivalent to the second and third credit tranches (SDR 138.5 million) plus the associated amounts 2/ available under the supplementary financing facility. The letter describes the policies and intentions of the Yugoslav authorities.

Yugoslavia is an original Fund member. Its quota in the Fund is SDR 277 million. Yugoslavia has used Fund resources on a number of occasions. The last stand-by arrangement with Yugoslavia for SDR 69.25 million, covering the first credit tranche, was granted in May 1979 and was used in full. In February 1980, Yugoslavia drew SDR 138.5 million under the compensatory financing facility, bringing the outstanding drawings by Yugoslavia under the facility to the equivalent of 100 per cent of quota.

On April 30, 1980, Fund holdings of dinars were equivalent to 269.8 per cent of quota, or 125 per cent of quota excluding outstanding purchases under the oil facilities and compensatory financing facility, and holdings resulting from gold sales to Yugoslavia. Yugoslavia is a participant in the Special Drawing Rights Department. At the end of April 1980, holdings were SDR 55.1 million, or 43.4 per cent of net cumulative allocation of SDR 126.9 million. Yugoslavia has acquired 177,144 ounces of fine gold in the gold distribution program, and received US\$19.4 million in the direct distribution of profits from gold sales. Yugoslavia has transferred one third of the latter amount to the Trust Fund.

1/ A mission consisting of Messrs. Tyler (EUR), Mountford (EUR), and Loser (ETR) with Mrs. Pabst (EUR) as secretary was in Belgrade from May 4-7, 1980 to finalize discussions which began in February-March 1980 during the 1980 Article IV consultation discussions.

2/ Including an amount equivalent to 12.5 per cent of quota related to the first credit tranche; the first credit tranche was drawn in May 1979.

II. The Economic and Financial Program

The background to the current problems of the Yugoslav economy and the policies to be followed in 1980 are described in the Staff Report for the 1980 Article IV consultation with Yugoslavia (SM/80/119, 5/20/80) and in Recent Economic Developments (SM/80/120, 5/27/80). In response to the sharp increase in the deficit in the current account of the balance of payments in 1979, which was financed in part by a sizable reduction in reserves, and the further acceleration in the rate of inflation, the authorities have introduced a stabilization program for calendar year 1980, in order to dampen domestic demand pressures, bring inflation under better control, and reduce the current account deficit. It is the firm intention of the authorities to continue with the stabilization effort in 1981. Under the Yugoslav constitutional system, final numerical targets for 1981 cannot be established until the end of 1980. The attached Letter of Intent therefore describes the financial program for 1980 in detail and the broad path that will be followed in 1981. The stand-by arrangement makes provision for a consultation with the Fund to reach understandings on quantitative aspects of the program for the period of the stand-by arrangement subsequent to December 31, 1980. The establishment of such undertakings is a performance criterion.

The main macroeconomic targets of the program for 1980 are a reduction in the growth rate of real social product to 5 per cent compared with 7.1 per cent in 1979, and a decrease in the rate of inflation to 17 per cent (in terms of the GSP deflator) about 3 percentage points less than in 1979. For the balance of payments, the current account deficit is to be reduced to a maximum of US\$2.5 billion in 1979. ^{1/} In combination with exceptional financing by the commercial banks and the use of Fund resources, foreign borrowing is planned to be sufficient in 1980 to permit an increase in gross official reserves of about US\$0.7 billion.

The stabilization effort will continue in 1981. Final quantitative targets cannot be established at this time, but present thinking is that the current account deficit of the balance of payments should be reduced to about US\$1.8 billion in that year. To achieve this, real growth of GSP will probably need to be kept at around the level planned for 1980 or perhaps somewhat lower.

1. Fiscal policy

On the basis of available information, the financial position of the public sector as a whole appears to have improved in 1979. The growth rate of consolidated public sector expenditures and revenues was apparently lower than that of nominal GSP, and the overall deficit was probably reduced to negligible proportions. More precise and reliable data are available

^{1/} The authorities hope that a firm implementation of the program could lead to a smaller deficit of about US\$2 billion but in the opinion of the staff it is more appropriate to base the financial program for the purpose of the stand-by arrangement on the somewhat more pessimistic assumption of a deficit of US\$2.5 billion.

Table 1. Yugoslavia: Summary Balance of Payments, 1977-80 1/

(In billions of U.S. dollars)

	1977	1978	<u>1979</u> Prel.	<u>1980</u> Forecast
A. Exports, f.o.b.	5.2	5.8	6.8	8.2
Imports, c.i.f.	<u>-9.8</u>	<u>-10.4</u>	<u>-14.0</u>	<u>15.3</u>
Trace balance	-4.6	-4.6	-7.2	-7.0
B. Services and transfers, net	<u>3.3</u>	<u>3.3</u>	<u>3.5</u>	<u>4.5</u>
Current account balance	-1.3	-1.3	-3.7	-2.5
C. Long-term capital, net	1.4	1.4	1.4	2.5
D. Short-term capital, including bilateral balances, and errors and omissions; excluding G	--	--	0.6	--
E. Total (A through D)	<u>0.1</u>	<u>0.1</u>	<u>-1.7</u>	<u>--</u>
F. Allocation of SDRs	--	--	--	--
G. Exceptional financing	0.1	0.3	0.2	0.4
H. Total (A through G)	<u>0.2</u>	<u>0.4</u>	<u>-1.5</u>	<u>0.4</u>
I. Reserve movements (increase -)	-0.2	-0.4	1.5	-0.4

Sources: Data supplied by the Yugoslav authorities; and staff estimates.

1/ Totals may not add due to rounding.

Table 2. Yugoslavia: Budget of the Federation

(In billions of dinars) 1/

	1976	1977	1978	1979 Prelimi- nary outturn	1980 Plan
Expenditure	75.5	89.0	77.9	97.4	125.3
Revenue	<u>64.9</u>	<u>80.0</u>	<u>72.6</u>	<u>93.6</u>	<u>119.1</u>
Deficit	-10.7	-9.0	-5.3	-3.8	-6.2
Financed by:					
Borrowing from National Bank	7.9	11.2	9.5	8.5	9.2
Other (net)	2.8	-2.2	-4.2	-4.7	-3.0

Source: Data supplied by the Yugoslav authorities.

1/ Totals may not add because of rounding.

only for the budget of the Federation (the central government) which accounts for only about one fifth of total consolidated public sector transactions, but has in recent years been the source of virtually all of the public sector deficit. In 1979, expenditures by the Federation rose 25 per cent, or less than the rate of increase in nominal GSP, and buoyant revenues led to a reduction in the deficit to Din 3.8 billion, equivalent to 0.3 per cent of GSP, compared to a deficit equivalent to 0.6 per cent of GSP in 1978. This decrease in the deficit enabled the authorities to keep borrowing from the National Bank to Din 8.5 billion.

For 1980, total expenditures by the Federation are budgeted to increase by 28.6 per cent, with the bulk of the increase due to a rise in defense expenditures. As a result the deficit will increase to Din 6.2 billion, equivalent to 0.4 per cent of nominal social product. Gross borrowing from the National Bank, however, is only expected to amount to Din 9.2 billion, or less in real terms than in 1978 or 1979. The Economic Resolution for 1980, which embodies the main policies that the various sectors of the economy must follow, specifies that current expenditures of the public sector as a whole must not rise by more than 16 per cent, which would be substantially less than the growth of total expenditures in the economy.

2. Monetary policy

Following a large expansion of money supply in 1978, the authorities sought in 1979 to follow more restrictive policies, as described in the Article IV consultation paper. In practice the conduct of monetary policy was complicated by the fact that the decline in net foreign assets of the banking system was considerably larger than forecast, due to the sharp deterioration of the balance of payments situation. To avoid an excessive squeeze on domestic liquidity, the authorities allowed an increase in domestic bank credit of 26.7 per cent (compared with an original target of 19 per cent), which was about 2 percentage points lower than the increase in GSP. The increase in narrow money supply, on the other hand, was only 17.3 per cent, considerably less than the nominal GSP increase, and slightly less than the planned increase of 18 per cent. Against this, it is obvious that the large increase in domestic credit accommodated the balance of payments deficit and the acceleration in the rate of inflation.

For 1980 the authorities intend to maintain tight monetary and credit conditions, with annual increases in both domestic credit and money supply 22 per cent, the forecast increase in nominal GSP. Moreover, in order to ensure the observance of the credit target for 1980, the authorities have established quarterly ceilings on bank credit, which are set out in Table 3, and are incorporated for the period of the proposed stand-by arrangement as performance criteria. With minor exceptions, which the authorities have acted to correct, the targets were broadly met in the first quarter of 1980. The authorities do not intend to increase these targets in the event that price increases exceed the planned level of 17 per cent on which the financial program is based. It is implicit in the monetary program that the economy was not excessively liquid at the end of 1979 and that the velocity

Table 3 . Yugoslavia: Monetary Survey

(Change in billions of dinars)

	1979				1980			
	I	II	III	IV	I	II	III	IV
					Projected			
Net foreign assets	-17.0	-16.5	-11.4	-33.7	-20.0	-5.0	4.0	-4.0
Domestic credit	56.6	38.9	63.0	94.8	60.0	60.0	60.0	85.0
Of which:								
National Bank credit to the Federation	(3.0)	(2.0)	(0.5)	(3.0)	(4.7)	(3.0)	(1.0)	(0.5)
Money supply <u>1/</u>	7.0	-2.2	28.0	24.2	15.0	17.0	25.0	27.0
Quasi-money <u>2/</u>	20.9	30.4	36.7	34.3)				
Other items, net	11.7	-5.8	-13.1	2.6)	25.0	38.0	39.0	53.0

Source: Data supplied by the Yugoslav authorities.

1/ Definition of National Bank of Yugoslavia, which includes government demand deposit.2/ Includes foreign exchange deposits.

of circulation will not increase in 1980. Obviously, either of these assumptions could be questioned. Against that, the authorities have emphasized their determination to adjust domestic targets and policies if the external targets during 1980 are not being realized.

Consistent with these ceilings and with the Federal Budget for 1980, the authorities have established sublimits on lending from the National Bank of Yugoslavia to the budget of the Federation. These sublimits are set out in Table 4, and are incorporated as performance criteria in the proposed stand-by arrangement.

Although it is not possible under the Yugoslav system to establish at this time quantitative monetary targets for 1981, the authorities have stated their firm intention to have a financial program for next year that will be consistent with a further improvement in the current account of the balance of payments.

3. Incomes and prices policies

In most recent years wages in Yugoslavia have risen quite strongly in real terms (5 per cent in 1977 and 6 per cent in 1978). In the period up to 1979 the unique system of wage determination by self-management agreements resulted in real wage increases that exceeded the increase in productivity and contributed to the development of excess domestic demand pressures, and had adverse repercussions on the Yugoslav competitive position. In 1979, however, the system of incomes determination in Yugoslavia worked in a more satisfactory fashion. As a result, the average increase in nominal personal incomes per employee was limited to 20 per cent in 1979, implying a small real decrease. For 1980, guidelines or principles have been established, in the framework of social compacts at the republican and Federal levels, that would require the increases in nominal personal incomes to be between 5-9 percentage points less than the nominal increase in GSP. The differential guidelines for various sectors would result in a real decrease in personal incomes in some sectors (e.g., banks, the public sector, and services). Individual work units completed their self-management agreements in March 1980 in line with these guidelines. Accordingly it is forecast that real wages per employee will again show a small decrease in 1980 on average.

The system for the determination of prices in Yugoslavia is complex. (Details are given in SM/80/120, pp. 24-27). A new and not yet fully established mechanism is to operate in the second half of 1980. In the meantime Federal and republican governments have agreed on national policies concerning 11 important commodities, previously subject to direct control. Also, the new guidelines provide that in general prices that were increased in the second half of 1979 cannot be changed until the second half of 1980. At the beginning of 1980 prices in general were rising at a rate in excess of that planned for the year as a whole but the authorities are convinced that the rate of inflation will moderate as the year progresses and the new policies take effect.

Table 4 . Yugoslavia: Quantitative Performance
Criteria in Proposed Stand-By Arrangement

	1979	1980		
	December 31 Actual	Proposed Ceilings Under Program ^{1/}		
		June 30	September 30	December 31
Net domestic assets of the banking system (In billions of dinars)	1,201	1,321	1,381	1,466
Net credit of the National Bank to the Budget of the Federation (In billions of dinars)	68.7	76.4	77.4	77.9
Cumulative change in net convertible foreign assets of the National Bank ^{2/} (In millions of U.S. dollars)	...	-900	-500	--
Convertible currency debt outstanding ^{3/} (In billions of U.S. dollars)	12.3	13.6	14.2	14.7

Source: Data supplied by the Yugoslav authorities.

^{1/} Quantitative performance criteria for 1981 to be determined at the time of the mid-term review.

^{2/} Net of exceptional borrowing by commercial banks.

^{3/} Debt outstanding in convertible currency with original maturities of more than one year. Excluding outstanding purchases from the Fund and increases in exceptional borrowings by the commercial banks in 1980. Valued at exchange rates prevailing on December 31, 1979.

4. Exchange rate, foreign borrowing, and reserve policies

During 1978 and 1979 the authorities followed a more active exchange rate policy than before, and the effective exchange rate depreciated by about 17 per cent over the two-year period, which was sufficient to produce a real effective depreciation of about 9 per cent (adjusted for relative movements in producer prices in Yugoslavia and in the major convertible trade partners in the convertible area). The effective depreciation obviously regained at least part of the competitiveness lost during the period prior to 1978. In the view of the authorities, which the staff shares, the continued disappointing export performance in 1979 was to a considerable extent the result of a combination of domestic demand pressures and a number of special factors affecting exports (see SM/80/119, p. 3). The authorities are convinced that the exchange rate policy followed in 1978 and 1979 was appropriate and are committed to continuing with an exchange rate policy in 1980 that is consistent with maintaining competitiveness and bringing about the planned improvement in the current account of the balance of payments. The average effective depreciation from the last quarter of 1979 to the first quarter of 1980 was 3.4 per cent.

In 1979 the large current account deficit was only partially covered by capital inflows, and the gross convertible reserves of the banking system declined by US\$1.2 billion to US\$2.0 billion, equivalent to 1.5 months of estimated convertible currency imports of goods and services in 1980. The official reserves held by the National Bank of Yugoslavia fell to US\$1.3 billion at the end of 1979. For 1980, the authorities wish to reverse last year's trend and are therefore planning for some increase in gross official reserves. Accordingly, they intend to increase gross long-term capital borrowing in 1980 to US\$4.3 billion, producing a net long-term capital inflow of US\$2.5 billion. In combination with the forecast current account deficit of US\$2.5 billion, such an inflow, plus the envisaged recourse to exceptional financing by the commercial banks of US\$0.4 billion, and the planned net use of Fund resources amounting to US\$0.3 billion, would allow a moderate increase in the gross international reserves of the National Bank of US\$0.7 million. Consistent with these plans, the authorities have established, for the purposes of the requested stand-by arrangement, quarterly targets for the net convertible foreign assets of the National Bank less exceptional financing in convertible currencies by the commercial banks, which are shown in Table 4 and which are incorporated for the period of the proposed stand-by arrangement as performance criteria.

The planned increase in foreign borrowing in 1980 is considered manageable and prudent by the authorities in the context of the level of Yugoslavia's external debt and the debt service situation foreseen for the next several years. An important factor in keeping the debt service position manageable is that most recent and projected financial credits incorporate grace periods of up to three years. At the end of 1979, outstanding debt repayable in convertible currency amounted to US\$13.5 billion (of which US\$12.8 billion had an original maturity of more than one year), and the debt service ratio on the latter debt, excluding purchases from the Fund, was 19.5 per cent. In order to avoid the emergence of a major debt service

problem, and consistent with the projected current account deficit, the authorities have established limits on the increase in outstanding foreign debt in convertible currencies with original maturities of more than one year. ^{1/} These limits are shown in Table 4 and are incorporated for the period of the proposed stand-by arrangement as performance criteria.

In order to improve the current account of the balance of payments, enterprises have been very strict in establishing the targets for exports, imports and services receipts that are incorporated in their individual and joint self-management agreements and the republican agreements within the Communities of Interest for External Economic Relations. (For details of the system see SM/79/111, 4/30/79, and also SM/78/246, 10/5/78). The authorities emphasize that all enterprises concerned are determined to monitor progress and so ensure that their individual and joint targets are met. A factor of some importance for the trade account in the second half of 1980 and more so in 1981, will be the operation of the new agreement with the EC, which should expand opportunities for Yugoslav exports to the member countries and prevent unexpected disruptions to exports, such as have sometimes occurred in the past.

In the attached letter, there is the standard clause that Yugoslavia will not introduce any multiple currency practices or introduce new or intensify existing restrictions on payments and transfers for current international transactions or enter into bilateral payments arrangements with Fund members; furthermore, the Government of Yugoslavia does not intend to introduce new or intensify existing restrictions on imports for balance of payments reasons.

III. Staff Appraisal and Proposed Decision

The severe deterioration in Yugoslavia's balance of payments position on current account in 1979 was partly due to the failure of the stabilization measures to bring about the intended dampening of domestic demand pressures, but also was caused by a combination of adverse special factors. Some of these factors also contributed to the acceleration of inflation. Although monetary, fiscal and incomes policies were tightened considerably in 1979, these policies did not begin to produce significant results until the second half of the year when there were signs of a gradual deceleration in the pace of domestic expansion. In view of the persistence of high rates of inflation, and the seriousness of the external imbalance, the authorities have decided to pursue firmer stabilization policies in 1980 and 1981.

The staff agrees with the need for a strong stabilization effort, and believes that the program announced for 1980 should result in the desired changes in trends. The planned reduction in the growth rate of real GSP to 5 per cent, in inflation to 17 per cent and in the current account deficit to US\$2.5 billion will constitute a major step in the direction of correcting the internal and external imbalances. In the staff's view the combination

^{1/} Excluding outstanding purchases from the Fund and excluding exceptional financing by the commercial banks.

of fiscal and monetary restraint, a firm incomes policy designed to reduce average wages per employee slightly in real terms, and continuation of an exchange rate policy designed to ensure external competitiveness, should be sufficient to produce the planned improvement in the external sector in 1980. It will, however, be important that the intended policies are implemented firmly and adjusted if necessary and the staff therefore welcomes the authorities' intention to take further measures in the course of the year if the program does not appear to be accomplishing its objectives. In particular, it is important that the monetary authorities do not intend to raise the credit targets in the event that price increases are greater than currently anticipated, especially since achieving the planned reduction in the rate of inflation may be difficult. The staff agrees with the Yugoslav authorities that a firm stabilization program will need to be continued in 1981.

Because of the size of the economic problems and the special institutional features of the Yugoslav economy, a strong effort will be required from the enterprise sector and from the republican and communal authorities as well as from the Federal Government. The evidence of 1979 and actions taken by all parties so far in 1980 suggest an understanding by all that some sacrifices must be made and that policies must be firmly implemented. In the staff's view, there is a full realization in Yugoslavia that the external targets must be achieved and that for the moment they have priority over domestic objectives. The planned improvement in the current account in 1980 is substantial but the authorities rightly recognize that a continued reduction in the deficit must occur in 1981. The staff feels confident therefore that when details of targets and policies for 1981 are determined at the end of the year, they will be such as to continue the priority that is currently being given to the external sector. In this context the consultation with the Fund regarding the 1981 program and the establishment of quantitative performance criteria for that year will have special significance.

In the opinion of the staff, the program described in the annexed letter can be expected to lead to the necessary easing of domestic demand pressures and a marked improvement in the balance of payments situation. In view of the substantial efforts being undertaken by the Yugoslav authorities, the staff feels that Yugoslavia deserves the support of the Fund. Accordingly the following draft decision is proposed for adoption by the Executive Board:

1. The Government of Yugoslavia has requested a stand-by arrangement with supplementary financing for the period from June 6, 1980 to December 31, 1981, for an amount equivalent to SDR 339.325 million.

2. The Fund approves the stand-by arrangement attached to EBS/80/114 and waives the limitation in Article V, Section 3(b) (iii).

Stand-By Arrangement--Yugoslavia

1. Annexed hereto is a letter dated May 16, 1980 from the Minister 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. These consultations may include correspondence and visits of officials of the Fund to Yugoslavia or of representatives of Yugoslavia to the Fund. For the purpose of these consultations, Yugoslavia will provide the Fund through reports at intervals or dates requested by the Fund, with such information as the Fund requests in connection with the objectives and policies set forth in the annexed letter. In particular, Yugoslavia will consult with 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 referred to in paragraph 5 below 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 Yugoslavia has outstanding purchases in the upper credit tranches, the Government will consult with the Fund, from time to time, at the initiative of the Government or at the request of the Managing Director, concerning Yugoslavia's balance of payments policies.

4. During the period from _____ to December 31, 1981, Yugoslavia will have the right, after making full use of any reserve tranche that it may have at the time of making a request for a purchase under the stand-by arrangement, to make purchases from the Fund in an amount equivalent to SDR 339.325 million, provided that:

(a) (i) purchases under the stand-by arrangement shall not, without the consent of the Fund exceed the equivalent of SDR 150 million until November 15, 1980, SDR 200 million until February 15, 1981, SDR 250 million until May 15, 1981, SDR 300 million until August 15, 1981, and SDR 339.325 million until November 15, 1981; and

(ii) the right of Yugoslavia to make purchases under this stand-by arrangement shall be subject to paragraph 5 below to the extent that such purchases would increase the Fund's holdings of dinars beyond the first credit tranche plus 12.5 per cent of quota.

(b) If at any time, any limit in (a)(i) above would prevent a purchase under the stand-by arrangement that would not increase the Fund's holdings of Yugoslavia's currency beyond the first credit tranche plus 12.5 per cent of quota, the limit will not apply to that purchase.

(c) Purchases under this arrangement shall be made with supplementary financing until purchases under the arrangement reach the equivalent of SDR 34.625 million, and then each purchase shall be made from ordinary resources and with supplementary financing in the ratio of 25 to 30.

5. (a) During any period before December 31, 1980 in which:

(i) the limits on the increase in outstanding foreign debt in convertible currencies referred to in paragraph 9 of the annexed letter are exceeded; or

(ii) the targets for the net convertible foreign assets of the National Bank of Yugoslavia, referred to in paragraph 10 of the annexed letter have not been met; or

(iii) the limits on net domestic assets of the banking system referred to in paragraph 15 of the annexed letter have been exceeded; or

(iv) the limits on the net lending of the National Bank of Yugoslavia to the Budget of the Federation referred to in paragraph 15 of the annexed letter have been exceeded; or

(v) the intentions stated in paragraph 17 of the annexed letter are not carried out, the Government of Yugoslavia will not request any purchase under this arrangement except after consulting the Fund and reaching understandings with the Fund regarding the circumstances in which such purchases may be made.

(b) Moreover, during the period of the stand-by arrangement after December 31, 1980, Yugoslavia will not request purchases under the stand-by arrangement unless Yugoslavia has reached understandings with the Fund on its policy intentions and performance criteria in accordance with the last sentence of paragraph 18 of the annexed letter or while the understandings thus reached are not being observed.

6. Purchases under the stand-by arrangement shall be made in the currencies of other members selected in accordance with the policies and procedures of the Fund, and may be made in special drawing rights if, upon the request of Yugoslavia, the Fund agrees to provide them at the time of the purchase. Purchases shall be made in exchange for the currency of Yugoslavia.

7. Yugoslavia will pay a charge for this stand-by arrangement in accordance with the decisions of the Fund.

8. 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 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 8, 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.

9. (a) Repurchase of the outstanding amount of Yugoslavia's currency that results from a purchase under this arrangement and is subject to charges under Article V, Section 8(b):

(i) may be made at any time;

(ii) will be expected normally as the balance of payments and reserve position of Yugoslavia improves;

(iii) shall be made in accordance with the representation of the Fund if, after consultation with Yugoslavia, the Fund represents that under its policies at the time of the repurchase Yugoslavia should repurchase because of an improvement in its balance of payments and reserve position;

(iv) with respect to purchases from ordinary resources, shall be completed five years after the date of the purchase, provided that the repurchase shall be made in equal quarterly installments during the period beginning three years and ending five years after the date of the purchase unless the Fund approves a different schedule; and

(v) with respect to purchases with supplementary financing, shall be completed seven years after the purchase, provided that the repurchase shall be made in equal semiannual installments during the period beginning three and one half years and ending seven years after the purchase.

(b) Any reductions in Yugoslavia's currency held by the Fund shall reduce the amounts subject to repurchase under (a) above in accordance with the principles applied by the Fund for this purpose at the time of reduction provided, however, that a repurchase attributed to a purchase with supplementary financing in advance of the schedule in (a)(v) above shall be accompanied by a repurchase in respect of the purchase from ordinary resources made at the same time if any part of the latter purchase is still outstanding. The amounts of the two repurchases shall be in the same proportions in which ordinary resources and supplementary financing were used in the purchases, provided, however, that the repurchase in respect of the purchase from ordinary resources shall not exceed the amount of the purchase still outstanding.

(c) Repurchase shall be made with special drawing rights, or with the currencies specified by the Fund at the time of the repurchase in accordance with the policies and procedures of the Fund at the time of the repurchase.

Annex to Stand-By Arrangement

Belgrade, Yugoslavia
May 16, 1980

Dear Mr. de Larosière:

1. The Yugoslav economy is passing through a particularly difficult period. The current account of the balance of payments was in deficit by US\$1.3 billion in both 1977 and 1978 and domestic prices were increasing at rates well in excess of 10 per cent. Domestic activity was buoyant, with real gross social product increasing by 7.9 per cent in 1977 and 6.6 per cent in 1978. A relatively rapid rate of growth was considered necessary to prevent a serious problem of unemployment. However, it added to the existing domestic and external pressures. Moreover, as the growth of world economic activity decelerated, various restrictions were placed against important Yugoslav exports in some markets.

2. The Government decided in 1979 that a stabilization effort was required to moderate domestic pressures and to contain the deficit in the current account of the balance of payments to a level that would not require excessive foreign borrowing. Accordingly, the target for the increase in real gross social product was reduced to 6 per cent and the aim was to reduce the general rate of price increase from 15 per cent in 1978 to around 13 per cent in 1979. With regard to the balance of payments, the current account deficit was to be kept to US\$1 billion, which would have implied that the debt service ratio for foreign debt in convertible currencies would remain below 20 per cent. These targets were to be achieved by the implementation of an integrated set of domestic and external policies, which included, inter alia, more restrictive credit policies and an exchange rate policy designed to maintain the external competitiveness of our economy. The stabilization program was supported by a stand-by arrangement with the Fund equivalent to SDR 69.125 million agreed to on May 23, 1979, covering the first credit tranche.

3. For several reasons, the course of events in 1979 deviated from the original plan. We probably had underestimated the underlying pressures on the economy that existed at the end of 1978 and which continued in the first part of 1979. As a result, domestic activity in the first half of the year was higher than we intended. Although additional measures were taken that reduced rates of growth in the second half of the year, the increase in real gross social product in 1979 as a whole is estimated to have been 7.1 per cent, some one percentage point above the target. However, there were important factors, all beyond our control, that prevented us from achieving our other goals. Above all, there was the unexpected and large increase in oil prices. Oil prices for Yugoslavia rose on average from US\$101 per metric ton in 1978 to US\$143 per metric ton in 1979. In addition, natural gas imports increased sharply in 1979, principally in order to fill a newly completed pipeline, while cereal imports increased because of a particularly

poor corn harvest in 1978 and a bad wheat crop in 1979. The value of imports of these three commodity groups was almost US\$1 billion higher than in 1978. Another major exogenous factor was the earthquake in Montenegro in April 1979, which adversely affected tourism not only in that region but also elsewhere; in addition, it reduced exports and necessitated additional imports for reconstruction. These factors, plus depressed deliveries of ships, a major export item, and a virtual cessation of corn exports because of the disastrous 1978 harvest, meant that the current account deficit rose to US\$3.7 billion, leading to a decline of US\$1.3 billion in gross convertible international reserves of the banking system to US\$2 billion at the end of the year, and substantial net foreign borrowing totaling around US\$2.1 billion. The latter, combined with the rise in interest rates, increased the debt service ratio on debt in convertible currencies (excluding purchases from the Fund) from 16.9 per cent in 1978 to 19.5 per cent in 1979.

4. Domestically, higher import prices were an important factor contributing to a rise in the rate of inflation from some 14 per cent in 1978 (year-on-year average for all domestic expenditure) to almost 21 per cent in 1979, although the rate of increase declined in the second half of the year. It was not possible to prevent the increase in prices being largely reflected in increases in personal income payments per employee, but we believe it is significant that these rose by only about 20 per cent compared with the previous year. In this respect, it appears that workers exercised considerable self-restraint in the self-management agreements on income payments.

5. Although many of the reasons for the adverse developments in 1979 were beyond our control, the Government has to face the fact that the deterioration that occurred in the balance of payments must be reversed in 1980. Yugoslavia has therefore decided that policies this year must bring about a substantial reduction in the current account deficit and thereby limit the growth of external debt. To achieve this and to aid in reducing the rate of inflation, a slower growth of domestic activity will be necessary. Therefore, a major stabilization effort has been introduced and will continue until the necessary corrections in the domestic and external sectors have been made. Given the size of the imbalance in 1979, it will not be possible to achieve all of the needed corrections in 1980 and we realize that the effort must continue in 1981. To support the stabilization program, which is described in detail below in respect of the 1980 period, Yugoslavia is requesting a new stand-by arrangement from the Fund for the period up to December 31, 1981 in a total amount equivalent to SDR 339.325 million, including the equivalent of SDR 200.825 million from the supplementary financing facility.

6. Although the stabilization program will extend over both 1980 and 1981, we are convinced that substantial progress must be made in 1980 to reduce the current account deficit. We intend to do everything possible to reduce the deficit to US\$2.0 billion this year and believe that there is a reasonable chance of achieving this. Such a large and rapid reduction might entail too great a disruption to real growth and employment but we are convinced that the current account deficit must not exceed US\$2.5 billion this year with another large reduction in 1981. Thus in 1980, we aim to reduce the

deficit by at least US\$1.2 billion which would be a reduction of at least one third. As a percentage of gross social product, the current deficit would decline as a minimum from 6 per cent in 1979 to below 4 per cent in 1980. A deficit of this size would entail an amount of foreign borrowing that we consider manageable (see below).

7. A major effort will be required to reduce the deficit to the extent sought, but we believe the needed improvement can be made. While part of it will come from larger net invisible receipts, the major adjustment will be on the trade account, where exports must increase strongly and the growth in imports must be sharply reduced. To achieve these results, the pattern of domestic production and expenditure must change so as to release more production for export and to reduce the import intensiveness of domestic output. Under the Yugoslav system of workers' self-management, all enterprises involved in foreign trade must agree among themselves within the Communities of Interest for Foreign Economic Relations on foreign trade plans that will lead to a viable balance of payments. In 1980, enterprises are making a major effort to produce more exportable goods and to substitute domestic products for imports wherever possible. They will be aided by the fact that a number of major development projects have recently been finished, which will reduce the demand for imported investment goods. Moreover, these projects will increase export supplies and permit greater import substitution. Throughout the economy, investment proposals are being re-examined to shift the emphasis for the time being toward projects that require few imports and away from import-intensive projects, especially those not directly related to export production or import replacement. Intensified efforts are being made to increase domestic supplies of raw materials, for example, coal and iron ore, and of intermediate products. Inter alia, this should keep the volume of oil imports, excluding amounts needed to fill a new pipeline, at no more than the 1979 level and possibly less.

8. In addition, in 1980 some of the particular trade difficulties of 1979 should not recur. So far, there is every indication that corn exports will revive and imports of wheat should not be needed to the extent experienced in 1979. Because of past orders, deliveries of ships will increase sharply in 1980 and 1981. The planned growth of gross social product is 2 percentage points less than the outcome in 1979, which will slow down import demand. Although overall world export demand may be weak in 1980, the main Yugoslav export markets are expected to be relatively less affected, and demand in them is expected to be around 6 per cent. Moreover, in 1979 we depreciated the dinar in terms of effective exchange rates by about 8 per cent following a depreciation of 9 per cent in the preceding year. We intend to continue with an exchange rate policy that will maintain our competitive position and we expect to regain some of the market shares lost in recent years. Although its impact in 1980 will be limited, the recently concluded agreement with the European Community should have an increasingly favorable effect on our economic relations with its member countries in the coming years, including 1981. Taking all these factors into account, export volume is forecast to increase by 8 per cent and value by 21 per cent. Import volume should decline by around 9 per cent and the value would increase by some 9 per cent. The forecast turnaround in imports is not out of line with improvements made in previous periods when policies have been directed

toward substantial improvement in the external sector. Workers' remittances should benefit from wage increases in Western Europe and tourism should show a recovery from 1979. Taking all the above into account, a current account deficit of US\$2 billion in 1980 may be possible and it is our firm intention not to exceed a maximum level of US\$2.5 billion.

9. The large deficit in the current account in 1979 necessitated a net increase of foreign borrowing in convertible currencies of US\$2 billion and at the end of that year the outstanding level of such debt was US\$13.5 billion, of which US\$12.8 billion had an original maturity of more than one year. During 1979, there was a refinancing of debt totaling around US\$0.8 billion and the conditions attached to the new credits generally provided for grace periods of three years and maturities of the order of 8-10 years. We intend to continue to pay careful attention to the terms of new foreign borrowing so as to avoid sharp peaks in servicing schedules, especially since, partly as a result of the rise in interest rates, the debt service ratio for convertible foreign debt, excluding purchase from the Fund, reached 19.5 per cent in 1979. To prevent a debt service problem from emerging and consistent with the maximum projected current account deficit for 1980, outstanding foreign debt in convertible currencies with original maturities of more than one year, (excluding purchases from the Fund) which stood at US\$12.3 billion at the end of 1979, will not exceed US\$14.7 billion by the end of 1980 (based on exchange rates current on December 31, 1979 and excluding net exceptional financing during 1980). To ensure orderly borrowing during the year, quarterly limits on the outstanding amounts have been set as follows: no more than US\$13.6 billion on June 30, 1980, US\$14.2 billion on September 30, 1980, and US\$14.7 billion on December 30, 1980.

10. As mentioned earlier, during 1979 the gross convertible international reserves of the banking system declined and in 1980 they will need to be built up again. It is our intention to increase the gross convertible reserves of the National Bank of Yugoslavia by at least US\$0.7 billion during 1980. This will necessitate a continuation of exceptional financing by the commercial banks, which has involved borrowing abroad in convertible currencies to maintain the level of the international reserves. In 1979, such borrowing totaled US\$250 million. To ensure an adequate level of liquidity in convertible currencies, the net convertible foreign assets of the National Bank of Yugoslavia less exceptional financing in convertible currencies by the commercial banks, which declined by US\$1,702 million in 1979 will show no further decline by the end of 1980. Consistent with this target for end-1980, and allowing for the expected pattern of net foreign borrowing and for the seasonal movements in the current account deficit, targets have been established providing for a decline of no more than US\$900 million by June 30, 1980 and no more than US\$500 million by September 30, 1980.

11. If the various balance of payments targets are to be achieved, policies must ensure that domestic activity is not too expansionary. To ensure such consistency, it has been decided to reduce the planned increase in real gross social product to 5 per cent in 1980 and to aim for a reduction in the gross social product deflator to 17 per cent compared with 20 per cent in 1979. All categories of domestic demand are planned to show smaller increases in real terms--the growth of personal consumption will decelerate from 5.5 per cent to 3.8 per cent, public consumption from 5.9 per cent to 2.1 per cent, and fixed capital formation from about 8 per cent to 5.8 per cent.

12. The achievement of these targets will require an intensified restraint by all sectors of the economy--the public and enterprise sectors in particular. In this regard, we would point out that self-management agreements covering such factors as prices and personal income payments were implemented in a responsible and effective manner in 1979 and, with increasing experience with the new system, it is expected that it will operate even more effectively in 1980. The Government is convinced that a strong consensus exists in Yugoslavia that all decisions taken in the economic field should reflect the economic aims enunciated in the stabilization program.

13. In some recent years there has been the tendency for public sector consumption to grow more rapidly than social product, and in all years the Federal Government has borrowed from the National Bank of Yugoslavia. The ratio of public sector expenditure to gross social product rose from about 36 per cent in 1973 to about 43 per cent in 1978. In 1979, however, this ratio declined to about 41 per cent. For the federal budget, expenditure in 1979 rose by 25 per cent compared with increases of 29 per cent in revenue and 28 per cent in nominal gross social product. The deficit declined from Din 5.3 billion in 1978 to Din 3.8 billion in 1979. For the public sector as a whole, there was virtually no deficit in 1979. For 1980, the intention is that the public sector will continue to grow more slowly than social product, although budget expenditure by the Federation will increase by 29 per cent. The deficit of the federal budget will rise to Din 6.2 billion but this is equivalent to only 0.4 per cent of gross social product. Gross borrowing from the National Bank will rise only fractionally (from Din 8.5 billion in 1979 to Din 9.2 billion in 1980), which is much less than the increase in expenditure. Current expenditure by the public sector as a whole is to increase by no more than 16 per cent.

14. Monetary policy is an important part of the stabilization program, since an excess supply of financial assets could weaken the implementation of other elements in the program. In 1978 there was an excessive rate of increase of money supply, which rose by 28 per cent and in 1979 strong steps were taken to decelerate monetary expansion, the target for the increase in money supply in that year being set at 18 per cent. In the first months of the year the demand for credit continued strongly and the National Bank had to take special measures to limit the expansion by imposing strict credit limits on the commercial banks and by reducing demand for consumer credits by raising down-payment provisions. These measures were effective, so much so that some relaxation was necessary in the second half of the year when the loss of liquidity of the commercial banks resulting from the continued external deficit threatened an abrupt decline in enterprise activity. At the end of 1979, money supply was only 17 per cent higher than a year earlier. Also, despite the need to counteract some of the liquidity loss caused by the external deficit, the rate of domestic credit creation was 27 per cent in 1979 compared with 30 per cent in the previous year.

15. For 1980, we consider that money supply should rise broadly in line with the reduced rate of growth of nominal social product. To that end, and given the planned balance of payments targets, the increase in money supply will be kept to 22 per cent and the increase in net domestic assets of the banking system to 22 per cent. To ensure that money supply does not increase excessively in the first half of the year, thereby prejudicing the whole year result, limits have been set within the year on net domestic assets of the

banking system, which totaled Din 1,201 billion on December 31, 1979. They are not to exceed Din 1,321 billion on June 30, 1980, Din 1,381 billion on September 30, 1980, and Din 1,466 billion on December 31, 1980. To ensure that lending by the National Bank of Yugoslavia to the budget of the Federation does not compromise the overall credit program, such net lending in 1980 is not to exceed Din 9.2 billion. As with total domestic credit creation, sublimits have been established within the year. Such credits to the federal budget, which totaled Din 68.7 billion on December 31, 1979, are not to exceed Din 76.4 billion on June 30, 1980, Din 77.4 billion on September 30, 1980, and Din 77.9 billion on December 31, 1980.

16. Detailed quantitative economic targets for 1981, including targets for increases in domestic credit, foreign borrowing and the net foreign assets of the National Bank of Yugoslavia cannot be established at this stage. However, as mentioned above, the Government is determined to continue with the stabilization program next year. Also, it intends to continue to give first priority to a further improvement in the balance of payments. Domestic policies in all fields will be formulated to maintain and if necessary strengthen the current measures of restraint. On the basis of a preliminary examination of the possible 1981 Plan, domestic activity would grow no faster and perhaps somewhat more slowly than is planned for 1980. Externally, the planned current account deficit of the balance of payments will decline further, perhaps to around US\$1.8 billion.

17. The Government of Yugoslavia does not intend to introduce any multiple currency practices or introduce new or intensify existing restrictions on payments and transfers for current international transactions or enter into any bilateral payments arrangements with Fund members; furthermore, the Government of Yugoslavia does not intend to introduce new restrictions or intensify existing restrictions on imports for balance of payments reasons.

18. The Government believes that the policies set forth in this letter are adequate to achieve the objectives of its program, but will take any further measures that may become appropriate for this purpose. The Government of Yugoslavia will consult with the Fund on the adoption of any measures that may become appropriate, in accordance with the policies of the Fund on consultations. Moreover, the Yugoslav authorities will consult with the Fund and reach understanding on the quantitative aspects of the program relating to the period of the stand-by arrangement subsequent to December 31, 1980.

Yours sincerely,

(Ksente Bogoev)
Governor, National Bank of Yugoslavia

(Ing. Petar Kostic)
Federal Secretary for Finance

Mr. J. de Larosière
Managing Director
International Monetary Fund
WASHINGTON, D. C. 20431