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CONFIDENTIAL

February 2, 1981

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 Executive Board Meeting 81/16, January 30, 1981.

Att: (1)

Stand-By Arrangement--Yugoslavia

Annexed hereto is a letter dated January 15, 1981 from the Governor of the National Bank of Yugoslavia and the Federal Secretary for Finance of Yugoslavia requesting a stand-by arrangement and setting forth:

(i) the objectives and policies that the authorities of Yugoslavia intend to pursue for the period of the stand-by arrangement;

(ii) the policies and measures that the authorities of Yugoslavia intend to pursue for the first year of the stand-by arrangement; and

(iii) the understandings of Yugoslavia with the Fund regarding reviews that will be made of progress in realizing the objectives of the program and of the policies and measures that the authorities of Yugoslavia will pursue for the second and third years of the stand-by arrangement.

To support these objectives and policies, the International Monetary Fund grants this stand-by arrangement in accordance with the following provisions:

1. For a period of three years from January 30, 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 this arrangement, to make purchases from the Fund in an amount equivalent to SDR 1,662 million, subject to paragraphs 2, 3, and 4 below, without further review by the Fund.

2. a. Until December 31, 1981, purchases under this arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 544 million, provided that purchases shall not exceed the equivalent of SDR 176 million until May 15, 1981, the equivalent of SDR 302 million until August 15, 1981, and the equivalent of SDR 428 million until November 15, 1981. Until December 31, 1982, purchases under the stand-by arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 1,108 million. The right of Yugoslavia to make purchases during the second and third years shall be subject to such phasing as shall be determined. None of these limits shall apply to 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.

b. Purchases under this arrangement shall be made from ordinary resources until purchases under the arrangement reach the equivalent of SDR 53.28 million, and then each purchase shall be made from ordinary resources and from supplementary financing in the ratio of 1 to 1.2 until purchases under this stand-by arrangement reach SDR 605.22 million, and thereafter wholly from supplementary financing.

3. Yugoslavia will not make purchases under this arrangement that would increase the Fund's holdings of its currency beyond the first credit tranche plus 12.5 per cent of its quota:

a. During any period before December 31, 1981, in which:

(i) the limits on net domestic assets of the banking system referred to in paragraph 22 of the annexed letter have been exceeded; or

(ii) the limits on the net lending of the National Bank of Yugoslavia to the Budget of the Federation referred to in paragraph 22 of the annexed letter have been exceeded; or

(iii) the targets for the net convertible foreign assets of the National Bank of Yugoslavia, referred to in paragraph 24 of the annexed letter have not been met; or

(iv) the limits on the increase in outstanding foreign debt in convertible currencies referred to in paragraph 25 of the annexed letter are exceeded; or

b. throughout the second and third years if suitable performance clauses have not been established in consultation with the Fund as contemplated in paragraph 28 of the annexed letter or such clauses, having been established, are not being observed; or

c. throughout the duration of the arrangement if Yugoslavia:

(i) imposes or intensifies restrictions on payments and transfers for current international transactions; or

(ii) introduces or modifies multiple currency practices; or

(iii) concludes bilateral payments agreements which are inconsistent with Article VIII; or

(iv) imposes or intensifies import restrictions for balance of payments reasons.

When Yugoslavia is prevented from purchasing under this arrangement because of this paragraph 3, purchases 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.

4. Yugoslavia's right to engage in the transactions covered by this arrangement 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 4, purchases under this 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.

5. Purchases under this 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 SDRs if, on the request of Yugoslavia, the Fund agrees to provide them at the time of the purchase.

6. Yugoslavia shall pay a charge for this arrangement in accordance with the decisions of the Fund.

7. a. Yugoslavia shall repurchase the amount of its currency that results from a purchase under this arrangement, and is subject to charges under Article V, Section 8 (b), in accordance with the provisions of the Articles of Agreement and decisions of the Fund, including those relating to repurchase as Yugoslavia's balance of payments and reserve position improves.

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 the reduction.

8. During the period of the arrangement, Yugoslavia shall remain in close consultation with the Fund. These consultations may include correspondence and visits of officials of the Fund to Yugoslavia or of representatives of Yugoslavia to the Fund. Yugoslavia shall provide the Fund, through reports at intervals or dates requested by the Fund, with such information as the Fund requests in connection with the progress of Yugoslavia in achieving the objectives and policies set forth in the attached letter.

9. In accordance with paragraph 28 of the annexed letter, Yugoslavia will consult the Fund on the adoption of any measures that may be appropriate at the initiative of the Government, or whenever the Managing Director requests consultation, because any of the criteria under paragraph 3 above have not been observed, or because he considers that consultation on the program is desirable. In addition, after the period of the 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.

Belgrade, Yugoslavia

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January 15, 1981

Dear Mr. de Larosière:

1. As you are aware, the Yugoslav economy has been facing a difficult period in recent years for a number of reasons, both internal and external. Among the latter have been the sustained and large increase in prices of petroleum and other imported raw materials and the low growth of world demand. Internally, our desire to increase employment opportunities led to excess demand in the economy. The result was an increase in the rate of inflation and the emergence of an unsustainable deficit in the current account of the balance of payments, which reached US\$3.7 billion in 1979, equal to about 6.0 per cent of gross social product.

2. In 1980 a strong stabilization program was introduced with a major aim of reducing substantially the current account deficit and the rate of inflation. The program included a comprehensive set of domestic and external economic policies. In our letter of May 16, 1980, we described the program in detail and in support of it we requested on behalf of the Federal Executive Council of the Socialist Federal Republic of Yugoslavia a stand-by arrangement in an amount equivalent to SDR 339.325 million for the period until December 31, 1981. On June 6, 1980 the Fund agreed to the requested stand-by arrangement.

3. As described below, we believe that considerable success has already been achieved, especially as regards the elimination of excess domestic demand and the improvement in the balance of payments. However, it was realized at the time the stand-by arrangement was requested that a full solution to our economic problems would take several years to achieve. Also, developments in the world economy, including further significant increases in prices of a number of important raw materials and continued weakness in demand in many foreign markets important to us, have not been favorable. Finally, the adjustment process in our economy will require structural changes in the pattern of production and investment to increase the supply of goods for export and import replacement. It will inevitably take several years for the results of our policies to become fully effective and, in this period, Yugoslavia would like to have the support of Fund resources. In these circumstances, the Government wishes to cancel the present stand-by arrangement with the Fund and requests a new stand-by arrangement in an amount equivalent to SDR 1,662 million for the period ending December 31, 1983 to support the economic program described below. With respect to the year 1981, the first year of the 1981-85 Five-Year Plan, policies are described in considerable detail. For the two subsequent years, the major outlines of policies are given. We emphasize that when the detailed annual targets and policies for these years are determined, they will be fully consistent with the aims of the stabilization effort, namely to bring about a situation in which the economy can achieve satisfactory domestic growth, with greater price stability and a sustainable balance of payments.

4. As you are aware, we believe that one reason for the large external deficits of 1977-79 was excess domestic demand. The program for 1980, therefore, provided for a sharp reduction in all components of domestic expenditure, but particularly investment, which had become excessive and in some instances inefficient. Initially, the target for the growth of real GSP was set at 5 per cent, compared with 7 per cent in 1979. During

the year, we decided that it would be necessary to reduce the growth rate even further so as to ensure that the external target of a current account deficit of around US\$2.0 billion was reached. Consequently the target for the growth in real GSP was reduced to 4.0 per cent and the increase is now expected to be 3.0-3.5 per cent. Total domestic demand is expected to increase in real terms by less than 2.0 per cent. Real private consumption in 1980 will rise by only 0.5 per cent, while real public sector expenditure will decline substantially. Real fixed investment is expected to decline by about 1.5 per cent. These trends in the domestic economy reduced import demand and increased export supplies with the result that the deficit on the current account of the balance of payments is expected to be of the order of US\$2.0 billion, equal to about 3.5 per cent of GSP. Overall, we believe the economy has adjusted well to the changed pattern of production and use of resources.

5. We consider that these results constitute a major achievement. An important contributing factor has been very considerable wage restraint, with real personal incomes per employee declining by about 7.0 per cent compared with 1979 thus helping restrain the growth of personal consumption. Similarly, expenditure by the public sector is estimated to have declined in real terms.

6. The area in which we have had least success is prices. Originally, we hoped that it would be possible to reduce the GSP deflator from 21 per cent in 1979 to 17 per cent in 1980. In the event, the rate of price increase has accelerated and retail prices in November 1980 were 37 per cent higher than in November 1979, and the GSP price deflator will be about 30 per cent in 1980. However, as explained in paragraph 17, there were special factors accounting for this acceleration.

7. As mentioned above, the deficit on the current account of the balance of payments was reduced substantially in 1980. Exports rose in dollar value terms by about 31 per cent and in volume by 10-11 per cent. In contrast, the value of imports rose by only 6 per cent and their volume fell by 11 per cent. The result is that the trade deficit declined by more than US\$1.2 billion in 1980 to about US\$6 billion. Net invisible receipts increased because of higher receipts from tourism and workers' remittances and despite a sharp rise in interest payments. On capital account we faced a number of difficulties in the first half of the year, some of them noneconomic, but in the second half we made determined efforts to obtain foreign financial credits in addition to the normal flow of trade-related credits. As a result, the net inflow of medium- and long-term capital reached about US\$1.7 billion. This, plus some net US\$0.3 billion in compensatory foreign borrowing by the commercial banks, permitted the gross convertible international reserves of the National Bank of Yugoslavia (with our 1,855 million fine ounces of gold valued at SDR 35 per fine ounce) to increase during 1980 by about US\$0.2 billion to reach about US\$1.5 billion at the end of the year. In addition, gross convertible foreign exchange holdings of the commercial banks rose by US\$0.4 billion to about US\$1.1 billion. We should point out, however, that the international reserves are still at an unsatisfactorily low level. At the end of 1978, those of the National Bank of Yugoslavia stood at US\$2.5 billion and since then the size of our external transactions has risen substantially. The official convertible international reserves are currently equal to about only one month of imports of goods and services from the convertible area.

8. We believe that the external improvement illustrates the strong effort that has been made to stabilize the economy. The elimination of excess internal demand released export supplies. Internally, Organizations of Associated Labor have acted individually, and jointly through our system of social compacts to become less import-intensive in their production. The decrease in the volume of investment also reduced demand for imported equipment. The depreciation of the exchange rate of the dinar, including the large depreciation in June 1980, improved the external competitiveness of the Yugoslav economy. It is noteworthy that our export improvement was achieved in a time when many of our foreign markets were expanding slowly.

9. The very large deficit of 1979 and the considerably smaller one of 1980 have increased our foreign indebtedness. As a result, the ratio of foreign debt service payments on medium- and long- debt to gross receipts from goods and services rose from 14.9 per cent in 1978 to around 18 per cent in 1980. If debt and receipts in convertible currencies only are considered, the increase is from 16.9 per cent to 20.4 per cent. However, the foreign debt situation remains manageable and we are determined to continue to reduce our borrowing requirements and reverse the increase in the debt service ratio.

10. We shall now describe the policies that Yugoslavia intends to follow in the next several years to continue the improvements achieved in 1980. They comprise both short-term policies of demand management and policies designed to change the structure of the economy, with special emphasis toward obtaining a pattern of output and demand that will permit a gradual return to higher growth rates without compromising the continued improvement in the balance of payments. These structural changes are particularly necessary since the economy cannot continue for any lengthy period with rates of growth as low as were required in 1980 if adequate increases in employment are to be attained. Necessarily, the process of structural change is gradual and it is for this reason that we are requesting Fund support over the next three years. The implementation of policies embodied in the 1981-85 Five-Year Plan will be the main vehicle for achieving the desired structural changes.

11. Before describing individual targets and policies, it may be useful to make some general comments on the Yugoslav system of planning and policy-making. It is basic to the system that targets and policies represent a consensus between all sectors, including the various levels of government and the sector of Organizations of Associated Labor. The implementation of agreed policies is frequently made through the mechanism of social compacts whereby those party to them accept the obligation to act individually in a way that will achieve joint aims. At times in the past, the working of the system may have seemed somewhat slow but we are convinced that the results achieved in 1980 are evidence that it is now working effectively and will continue to do so. Another important feature of our planning system is its flexibility. The Five-Year Plan establishes targets and policies. However, these are implemented through the Annual Plans and the latter must be pragmatic and able to react to the particular economic environment and needs that exist in each calendar year. Thus, the quantification of targets in an Annual Plan is done only in the final months of the preceding year. We should, however, emphasize that the stabilization of the economy is a fundamental basis of the 1981-85 Plan and the Annual Plans will include

policies in all areas that are appropriate for the achievement of external and internal stability. The elaboration of the 1981-85 Plan is in its final stages and we expect it to be completed by about March 1981. While the various targets mentioned below are preliminary and subject to change, we do not expect that any changes will be major. Final details of the 1981-85 Plan will be described to the Fund in the course of consultations later in 1981.

12. Within the 1981-85 Plan, the balance of payments will continue to have priority, since a further reduction in the current account deficit and net foreign borrowing is necessary. We have set a target for the cumulative deficit on current account for the five years of around US\$6 billion. Of necessity this figure must be regarded as somewhat tentative, since it is in current prices and the outcome will depend in part on developments in world prices. Our assumption is that the average annual increase in dollar prices in our foreign trade will be around 10 per cent. As explained below, we are aiming at a current account deficit of US\$1.8 billion in 1981 and we hope that it will be possible to reduce this to some US\$700-800 million by 1985.

13. The attainment of such an outcome will depend on developments in both the trade and services accounts. Our working assumption is that the volume of exports of goods will need to increase at an average rate of 8 per cent per annum and imports of goods at an average rate of around 3 per cent per annum. If these growth targets can be met, the coverage of import requirements by exports would rise from 51 per cent in 1979 and 57 per cent in 1980 to around 70 per cent in 1985. We expect that the value of receipts from services will increase at a somewhat slower rate than that of merchandise exports. On the basis of the above import growth and unless there are unanticipated adverse movements in the terms of trade, we believe it will be possible to realize an average annual rate of growth of real GSP of between 4.0-4.5 per cent over the five years 1981-85. As described below, for the first year, 1981, the planned growth rate will be below the average but we hope that in subsequent years there can be an acceleration so that by the end of the Plan period the rate will be around 5 per cent.

14. There are various preconditions that must be met if the above targets are to be reached. Obviously, the supply of saleable exports and import substitutes, especially in the energy field, must increase. This will necessitate a change in the structure of investment and production. Priority sectors have already been decided upon and in the 1981-85 Plan investment and production targets are being set accordingly. As a result, growth rates of production in the sectors of energy, basic metals and chemicals will increase by about 7 per cent per annum, compared with a rate of 5 per cent for industry as a whole. The planned increase in agricultural output is 4.5 per cent per annum, about twice the average rate of the last five years. Equally, the noneconomic sectors will receive proportionately less investment resources than in the past. The growth of domestic demand will be kept within limits that permit adequate domestic savings with only a modest addition required from foreign borrowing. Domestic policies in the monetary, fiscal, personal incomes, and prices fields will be tailored to keep domestic demand within the necessary limits. Exchange rate policy will be implemented to ensure that the Yugoslav economy is competitive and our external commercial policies will

emphasize the need to expand export sales. Finally, we remain committed to greater participation in the international division of labor. It is our intention to contain the growth rate of imports not by administrative restrictions, but through the increase of fully competitive domestic production.

15. Since the large increase in the cost of imported petroleum has been a major factor in the worsening of the balance of payments, particular attention is being given to the energy sector. Already, prices of all kinds of energy have been increased in line with the rise in the price of oil. Measures to cut the use of gasoline have been introduced, including bans on the use of automobiles on six days each month. In the 1981-85 Plan, emphasis is being given to investment in coal and hydroelectricity and oil exploration will continue. It is estimated that by 1985, the share of petroleum as a source of total energy will be 39 per cent, compared with 42.5 per cent in 1979.

16. The 1981 Annual Plan implements the medium-term objectives outlined above. We intend to continue with targets and policies similar to those successfully operated in 1980, although in some areas the restrictiveness of policies will be less severe than in the latter year. In real terms, GSP is planned to rise by about 3 per cent in 1981, which is not greatly different than the rate recorded in 1980, but considerably below the average rate of more than 7 per cent per annum in 1977-79. Real gross domestic expenditure should not change; a decline of 5 per cent in fixed investment would largely offset an increase of 2.5 per cent in real private consumption. The stability of domestic expenditure compared with the growth of GSP, combined with a further decline of 3 per cent in the volume of imports of goods and services, would permit an increase in the volume of exports of goods and services of 7 per cent. After allowing for price changes, this would imply a reduction in the current account of the balance of payments to US\$1.8 billion, or the equivalent of 2.5 per cent of GSP.

17. In 1981, we believe that it will be possible to reduce the rate of inflation. In 1980 price developments were the least satisfactory element in the economy, but although the increase of about 37 per cent was much greater than we would wish, there were several mitigating factors. First, the original target did not anticipate the need for the large depreciation of the exchange rate of the dinar in June 1980. Second, world prices of imports of petroleum and other raw materials increased by much more than we expected. Finally, during the course of the year, we decided it was essential to increase the prices of some important goods and services, including energy, to provide sufficient incentives for increased domestic supplies. We estimate that at a constant exchange rate and constant foreign prices, the rate of inflation would have been only half the actual figure and that perhaps about half of the remainder resulted from the above-mentioned structural price adjustments. In 1981, some of the above factors should not operate so adversely. In particular, we do not currently foresee the needs for a large depreciation of the exchange rate of the dinar or major structural price changes. As in 1980, there should not be excess domestic demand. The biggest problem will probably be in the area of import prices, especially of oil. Here, there are many uncertainties, so much so that the 1981 Economic Resolution does not include a specific price target, although we are aiming for a considerably slower rate of increase of prices than in 1980. For some operative purposes, however, a working hypothesis is necessary. A cautious assumption

of an increase of 20 per cent between the beginning and end of the year has been made. It is realized that a higher rate of inflation is possible and if this is so, it will have implications for other policies, in particular credit policy. However, we consider it is desirable to be cautious from the beginning and face the possible need for adjustment rather than the reverse. Similarly, although no specific price targets have been set for 1982-85, we are planning a deceleration in the rate of increase of prices during these years.

18. Incomes policy was particularly effective in 1980. The Economic Resolution of the Federation for that year established that the increase in total nominal personal income payments should be 5 percentage points less than the increase in nominal GSP. Within this reduction, the shortfall of nominal personal incomes within the noneconomic sector, e.g., in financial services and administration, was to be 7-9 percentage points. On the basis of the latest available data, nominal personal income per employee in 1980 will be about 21 per cent greater than in 1979, meaning that real personal income per employee will decline by about 7 per cent. Moreover, implicit payments to workers by way of collective consumption were limited to an increase of 14 per cent in the economic sector and only 10 per cent in the noneconomic sector. It is expected that these limits will not be exceeded, which means that in real terms this element of income will have declined even more sharply than direct personal income payments. Besides contributing to the sharp slowdown in the growth of personal consumption, these trends strengthened self-financing for investment of Organizations of Associated Labor. For 1981, a further reduction in real personal income would be inappropriate. Accordingly, the basic aim will be to permit a modest increase in real personal income payments per employee of 1.3-1.5 per cent, which is in line with the expected increase in productivity.

19. In our letter of May 16, 1980 we described our efforts to reduce the relative importance of public sector expenditures in general and borrowing by the Budget of the Federation from the National Bank of Yugoslavia in particular. In the 1980 Economic Resolution of the Federation, it was stated that public sector expenditure was not to increase by more than 16 per cent. With the much faster rate of inflation, nominal public sector expenditure rose by more than planned. However, although precise data are not yet available, we expect that there will be a significant decline in real expenditure since real personal income payments and investment in the public sector have decreased sharply. The outcome of the Budget of the Federation may be worse than originally planned because of the elimination of the 10 per cent import surcharge and a shift in the pattern of imports away from those subject to high rates of customs duties. Total revenue will therefore be less than planned, and the deficit may exceed the original forecast of Din 6 billion. However, any additional financing requirement will not come from the National Bank of Yugoslavia, but from the commercial banks within their existing credit ceilings.

20. For 1981 there will be a virtual prohibition on new investment projects in the public sector and total expenditure in the sector will be kept 4-5 percentage points below the increase in nominal GSP. For the Budget of the Federation, there will be an important increase in revenue since the Federation will receive 68 per cent of customs duties instead of 42 per cent in

1980. The remaining portion accrues to the Communities of Interest for Foreign Economic Relations of the republics and autonomous provinces. Principally because of this factor, the proposed deficit will be only Din 1.1 billion and borrowing from the National Bank of Yugoslavia will be reduced from Din 9.2 billion in 1980 to Din 4.6 billion, of which Din 3.0 billion will be used to amortize bonds held by the commercial banks. Guidelines in the draft 1981-85 Plan provide that public sector expenditure should continue to increase more slowly than nominal GSP and that reliance on borrowing from the National Bank of Yugoslavia should be eliminated.

21. Monetary policy has always been an important part of stabilization efforts since an excess supply of financial assets could weaken the implementation of other policies. For 1980, the original target for the increase in money supply between December 1979 and December 1980 was 22 per cent, which was the expected growth of nominal GSP. The actual increase in nominal GSP has been more than 30 per cent, but we have resisted requests to permit corresponding increases in the money supply and the final increase was only about 24 per cent. Domestic credit expansion, at 28 per cent, exceeded the original target of 22 per cent but this does not represent a failure of credit policy. Among the factors causing the acceleration was the fact that a significant part of foreign borrowing that was originally planned to be made directly by the Organizations of Associated Labor was finally made by the National Bank of Yugoslavia. The shortfall in planned foreign borrowing by the Organizations of Associated Labor was replaced by domestic credit from the banking system but this did not of itself raise money supply above planned levels. Also, the book value of domestic credits denominated in foreign exchange increased following the June 1980 depreciation. National Bank of Yugoslavia's lending to the Budget of the Federation did not exceed the original planned level of Din 9.2 billion.

22. For 1981 we intend to continue with a tight monetary policy. We start from the assumption that there is no excess liquidity in the economy at present. On this basis we consider that it would be prudent to have the money supply increase by several percentage points less than the rate of increase of nominal GSP. We are therefore planning an increase of 22 per cent in money supply, compared with a forecast increase of 24 per cent in nominal GSP. Consistent with this target, the expected decline in net foreign assets of the banking system and the increase in quasi-money assets, the increase in credit during 1981 has been set at Din 345 billion, or 22 per cent. Based on normal seasonal patterns and the fact that the rate of inflation is expected to decelerate during the course of 1981, the cumulative increase from December 31, 1980 in the net domestic assets of the banking system, which on September 30, 1980 totaled Din 1,448 billion, and which are estimated to have amounted to Din 1,538 billion on December 31, 1980 is not to exceed Din 96 billion on March 31, 1981, Din 179 billion on June 30, 1981, Din 259 billion on September 30, 1981, and Din 345 billion on December 31, 1981. As mentioned in paragraph 20 lending by the National Bank of Yugoslavia to the Budget of the Federation is to be limited in 1981 to a total of Din 4.6 billion. In line with seasonal requirements, all of this amount will be utilized by March 31, 1981. In setting the monetary targets we have made a conservative assumption regarding price increases. Should our assumptions substantially underestimate the increases that actually occur, we may be

obliged to re-examine our monetary targets if planned economic activity is seriously affected. However, we would emphasize that nothing will be done in the monetary field that would prejudice the attainment of the overall objectives of the stabilization program, especially in the external sector. Beyond the end of 1981 it is not possible to establish at this time quantitative targets for monetary expansion. However, as was the case in 1980 and as is planned for 1981, we intend to continue with firm monetary policies that will support the stabilization program. In particular, it is expected that the rate of increase of money supply will be less than the rate of increase of nominal GSP.

23. In the past, interest rates have played a relatively modest role in resource allocation in Yugoslavia although there have been selective differentiations to aid certain sectors and regions. Even before the sharp acceleration in the rate of inflation, some real interest rates were negative and none were high. It is now believed that a more active interest rate policy is desirable, especially since in the 1981-85 Plan much more emphasis is to be placed on directing investment into the most productive sectors. Accordingly, the banking system is currently preparing proposals for presentation to the Federal Executive Council of the Socialist Federal Republic of Yugoslavia that will be designed to increase the effectiveness of interest rates in resource allocation. The final form of the proposals is still to be decided and their implementation cannot take place until part way into 1981. However, it is expected that they will include increases in the average level of interest rates paid by banks and charged by them. It would be difficult at the current levels of inflation to have the large increases in interest rates needed to make them positive in real terms. Rather we would aim at obtaining positive real interest rates through a combination of raising nominal interest rates and reducing the rate of inflation. The measures that will be introduced in 1981 represent a first step in this process and it is our intention to continue to examine the system of interest rates in the light of experience over the program period.

24. As mentioned above, the target for the current account of the balance of payments in 1981 is a deficit of US\$1.8 billion, equal to about 2.5 per cent of GSP. The forecast assumes that the dollar value of exports will rise by 19 per cent (7 per cent in volume) and imports by 14 per cent (a decline of 3 per cent in volume). Under these assumptions, the trade deficit would remain at about US\$6.0 billion, while net invisible receipts are expected to rise by about US\$0.4 billion. On capital account, after allowing for gross receipts from trade-related credits, including those available under bilateral payments agreements, World Bank credits, the net outflow because of trade credit extended by Yugoslavia and debt repayments, there will be a deficit of about US\$1.8 billion to be financed by financial credits from various sources. The Yugoslav commercial banks are expected to obtain net about US\$400 million. The remainder will need to be obtained through net foreign borrowing by the National Bank of Yugoslavia and the requested use of Fund credit. Our aim is to maximize borrowing by the National Bank of Yugoslavia so that some short-term foreign debt can be repaid and so that part of purchases under the standby arrangement can be used to increase the gross official international reserves from their present low level. To this end, we have set targets for the change in net convertible foreign assets of the National Bank of Yugoslavia, excluding its medium- and long-term borrowing other than purchases from the

Fund, and less the increase in compensatory borrowing by the commercial banks. During 1981, the net decline in these convertible foreign assets will not exceed US\$750 million. Consistent with this target and allowing for the seasonal pattern in the balance of payments, targets have been established for a decline of no more than US\$150 million by March 31, 1981, US\$350 million by June 30, 1981, US\$550 million by September 30, 1981, and US\$750 million by December 31, 1981.

25. The current account deficit in 1980 necessitated further net foreign borrowing in convertible currencies. On September 30, 1980, the total of such debt outstanding was US\$16.0 billion, of which US\$13.7 billion had a maturity of more than one year. It is estimated that at the end of 1980 the corresponding data were about US\$16.4 billion, and about US\$14.1 billion, respectively. The ratio of debt service for medium- and long-term convertible foreign debt (excluding purchases from the Fund) to receipts in convertible currencies from exports of goods and services rose from 16.5 per cent in 1979 to 20.4 per cent in 1980. Further net borrowing will be needed in 1981, but to maintain a sound debt servicing position we intend to limit the increase in convertible debt with maturities of more than one year, including borrowing by the National Bank of Yugoslavia but excluding compensatory borrowing by the commercial banks and purchases from the Fund, to no more than US\$1.7 billion during 1981 (based on exchange rates current on December 31, 1980). Semiannual cumulative limits have been set as follows: no more than US\$1.0 billion on June 30, 1981 and US\$1.7 billion on December 31, 1981.

26. Detailed quantitative targets for the balance of payments for 1982 and 1983 cannot be established at this stage. However, we should reiterate that the Federal Executive Council of the Socialist Federal Republic of Yugoslavia will continue to give priority to further reductions in the current account deficit. Domestic and external policies will be formulated to this end.

27. The Federal Executive Council of the Socialist Federal Republic 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 Federal Executive Council of the Socialist Federal Republic of Yugoslavia does not intend to introduce new restrictions or intensify existing restrictions on imports for balance of payments reasons.

28. The Federal Executive Council of the Socialist Federal Republic of Yugoslavia believes that the policies set forth in this letter are adequate to achieve the objectives of its program but will take any measures that may become appropriate for this purpose. The Yugoslav authorities will consult with the Fund and reach understandings before, or shortly after, the beginning of the second and third years of the program with regard to the program relating to the second and third years of the stand-by arrangement. In

addition, the Federal Executive Council of the Socialist Federal Republic of Yugoslavia will consult with the Fund, in accordance with the Fund's policies on consultations on the adoption of any measures that may become appropriate.

Yours sincerely,

/s/

Ksente Bogoev
Governor, National Bank of Yugoslavia

/s/

Ing. Petar Kostic
Federal Secretary for Finance