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EBS/82/181  
Correction 1

CONFIDENTIAL

November 9, 1982

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

The following corrections have been made in EBS/82/181  
(10/7/82):

Page 1, para. 1, line 5: for "(SDR 1,357,8)" read "(SDR 1,357.8 million)"

Page 2, footnote 2, line 4: for "prices in U.S. terms" read "prices in  
U.S. dollar terms"

Page 4, footnote 1, line 3: for "exclude personnel income" read "exclude  
personal income"

Page 12, 2nd full para., line 5: for "US\$1.8 billion" read "US\$850 million"

Page 14, para. 2, line 6: for "may be but little stronger" read "may be  
little stronger"

Page 19, column 4, heading: for "Estimate 2/" read "Estimate 1/"

Page 20, column 4, heading: for "Estimate" read "Estimate 1/"

Corrected pages are attached.

Att: (7)



CONFIDENTIAL

INTERNATIONAL MONETARY FUND

YUGOSLAVIA

Stand-By Arrangement: Review of Developments

Prepared by the European Department

(In consultation with the Exchange and Trade Relations Department,  
the Legal Department, the Research Department, and  
the Treasurer's Department)

Approved by L. A. Whittome and Subimal Mookerjee

October 5, 1982

I. Introduction

On January 30, 1981 the Fund approved a three-year stand-by arrangement for Yugoslavia for an amount equivalent to SDR 1,662 million or 400 per cent of quota, to be financed from the Fund's ordinary resources (SDR 304.2 million) and from the supplementary financing facility (SDR 1,357.8 million). A Fund mission comprising Messrs. Dakolias, Manison, Kronenberg (all EUR), Keller, (ETR) and, as secretary, Miss McKay (EXR) was in Belgrade from August 16 to 27, 1982 to review developments under the stand-by arrangement during the first half of 1982. In addition to discussions with senior officials, meetings were held with Mr. Srebcić, Vice President of the Federal Executive Council, Mr. Florjancić, Federal Secretary for Finance, and Mr. Makić, Governor of the National Bank of Yugoslavia. This paper, describing the mission's findings, is being circulated as a basis for discussion by Executive Directors.

The performance criteria under the second year of the stand-by arrangement were met on March 31 and June 30, 1982. These specified ceilings on domestic credit extended by the banking system, on National Bank credit to the budget of the Federation, and on outstanding convertible currency debt (Table 2). Yugoslavia to date has made seven purchases totaling SDR 969.5 million under the stand-by arrangement. Fund holdings of Yugoslav dinars as of August 31, 1982 were equivalent to 453.5 per cent of quota. Yugoslavia's use of Fund resources, the proposed phasing of the remaining purchases under the stand-by, and the prospective developments of Fund holdings of Yugoslav dinars until the end of the stand-by are set out in Appendix I and the attached tables.

## II. Economic Performance

### 1. External sector

The program for 1982 sought to reduce the deficit in the balance of payments on current account with the convertible currency area further to about US\$500 million or 0.8 per cent of the planned gross social product (GSP). A rapid expansion of exports to the convertible currency area was given priority; to achieve it an active exchange rate policy was to be pursued, supported by restraints on domestic demand and costs. Total exports were expected to grow by about 8.5 per cent in volume with exports to the convertible currency area alone rising by 12 per cent. Only a modest increase in import volume was planned. The authorities expected to be able to hold down new borrowing abroad considerably. Net medium- and long-term financial drawings, excluding purchases from the Fund, were planned to total about US\$950 million, most of it on account of the National Bank of Yugoslavia. Short-term liabilities of the commercial banks were expected to decline by US\$500 million.

Performance has not been as good as had been hoped. In the first half of 1982 the current account deficit with the convertible currency area alone was still as high as US\$1.5 billion compared with US\$2.1 billion in the first half of 1981 (Table 3). <sup>1/</sup> The current account with the nonconvertible currency area was in surplus to the extent of US\$600 million, part of which was used to pay off indebtedness to the U.S.S.R. relating to oil imports. The combined current account deficit declined to US\$0.9 billion from US\$1.9 billion between the two first half years (Table 4). The volume of total exports is estimated to have increased by 7 per cent over the same period with exports to the convertible currency area alone growing by about 8 per cent.

Deliberate efforts to redirect trade continue. Taking a slightly longer period of comparison, namely, from the first of the year to mid-August, real exports to the convertible currency area increased by 9 per cent between 1981 and 1982, with exports to the socialist countries paid for in convertible currency declining by 20 per cent; exports paid for in nonconvertible currencies increased by only 1.6 per cent. <sup>2/</sup> Imports from the convertible currency area declined by 10 per cent and those from the nonconvertible currency area by 13 per cent between the

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<sup>1/</sup> Errors and omissions relate mainly to flows of goods and services with respect to the convertible currency area. The current account deficits adjusted to account for this factor were US\$817 million in the first half of 1982 and US\$1,134 million in the corresponding period of 1981.

<sup>2/</sup> No figures for export and import prices in Yugoslavia are available for the period January to August 1982. The staff has therefore derived volume figures by assuming no change in import and export prices in U.S. dollar terms compared with the same period of 1981.

same two periods. Unfortunately, this decline resulted in shortages of some imported inputs, particularly of energy products, which in turn held back industrial production and raised prices.

Net receipts from invisibles were expected to increase in the first half of 1982 but instead showed a decline as a consequence of a shortfall in tourist receipts and higher interest payments. Workers' remittances continued to increase but withdrawals of foreign exchange deposits were higher than expected.

The authorities take the view that exchange rate policy played an appropriately active role in the first half of 1982 even though the ambitious targets had been set for merchandise and invisible exports. In the first half of 1982 the nominal effective exchange rate for the dinar was depreciated in line with differential developments between Yugoslav prices and costs and those of Yugoslavia's main trading partners (Chart I). As a result, no discernible gain in real external price competitiveness was recorded.

External reserves came under pressure in the seven months to end-July 1982. The reserves of the National Bank declined by US\$893 million or by more than one half, and those of the commercial banks by US\$216 million (Table 5). Although these developments to some extent reflect seasonal factors in the current account of the balance of payments in the first part of the year, they were exacerbated by difficulties in securing sufficient medium- and long-term credits and by a large reduction in short-term credits from foreign commercial banks. The turnaround in the capital account with the convertible currency area in the first half of 1982 compared with the same period of 1981 was of the order of US\$1.1 billion. While a partial reversal was planned, its eventual magnitude and timing had certainly not been anticipated.

The squeeze on short-term credits was to a considerable extent concentrated on a major commercial bank in Zagreb which is now being assisted by the National Bank of Yugoslavia and by other commercial banks in meeting its obligations. Disbursements of suppliers' credits appear to have continued at a normal rate, but the inflow of medium- and long-term financial credits has fallen far short of expectations. The Yugoslav banks, including the National Bank, have not had access to the American capital markets. Financial credits from other sources amounted to US\$320 million in the first half of 1982.

## 2. The domestic economy

### a. Demand and supply

The economic program for 1982 was intended to restrain domestic demand so as to release additional resources for the external sector. Real domestic demand was to be reduced by 2 per cent. There was to be a 6 per cent decline in gross fixed capital formation while real consumption expenditures were to be held at approximately the same level as in 1981 (Table 6). Real GDP was nevertheless projected to rise by 2.5 per cent as a result of a substantial increase in net exports of goods and services.

However, in the first half of 1982 domestic demand was more expansionary than had been envisaged, falling only marginally compared with the same period a year earlier. Real personal consumption is estimated to have risen by 2.5 per cent between the same two half years. Substantial increases in nominal personal incomes in the last part of 1981 and in the initial months of 1982 caused retail sales to be particularly buoyant. In recent months there has been a moderation in the growth of retail sales as real personal incomes declined. Public consumption expenditures <sup>1/</sup> also rose at a rate considerably faster than originally planned, associated with a larger-than-anticipated rise in revenue collections. In the first half of 1982 real fixed investment fell by 3 per cent, only half the projected rate of decline. While there was a sharp fall in bank-financed enterprise investments, capital outlays by public sector entities were higher than planned.

Industrial production meanwhile rose at a slower rate than planned. In the first half of 1982 it was only 1.2 per cent higher than a year earlier compared with the 2.5 per cent planned for the year as a whole. Industrial production has weakened in recent months, with its level in July falling 2.3 per cent below that of a year earlier. Shortages of imported inputs, especially of raw materials and energy supplies, were a major factor contributing to shortfalls in industrial output. Industrial production is expected to remain relatively depressed during the rest of the year. Agricultural production, on the other hand, is expected to rise appreciably due to favorable harvests of cereal crops. The growth of real GSP has now been revised downward for 1982 from 2.5 per cent to 1 per cent.

b. Prices and incomes

The program for 1982 assumed that the increase in the retail price index would be reduced to 15 per cent for the 12-month period to December 1982. The 12-monthly rate of increase in the retail price index had already fallen from a peak of 52 per cent in May 1981 to 39 per cent by December 1981 and further to 27 per cent in April 1982. During the first four months of 1982 the retail price index rose by 7.4 per cent (Table 7), with prices of industrial products increasing by 6.5 per cent and those of foodstuffs by 16.6 per cent as a result mainly of the elimination of some subsidies and seasonal factors. However, in the subsequent three months the retail price index rose again by 11 per cent, bringing the 12-monthly rate of increase back to 31 per cent by July 1982 (Table 8). Other domestic prices have shown similar developments over the last 15 months (Chart II).

Large increases in administered prices in agriculture and energy were thought necessary to improve the structure of relative prices.

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<sup>1/</sup> The national accounts figures according to Yugoslav methodology only include the material costs of general and collective consumption. In particular, they exclude personal income payments by public sector entities which in nominal terms rose at a rapid rate in the first half of 1982.

#### IV. Economic Prospects

To correct for past excesses, the authorities are taking new measures to restrict domestic demand. Their target is to reduce real domestic demand in the second half of 1982 by more than 3 per cent compared with the corresponding period a year earlier, mainly by a reduction in real personal consumption (Table 6). Tighter incomes policies and restrictions on consumer credit will constitute the main instruments for achieving this result. However, the planned reduction in real consumption may prove difficult to implement as it requires a further decline in real wages in the industrial sector when they have already been reduced by the recent substantial increases in prices, especially of food prices (nearly 30 per cent during the first seven months of 1982); at the prevailing level of incomes, outlays on food comprise about 50 per cent of the consumer's expenditure basket. The authorities, although recognizing these difficulties, see no alternative to a further reduction in real wages, given the seriousness of the balance of payments situation. Continuous wage restraint would release resources needed for improvement in the balance of payments and would maintain the improved position of the agricultural sector.

In July measures to restrict investment further were taken. These included limiting increases in long-term credits for financing investment to 1 per cent per quarter; eliminating bank credit for financing project cost overruns and short-term credits for financing investment; and severe curtailment of investments by public sector entities.

For the full year 1982 real domestic demand is still projected to fall by 2 per cent. The authorities intend to continue to restrain domestic demand over the remainder of the period of the Medium-Term Plan (1981-85). The Plan envisages that domestic demand, especially consumption and investment in nonpriority sectors, will be severely restricted over the next three years during which the growth of output is planned to be supported by the expansion of exports. The annual growth rate of real GSP over the plan period has been revised downward to 2.5 per cent compared with the original 4.5 per cent.

Developments in the balance of payments to the end of 1982 will depend critically on confidence factors in the policy actions already taken and those yet to be taken. The authorities are expecting to mobilize medium-term financial credit from European banks amounting to US\$200 million and, in September, they were finalizing negotiations for a syndicated loan from U.S. and Japanese banks for US\$200 million. They plan to reduce short-term debt further. At the same time they expect a significant turnaround of the current account position. The volume of exports to the convertible currency area is expected to show a large increase in the second half of the year, especially for agricultural products, while that to the nonconvertible currency area may show a further decline. Imports from the convertible currency area are to decline further, both in relation to the first half of the year and also relative to the same period of the previous year. Imports from the

nonconvertible currency area, especially raw materials, are planned to increase sharply, but this may prove difficult to achieve over a short period of time.

Receipts from tourism may be lower than expected, and the turnaround in net receipts from services now planned will depend critically on the rate of withdrawal of foreign exchange deposits, and the extent to which the recent reduction in interest rates in international markets will be sustained for the remainder of 1982.

Although the authorities project a substantial reversal in the second half of 1982 of the earlier losses of external reserves, it is more likely that the level of gross official reserves reached at the end of the year will not be much higher than that prevailing at the end of June, that is, US\$850 million; external reserves of commercial banks were approximately the same amount at end-July. Reserves at the end of 1982 could thus be very low in relation to the amount needed to finance the seasonally large current account deficit in the first half of 1983. The scope for further restraint on imports is quite limited, in view of the substantial reduction in import volume over the last two years.

Outstanding external medium- and long-term convertible debt (excluding that to the IMF) amounted to US\$15.6 billion at the end of 1981 (Table 15) and was estimated to have declined marginally to US\$15.4 billion by August 1982. It is expected to decline further during the remainder of 1982 and in 1983. The service payments on debt which are estimated to have amounted to US\$3.6 billion in 1981 are expected to rise to US\$4.4 billion in 1982, amounts that correspond to 23.1 per cent and 25.6 per cent, respectively, of exports of goods and services (Table 16). The amount of external debt servicing is projected to show a further increase in 1983 and to decline thereafter. Such developments will, however, depend largely on the evolution of interest rates. Short-term debt at the end of 1981 amounted to US\$2.3 billion but has declined rapidly during 1982 and at the end of July totaled US\$1.9 billion.

#### V. Staff Appraisal

The Yugoslav external current account is subject to marked seasonal variations and with the current account being significantly stronger in the second half of the calendar year. It is therefore necessary to contrast comparable half years. On this basis it was an achievement that the deficit on the current account in convertible currencies was reduced by approximately US\$500 million to a level of \$1,500 million or 1.5 per cent of GSP between the first half of 1981 and the first half of 1982. However, recent developments throw doubt on the ability to reduce the current account deficit with the convertible currency area for the year as a whole to US\$500 million as against the US\$1,820 million recorded in 1981.



More importantly the improvement in the first half of 1982 in the current account was in any case more than offset by a continued deterioration in the capital account as a result both of difficulties in raising new loans and of the reduction of short-term credits. As a result, the external position had become very difficult by the middle of 1982 with gross official reserves at US\$850 million, equivalent to no more than three weeks of imports, and having fallen by approximately one half in the first six months of the year. The somewhat disappointing performance of exports together with lower-than-expected receipts from tourism and net workers' remittances brings the appropriateness of the exchange rate into question. In the staff's view it is important that this matter be re-examined.

Against the background of severe strain in the overall balance of payments, it was disappointing that domestic demand in the first half of 1982 was higher than had been anticipated or than was compatible with a better evolution of the overall balance of payments. The most marked weakness lay in the field of personal consumption. Comparisons are made difficult by the uneven pattern of the last 18 months but personal consumption rose by some 2 1/2 per cent between the first half of 1981 and the first half of 1982. This seems to be directly attributable to the sharp rise in real personal incomes which occurred during the final part of 1981 and which was maintained in the early months of 1982. In the staff's opinion it is a matter for regret that the restraints on enterprises in raising prices to increase profitability and to pay higher wages did not prove adequate to produce the desired outturn.

The sharper than foreseen rise in domestic demand was accompanied by a resurgence of price pressures after April. The authorities have sought to buy time by imposing a six-month price freeze to take effect from end-July 1982. It is of importance that this opportunity be taken to break the practice by which enterprises raise prices and wages without undue difficulty. The authorities are now preparing legislation that would require enterprises to set wages on the assumption of no increase in prices. However, the wage/price spiral has long presented peculiar difficulties to the authorities, and the staff very much hopes that on this occasion fully adequate measures will be taken to restrain the increase in personal incomes.

The much stronger-than-expected development of nominal GDP at a time when the credit ceilings continued to be observed raises a separate set of questions. It appears that the extent of the interenterprise credit market, including the accumulation of unpaid bills, has again been underestimated both by the Yugoslav authorities and by the staff. It seems also that insufficient allowance has been made for the effect of transactions financed through domestic holdings of foreign exchange. Both these developments show up ex post as an increase in income velocity. This is not the first time that income velocity has ex ante been underestimated. The staff believes that, given the uncertainties, the most effective way to provide a more effective surveillance of development in the future is to arrange that when the performance clauses are established for 1983 they should be buttressed by a series of quarterly reviews which would be addressed to the most recent economic developments.

As regards the balance of payments, the more rapid-than-expected increase in inflation, without a commensurate increase in interest rates, seems to have contributed to a lack of domestic confidence which has shown itself particularly in the movements of net remittances. It is well possible that a series of changes in the system of administrative controls has also not been helpful in this respect. These same concerns have been shared by foreign observers and in conjunction with the general unease about the balance of payments situation in East European countries and the particular difficulties of one major Yugoslav commercial bank have led to a sharp deterioration in the capital account and especially in the short-term capital account.

The second half of the calendar year customarily shows a significantly stronger outturn in the current account than the first half. However, the recent trend on the capital account, if continued, could considerably, or even wholly, offset the extent to which this improvement will strengthen the balance of payments for 1982 as a whole. This leads to the possibility that by the end of 1982 the overall position may be little stronger than at present despite the fact that a seasonally unfavorable six-month period will then need to be faced. More specifically, there is a threat that the first half of 1983 will commence with very low levels of reserves and stocks of imported goods and a minimal amount of financial credits in the pipeline.

In these circumstances, the staff most strongly supports the view of the authorities that further effective measures need urgently to be taken to control the development of incomes and in particular to restrain consumption. It is difficult to judge whether the measures to be introduced will prove to be fully adequate to achieve the Government's objectives. The staff therefore hopes that the Yugoslav authorities will be prepared to reinforce these measures at very short notice should this be required. At the same time these measures need in the opinion of the staff to be fully supported by monetary policy and, most importantly, given the external difficulties, by measures to ensure that the economy is fully competitive.

Table 3. Yugoslavia: Balance of Payments  
(Convertible Currency Area), 1981-82

(In millions of U.S. dollars)

	Projections revised 1982	First half 1981	Second half 1/	Estimate 1/ First half 1982	Projection Second half
A. Goods and services and unrequited transfers	-500	-2,056	235	-1,543	1,043
Exports, f.o.b.	6,380	2,529	3,191	2,746	3,634
Imports, c.i.f.	-9,590	-5,597	-5,003	-4,997	-4,593
Trade balance	-3,210	-3,068	-1,812	-2,251	-959
Services and unrequited transfers (net)	2,710	1,012	2,047	708	2,002
B. Long-term capital					
Long-term capital received (net) 2/	-113	482	336	128	-241
Drawings	2,050	1,407	1,106	989	1,061
Repayments	2,163	-925	-770	-861	-1,302
Long-term loans extended (net)	-250	-39	-196	-51	-199
Total	-363	443	140	77	-440
C. Short-term capital (net)	-600	402	-235	-340	-260
D. Allocation of SDRs	--	38	--	--	--
E. Errors and omissions	573	922	-324	726	-153
F. Total (A through E)	-890	-251	-184	-1,080	190
G. Reserve movements					
Use of Fund credit	650	303	369	303	347
SDRs					
Reserve position in the Fund					
Gold					
Official foreign exchange (increase -)	240	-52	-185	777	-537

Source: National Bank of Yugoslavia.

1/ The trade flows for the first half of 1982 have been converted at statistical exchange rates which were the actual rates prevailing at the end of 1981. Since the exchange rates for the major currencies have shown a depreciation in the first half of 1982, vis-à-vis the U.S. dollar, the use of statistical rates tends to overestimate somewhat the trade flows invoiced in most non-dollar currencies in terms of current U.S. dollars. The statistical rates used for 1982 have also been used to revise estimates for the trade flows for 1981. For the first half of 1981, this procedure tends to underestimate somewhat the trade flows in terms of current U.S. dollars while for the second half it tends to overestimate them.

2/ Includes medium- and long-term borrowing by the National Bank and commercial banks.

Table 4. Yugoslavia: Balance of Payments, 1981-82

(In millions of U.S. dollars)

	Projections (Revised) 1982	Estimates		Estimate <sup>1/</sup> First half 1982	Projections Second half 1982
		First half 1981	Second half 1981		
A. Goods and services and unrequited transfers	-310	-1,858	912	-936	626
Exports, f.o.b.	10,870	4,576	5,629	4,897	5,973
Imports, c.i.f.	-14,190	-7,542	-6,986	-6,635	-7,555
Trade balance	-3,320	-2,966	-1,357	-1,738	-1,582
Services and unrequited transfers (net)	3,010	1,108	2,269	802	2,208
Credits					
Workers' and emigrants' remittances	4,515	1,800	2,394	1,925	2,590
Travel	2,000	450	1,263	495	1,505
Transportation	1,866	700	1,050	785	1,081
Interest	340	183	183	159	181
Other	1,997	900	880	970	1,027
Total	10,718	4,033	5,770	4,334	6,384
Debits					
Workers' and emigrants' remittances	-3,315	-1,128	-1,357	-1,570	-1,745
Travel	-115	-70	-55	-60	-55
Transportation	-870	-385	-466	-400	-470
Interest	-2,415	-907	-1,080	-1,052	-1,363
Other	-993	-435	-543	-450	-543
Total	-7,708	-2,925	-3,501	-3,532	-4,176
B. Long-term capital					
Long-term loans received (net) <sup>2/</sup>	-163	466	332	112	-275
Drawings	2,200	1,477	1,254	1,081	1,119
Repayments	-2,363	-1,011	-922	-969	-1,394
Long-term loans extended (net)	-250	-40	-210	-55	-195
Total	-413	426	122	57	-470
C. Bilateral balances	-500	-170	-606	-885	385
D. Short-term capital (net)	-600	402	-235	-340	-260
E. Allocation of SDRs	—	38	—	—	—
F. Errors and omissions	933	878	-344	1,024	-91
G. Total (A through F)	-890	-284	-151	-1,080	190
H. Reserve movements					
Use of Fund credit	650	336	336	303	347
SDRs					
Reserve position in the Fund					
Gold					
Official foreign exchange (increase -)	240	-52	-185	777	-537

Source: National Bank of Yugoslavia.

<sup>1/</sup> The trade flows for the first half of 1982 have been converted at statistical exchange rates which were the actual rates prevailing at the end of 1981. Since the exchange rates for the major currencies have shown a depreciation in the first half of 1982, vis-à-vis the U.S. dollar, the use of statistical rates tends to overestimate somewhat the trade flows invoiced in most non-dollar currencies in terms of current U.S. dollars. The statistical rates used for 1982 have also been used to revise the estimates for the trade flows for 1981. For the first half of 1981, this procedure tends to underestimate somewhat the trade flows in terms of current U.S. dollars while for the second half it tends to overestimate them.

<sup>2/</sup> Includes medium- and long-term borrowing by the National Bank and commercial banks.