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Statement by Mr. Polak on Yugoslavia
Executive Board Meeting
February 22, 1982

I should like to begin by thanking the staff on behalf of the authorities in Yugoslavia for the excellent papers they have produced for the discussion today. The report on the Article IV consultation and the review paper on the stand-by arrangement together provide a very clear picture of policy developments in Yugoslavia over the last dozen years. Inevitably, there is some overlapping between the two papers and I would personally favor, in cases such as this one, the preparation by the staff of a single paper to deal with the two interconnected subjects.

The staff correctly begins its exposition by a reference to the period 1970-79. These were years of rapid economic growth, but they were also characterized by a deterioration of economic management. This was evidenced by excessive and partially wasteful investment, increasing inflation, severe balance of payments deficits and, an accumulation of foreign indebtedness. As this situation unfolded, there gradually developed a realization that major policy changes were necessary--at first at the Federal level, then in the republics and provinces.

Since 1980 a process of adjustment of policies has been under way. In the beginning the adjustments were tentative and relatively minor, such as those that supported a first credit tranche drawing of Yugoslavia in 1980. A much stronger set of measures accompanied the stand-by arrangement for 1981-83 that was approved a year ago. Still, the first year's effort under that stand-by arrangement was not yet as strong as a number of Board members would have liked, or as, indeed, the authorities in Belgrade would have liked. At that time there were still important constraints on the extent to which policy could be redirected. When the Board approved the stand-by arrangement in January 1981, and again on the occasion of the mid-year review, important reservations were expressed with respect to certain aspects of policy. Most important among these ranked fiscal policy and insufficient flexibility of the exchange rate and of interest rates.

In the event the doubts about fiscal performance proved to be unjustified. The authorities kept a tight lid on expenditure, while a disappointingly steep rate of inflation raised revenues. Thus the Federal Government's accounts ended the year virtually in balance.

In other areas the combination of less than perfect measures and less than perfect cooperation led to disappointment. Thus the first half of 1981 saw sharp inflationary developments and an unsatisfactory performance of exports to the convertible area.

Nevertheless, the fact that major elements of policy were closely observed contained the damage within reasonable bounds. First of these was fiscal policy, as already mentioned. Second, incomes policy constrained the growth in the wage bill of each enterprise to the growth of its income, with the net--unplanned--result that real wages per worker declined 13 per cent over the two years 1980 and 1981 combined. Third, the monetary targets, which in the letter of intent had been geared to an expected rate of inflation of 20 per cent, produced a tight liquidity squeeze as inflation reached twice that rate and the authorities stuck to the targets initially agreed.

It is clear that the determination shown by the Federal Government is now paying off in a general recognition of the need for persistence in the policy course adopted. As noted in paragraph 5 of the letter of intent "In ordinary circumstances the Federal Executive Council would come under increasing pressure to ease policies. On this occasion, however, steps have been taken to explain fully the need for the present course of action and to mobilize support for it throughout the country." This general recognition made possible major further improvements in two other major fields of policy.

(i) The exchange rate for the dinar was depreciated by about 25 per cent in the six months to January 1982 and from now on will be adjusted monthly on the basis of expected developments in relative costs and prices and the evidence provided by the behavior of exports.

(ii) Interest rates were raised. In spite of a long tradition in the country of low and stable interest rates, there was an important policy breakthrough when, last month, the discount rate was doubled. This in turn will lead the commercial banks to raise their interest rates for deposits and for household credits to levels that will be close to the expected rate of inflation of 15 per cent per annum. The interest rate increases for credits to exports and agriculture granted by the National Bank still keep these rates at very low levels, but the amounts of credit that can be obtained under these facilities are of course strictly rationed. The staff welcomes the moves made "as a step, but only a first step, toward an interest rate structure that will give the appropriate signals and incentives to the investment and saving decisions of enterprises and households." (EBS/82/20, p. 14). It is probably a fair comment to say that this move is "a first step"; but the increase in the discount rate from 6 per cent to 12 per cent is a major move in itself, as well as a clear indication (which is confirmed in the letter of intent) that the Government is now committed to a more active interest rate policy than that followed in the past.

As was already clear at the time of the mid-year review, the performance of the Yugoslav economy was quite satisfactory in terms of the variables describing the real side of the domestic economy, as well as the balance of payments. It can be noted that in those instances where the growth targets of the Five-Year Plan were too ambitious, this has been recognized by the scaling down of these targets. But an adjustment in the opposite direction was made to the target for the current account. The original aim had been the achievement of current account equilibrium by 1985. Now this target has been brought nearer, to 1983, with the current account deficit for 1982 projected at only $500 million (and a revised deficit in 1981 of $750 million). The aim is now to obtain current account surpluses in 1984 and 1985. The explanation behind this change in emphasis is clear. Although Yugoslavia has been spared the severe liquidity difficulties that certain other East European countries have encountered and has been able to establish a comfortable level of reserves, it has concluded that the risks involved in heavy reliance on capital imports (especially on short-term credits) is not worth the somewhat more rapid growth that can thereby be obtained in the short run.

In conclusion, Yugoslavia entered into its stand-by arrangement with the Fund with a clear determination to achieve the broad aims set out in the letter of intent, even though at that time not all the necessary policy instruments had been put in place. The experience of the first year provided further clarity on what additional policy action was needed and provided the impetus for the adoption of required policies. The willingness on the part of the authorities to take these additional measures augurs well for the success of the program in the next two years so that Directors can feel confident in agreeing to the proposed decision for the second year of the program.

I also recommend adoption of the decision following the 1981 Article IV consultation which, in its second paragraph, deals with a relatively minor restraint on the availability of foreign exchange for travel purposes. Perhaps of greater importance in this general area are the measures taken by the authorities in the direction of further liberalization of trade and the interest expressed by the authorities, in paragraph 15 of the letter of intent, in achieving external convertibility for the dinar.