DOCUMENT OF INTERNATIONAL MONETARY FUND
AND NOT FOR PUBLIC USE

FOR AGENDA

0451

EBS/94/4

CONFIDENTIAL

January 14, 1994

To: Members of the Executive Board

From: The Secretary

Subject: Former Yugoslav Republic of Macedonia - Request for Purchase Under the Systemic Transformation Facility

Attached for consideration by the Executive Directors is the staff report on the former Yugoslav Republic of Macedonia's request expected to be received for a purchase under the systemic transformation facility equivalent to SDR 12.4 million. This matter is proposed to be scheduled for discussion on Friday, January 28, 1994. However, the Board date is subject to having received specific assurances of the timely availability of financing needed to clear arrears to the World Bank. A draft decision appears on page 18.

Mr. Thomsen (ext. 38808) or Mr. S. Brown (ext. 34541) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

Other Distribution:
Department Heads

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

FORMER YUGOSLAV REPUBLIC OF MACEDONIA

Request for Purchase Under the Systemic Transformation Facility

Prepared by the European I Department and
the Policy Development and Review Department

(In consultation with the Fiscal Affairs, Legal,
Monetary and Exchange Affairs, Statistics
and Treasurer's Departments)

Approved by Desmond Lachman and J. van Houten

January 14, 1994

Contents | Page

		Page
I.	Introduction	1
II.	Background to the Discussions	2
III.	Report on the Discussions and Description of the Program	2
	1. Main objectives and policy design	3
	2. Incomes policy	3
	3. Monetary and exchange rate policies	4
	4. Public sector policies	6
	a. Central Government	6
	b. Pension Fund	8
	5. External policies	9
	6. Structural reforms	13
IV.	Staff Appraisal	15

Tables

1.	Main Economic Indicators	19
2.	Monetary Survey	20
3.	National Bank Accounts	21
4.	Summary of Fiscal Measures	22
5.	Summary of General Government Operations, 1991-94	23
6.	Balance of Payments, 1990-94	24
7.	Sources and Uses of Foreign Exchange in 1994	25

8. Balance of Payments--Quarterly Projections, 1994 26
9. Estimated External Arrears by Creditor at end-1993 27
10. Illustrative Medium-Term Balance of Payments Scenarios, 1993-98 28
11. Indicators of Fund Credit, 1993-98 29
12. Exports, 1990-94 44

APPENDIX I Policy Statement 30

APPENDIX II Eligibility and Access under the STF 43

APPENDIX III Statistical Issues 45

APPENDIX IV Relations with the Fund 49

APPENDIX V Relations with the World Bank Group 51

Charts

1. Inflation and Exchange Rates 2a
2. Industrial, Production, Productivity, and Real Wages 2b
3. Unemployment Rate 2c
4. Monetary and Credit Developments 2d

I. Introduction

The authorities of the former Yugoslav Republic of Macedonia (FYRM) have indicated their intention to request an initial purchase under the Systemic Transformation Facility (STF) for an amount equivalent to SDR 12.4 million or 25 percent of quota in support of an economic program for 1994 (see the attached letter dated January 14, 1994 and the accompanying Policy Statement in Appendix I). 1/ A second purchase of the same amount is expected to be requested when conditions for this purchase under the STF are met. In the Policy Statement, the authorities explain their intention to reach understandings with the Fund before end-June 1994 on a program that could be supported by a stand-by arrangement in the upper credit tranches or a similar Fund arrangement. 2/

The FYRM succeeded to the membership in the Fund of the former Socialist Federal Republic of Yugoslavia (SFRY) effective December 14, 1992. The first Article IV Consultation was concluded by the Executive Board on August 25, 1993 (EBM/93/115). Executive Directors noted that, in part, the present imbalances had originated in the political crisis in the region, but emphasized that lax policies had severely exacerbated the problems. They urged an effective incomes policy, a much tighter monetary policy, and a restoration of budgetary discipline. They warned that stabilization policies would not be sustainable unless accompanied by broad-based reforms centered around privatization and bank rehabilitation.

Fund and World Bank staff have been cooperating closely with a Donor Group chaired by the Netherlands' authorities with the aim of mobilizing assistance for clearance of the FYRM's arrears to the Bank. Following determination by the Bank that there was a credible plan for the clearance of such arrears, the FYRM succeeded to the membership of the former SFRY in the Bank on December 30, 1993. The Bank is presently at an advanced stage of negotiations on an Economic Recovery Loan with the authorities and it plans to initiate discussions on an Enterprise and Financial Sector Adjustment Loan (EFSAL) soon.

The eligibility of the FYRM to use the STF is discussed in Appendix II. Economic analysis is seriously hampered by the rudimentary statistical base as discussed in detail in Appendix III. Relations with the Fund and the Bank are summarized in Appendices IV and V, respectively.

1/ Discussions on an economic program for 1994 were held in Skopje from October 26 to November 12. The Fund mission consisted of Mr. Thomsen (Head), Mr. Brown, Ms. Gulde-Wolf (all EUI), Mr. Hardy (MAE), Ms. Doughty (PDR), Mr. Kurihara (FAD), and Mr. Vargas (staff assistant, EUI). The mission met with President Gligorov, Prime Minister Crvenkovski, the entire Cabinet, the Governor of the National Bank, senior officials from economic ministries and institutions, and, at the Government's request, with key members of the labor unions and the business community.

2/ On November 29, 1993 (EMB/93/162), the Executive Directors agreed that the decision to extend eligibility for assistance under the ESAF Successor to the FYRM would be adopted by the Board on a lapse of time basis at the appropriate time (Buff/93/67). This follows the decision by the management of the World Bank in October 1993 that the FYRM will become IDA-eligible.

II. Background to the Discussions 1/

In 1991-92, inflation reached levels verging on hyperinflation (Chart 1) and domestic and external payment delays started to increase rapidly due to lax policies and to the output collapse caused by the events associated with the break-up of the former SFRY (Chart 2, Table 1). Loss of transfers, markets and transshipment routes reduced output to close to 60 percent of its pre-crisis level and attendant inflationary pressures were sustained by long-standing policy weaknesses in three areas. First, deficits in self-managed social enterprises surged because of a lack of an effective incomes policy to counter the inherent tendency of self managed enterprises to protect wages and employment (Charts 2 and 3). Second, these deficits were accommodated by the National Bank, whose main concern remained enterprise liquidity rather than inflation control (Chart 4). Third, failure to contain spending under relatively generous entitlement programs, in conjunction with the lack of a resilient revenue base, opened up large deficits in the public sector. Government recourse to the banking system was terminated with the introduction of a national currency in April 1992, but public sector arrears grew sharply.

There was a further significant deterioration in economic performance in 1993. Real wages rose by 24 percent during the first eight months of 1993, despite a further drop in output, which is estimated to have fallen to half its pre-crisis level by end-1993. Almost half of all social enterprises were incurring losses, which prompted the National Bank to relax monetary policy substantially at mid-year. Interest rates were reduced and the National Bank permitted a sharp increase in base money. This relaxation coincided with the emergence of large speculative pressures in the foreign exchange market following the decision in early September to intensify the compliance with UN sanctions against the Federal Republic of Yugoslavia. The exchange rate depreciated by 30 percent in September-October, notwithstanding intervention by the National Bank, and inflation increased to close to 15 percent per month. All debt servicing payments remained suspended, except for payments to the Fund and, from October 1993, payments to the World Bank. At the same time, the budget deficit is estimated to have widened from 7 percent of GSP in 1992 to 11 percent of GSP in 1993, despite a sharp curtailment of discretionary expenditures under a strict cash management system. The growth in public sector domestic arrears continued to accelerate sharply.

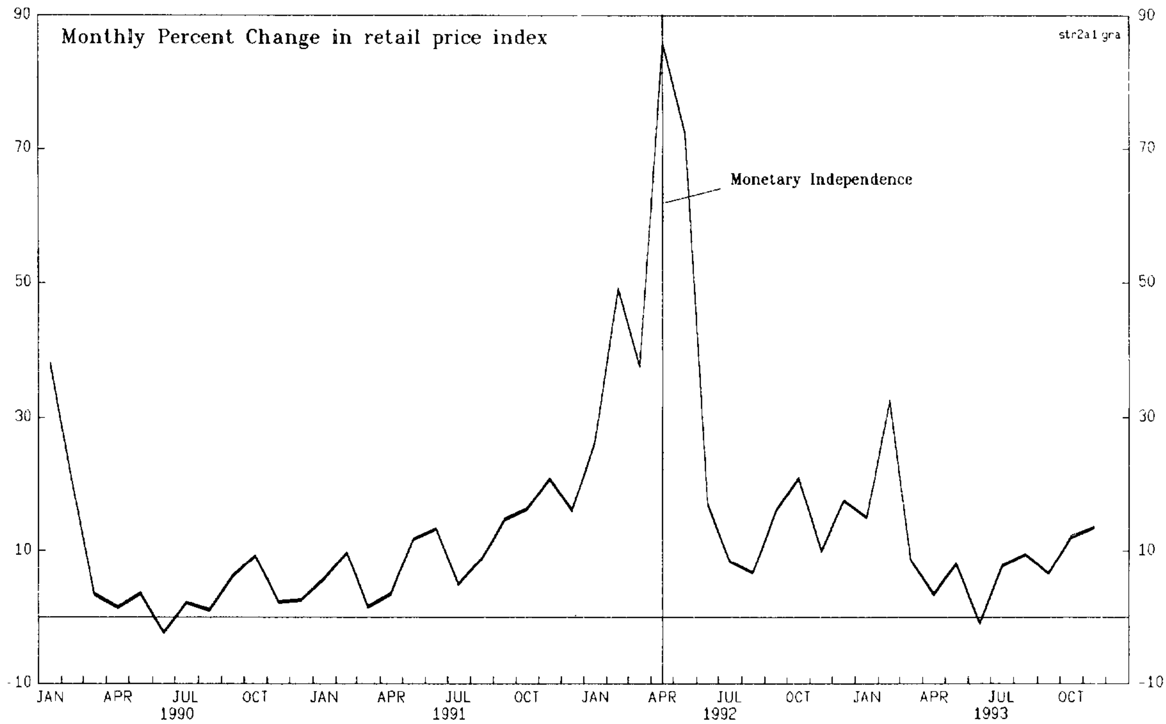
III. Report on the Discussions and Description of the Program

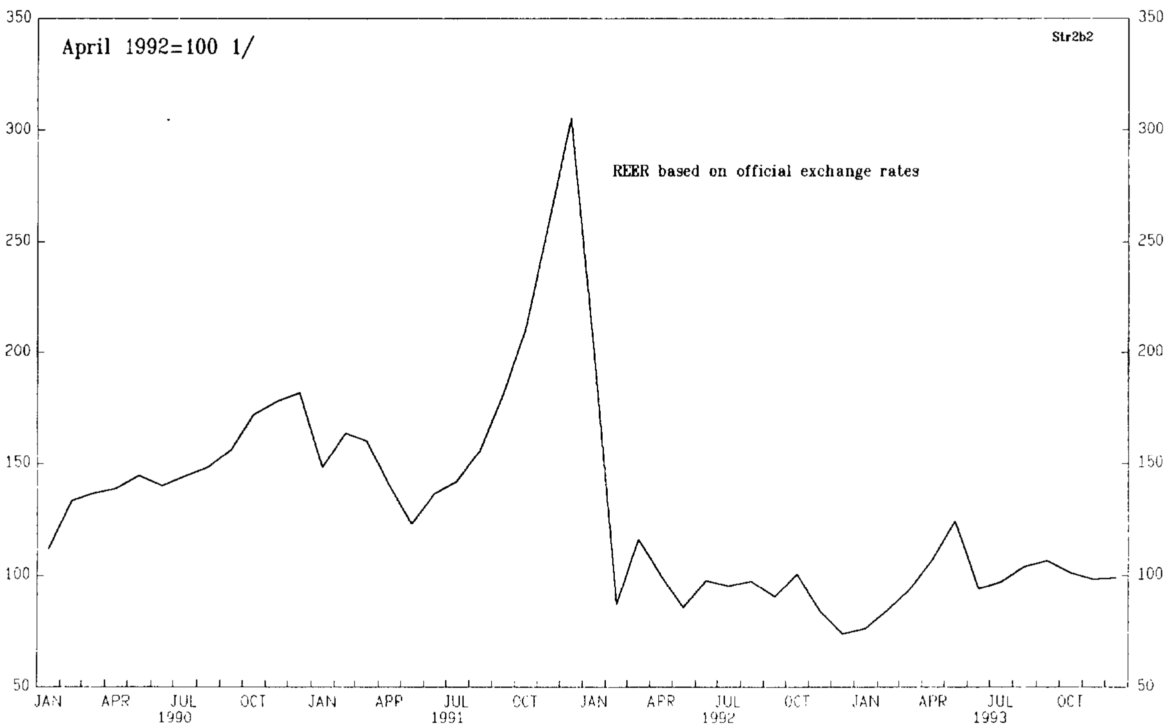
Discussions were mainly concerned with the underlying causes of the acute stabilization problems and with the available policy options for 1994. The primary objectives and policies are described in the attached "Policy

---

1/ A detailed account of developments since independence, including the impact of the shocks caused by the crisis in the region, is contained in the Staff Report for the 1993 Article IV Consultation (SM/93/171, 8/4/93).

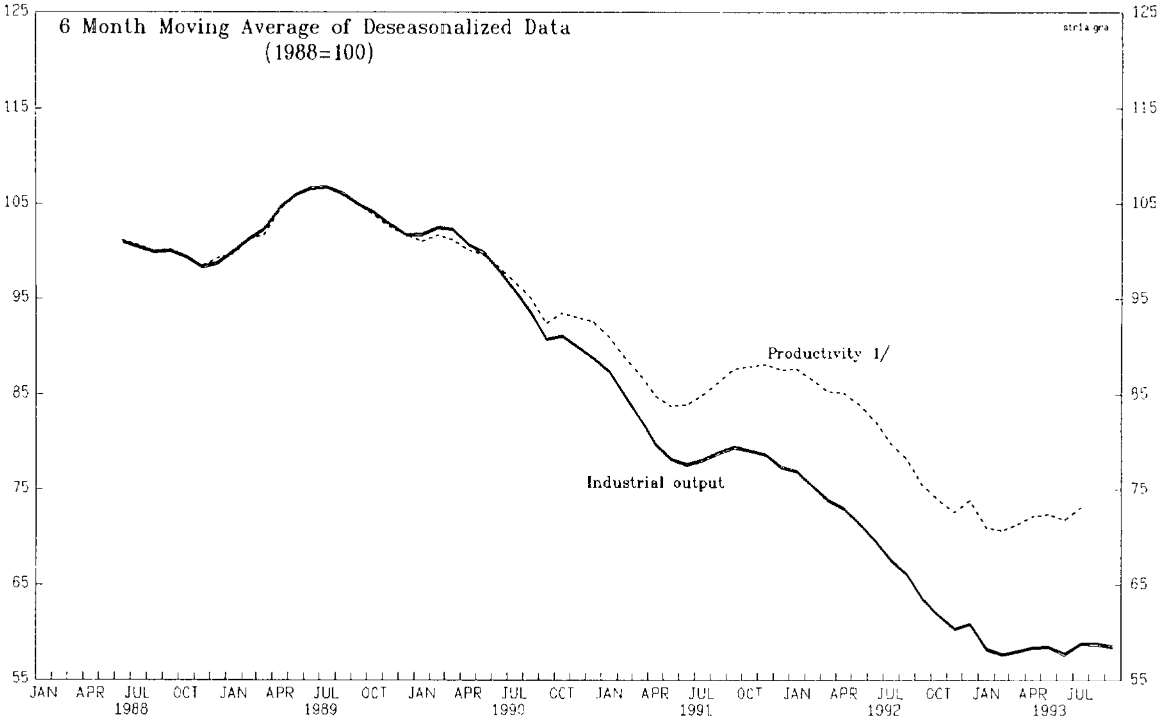
CHART 1
FORMER YUGOSLAV REPUBLIC OF MACEDONIA
INFLATION AND EXCHANGE RATES





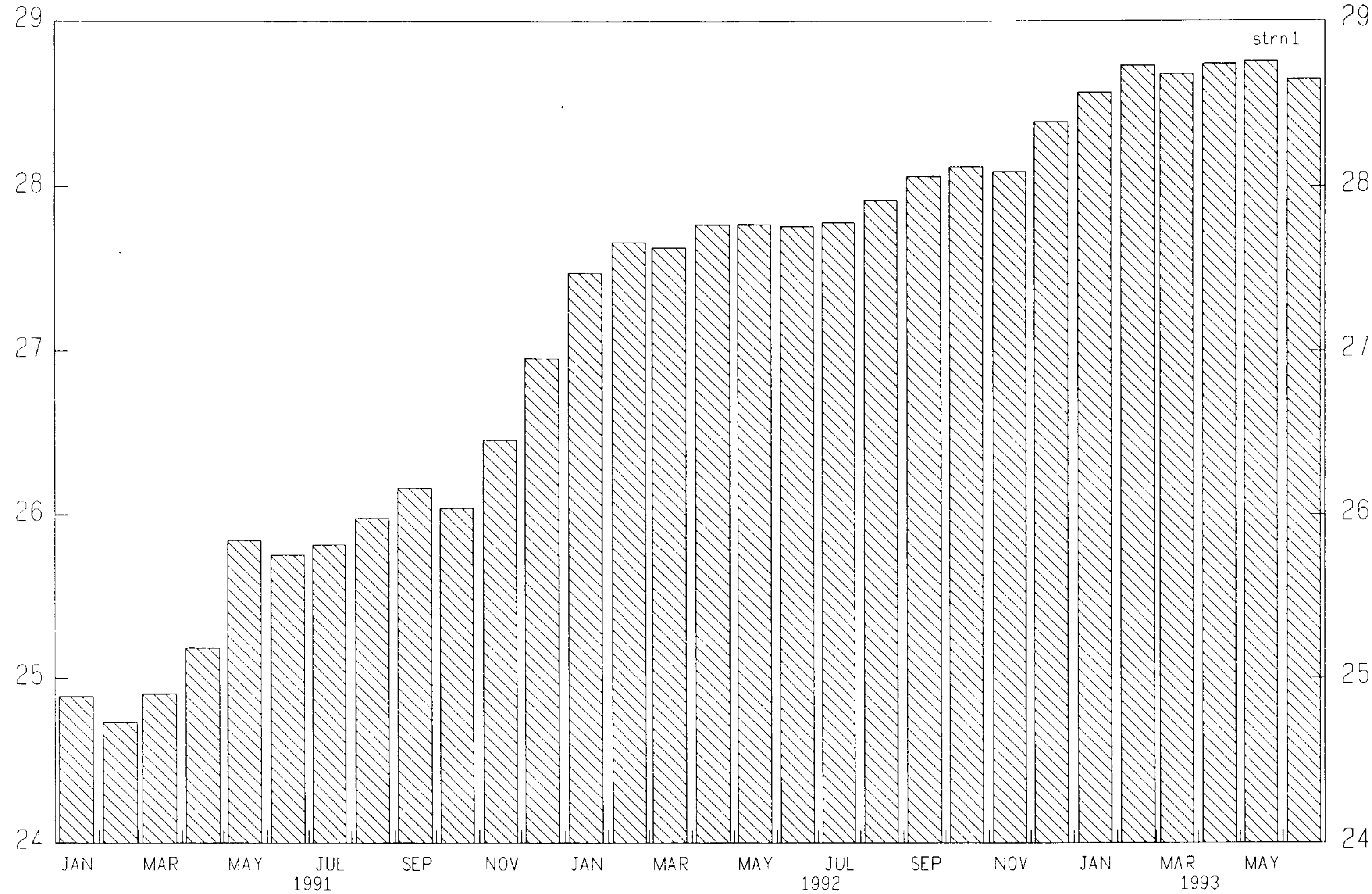
Source: The FYRM authorities and staff estimates.
1/ Deflated by relative consumer prices. An increase in the index denotes an appreciation.

CHART 2
FORMER YUGOSLAV REPUBLIC OF MACEDONIA
INDUSTRIAL PRODUCTION, PRODUCTIVITY, AND REAL WAGES



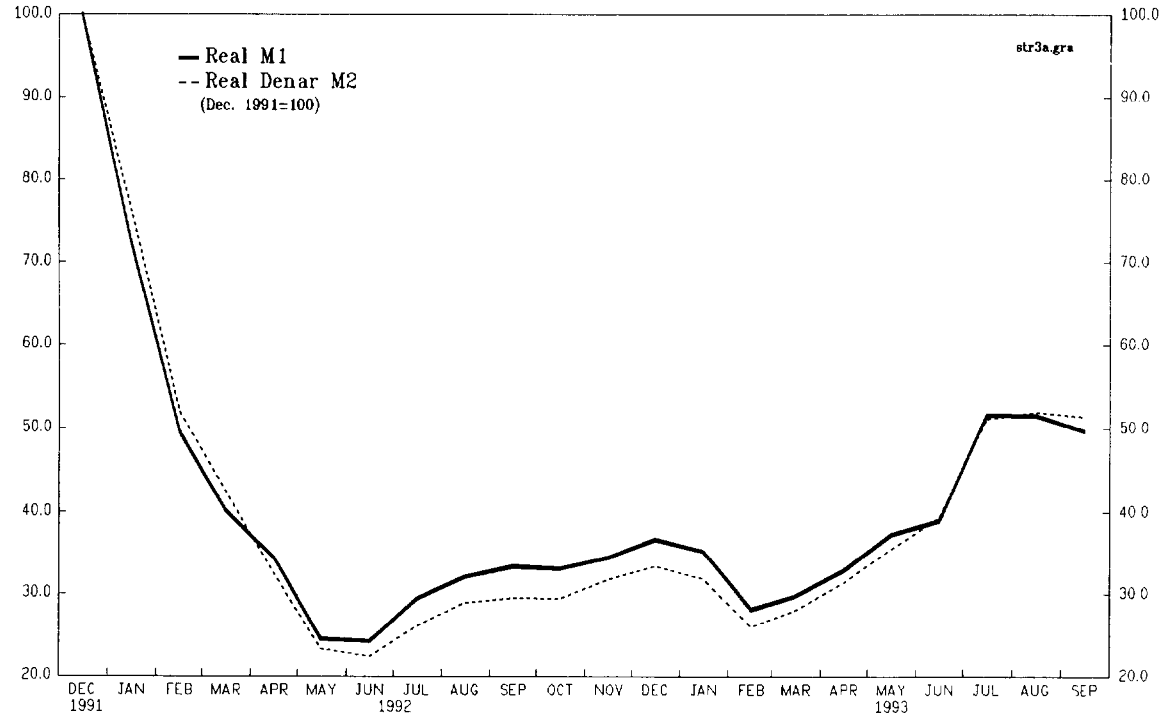
Source: The FYRM authorities and staff estimates.
1/ Measured as output per worker in industry.

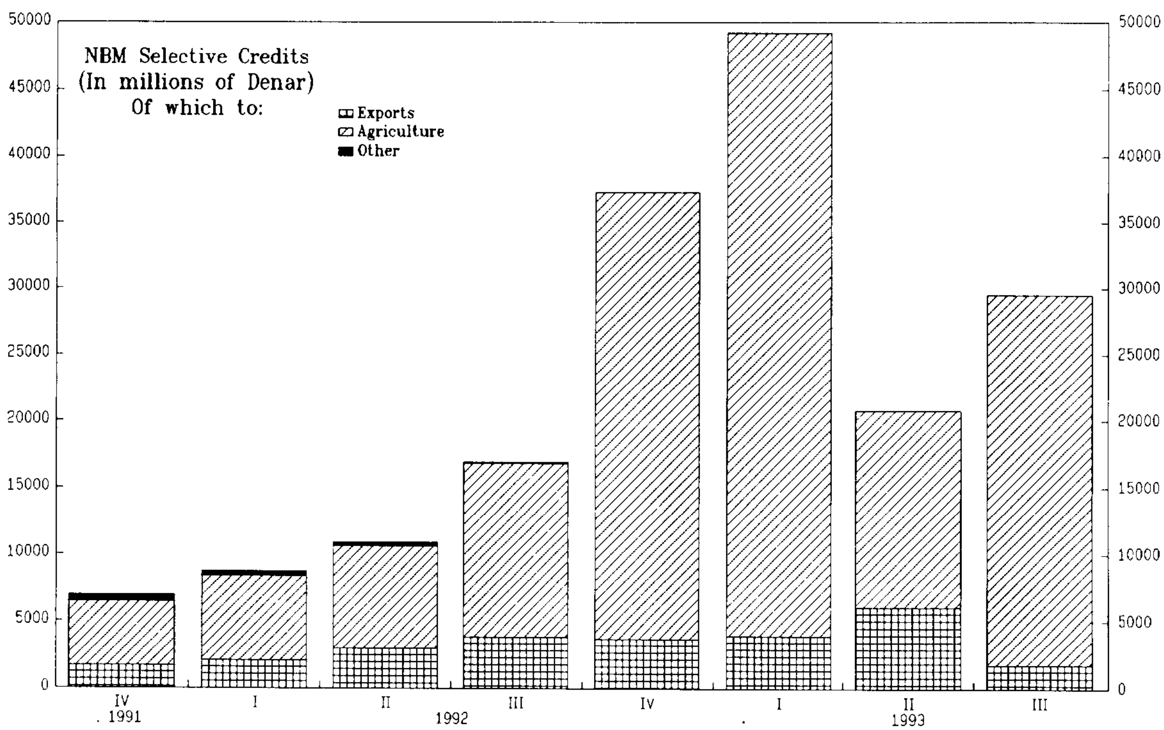
CHART 3
FORMER YUGOSLAV REPUBLIC OF MACEDONIA
UNEMPLOYMENT RATE 1/



Sources: Data provided by the FYRM authorities.
1/ These data may overstate the unemployment rate by as much as 2-5 percent, reflecting that some of the registered unemployed may work in the private sector or as part of the active agricultural population.

CHART 4
FORMER YUGOSLAV REPUBLIC OF MACEDONIA
MONETARY AND CREDIT DEVELOPMENTS





Source: Data provided by the FYRM authorities.

Statement", including quantified annual targets and a financial program for 1994. Due to considerable uncertainty about the impact on the FYRM of the intensified UN sanctions against the Federal Republic of Yugoslavia, quarterly targets and benchmarks are specified for the first half of 1994 only. Those for the second half of the year will be determined before end-June 1994, taking into account developments during the first semester and the annual targets specified in the "Policy Statement".

1. Main objectives and policy design

The authorities' overriding concern was that the economy was poised at the brink of hyperinflation. Their main objective for 1994 is to reduce inflation significantly as a precursor to comprehensive structural reform. In their view, the weak balance of payments position necessitates a flexible exchange rate policy, precluding the use of a nominal exchange rate anchor. Instead, the program's anti-inflationary thrust relies on the imposition of wage controls, tightening of monetary policy, and stricter budgetary discipline. On the strength of these policies, the program targets a deceleration in monthly inflation from 12-15 percent in the last quarter of 1993 to below 10 percent in early 1994, 5 percent in the middle of the year, and 2-3 percent by end-1994 (70 percent from December to December). It also targets a small increase in net foreign assets of about US$20 million.

The authorities were confident that stabilization of the economy, combined with comprehensive structural reforms, will lay the basis for a recovery in output and employment. They were aware, however, that a significant recovery was unlikely in 1994 without improved access to traditional markets and transshipment routes. There was consensus that the tightening of UN sanctions against the Federal Republic of Yugoslavia in 1993 would have the effect of reducing GSP by about 8 percent in 1994.

2. Incomes policy

The authorities emphasized that the lack of an effective incomes policy to counter the rigidities in real wages and employment intrinsic to the self-management system was a major reason for the past surge in inflation. Looking to 1994, they were particularly concerned that the real wage decline that would have to accompany the anticipated decline in output would be achieved only through rapidly increasing inflation. A wage control law was seen as an essential prerequisite for preventing such an intensification of the wage-price spiral in 1994. Even if a further output reduction in 1994 had not been expected, the authorities considered that a wage control law would have been necessary to ensure a less inflationary reversal of the excessive real wage increases that took place during 1993.

A new law has been introduced that targets a reduction in average real wages by 16 percent through end-June 1994, by permitting only partial indexation of wages. Within this total, real wages in the economic sector are to be reduced by 14 percent and those in the non-economic sector (largely equivalent to the public sector) by 22 percent. 1/ In determining the partial indexation formula, the authorities took into account the gap between real wages and productivity that has developed in recent years, the expected decline in output in 1994, and the targeted relative increase in wages in the economic sector. The law pertains only to enterprises with social capital, which account for 83 percent of total employment, in order to encourage such enterprises to complete privatization early. The law is to remain in effect through end-1994.

3. Monetary and exchange rate policies

National Bank officials emphasized that the ambitious inflation target for 1994 reflects a fundamental shift in the focus of monetary policy to inflation control and away from enterprise liquidity and sectoral support. The officials underscored, however, that this refocusing of monetary policy could become unsustainable if the accompanying wage control law does not succeed in reimposing a significant measure of financial discipline in socialized enterprises.

National Bank officials explained that reserve money will be the prime intermediate target of monetary policy. The monetary program for 1994 limits the permissible increase in reserve money to 17 and 12 percent during the first and second quarters, respectively, of 1994 (Tables 2 and 3). This program is consistent with the above-mentioned paths for inflation, output, and reserve accumulation, and is based on conservative assumptions about money demand. Despite the targeted sharp deceleration in inflation, velocity is assumed to remain unchanged during the first semester and to start declining only from mid-year, reflecting the relative stickiness of inflationary expectations in the short run due to the past volatility in inflation.

The authorities noted that they had taken steps to strengthen significantly their control over reserve money growth. Until recently, the

---

1/ The law, which comes into effect with the payment of wages in January, 1994, stipulates monthly maximum limits for net personal incomes per employee. In the economic sector, January wages are limited to 95 percent of the average monthly wage paid in August-September, 1993, adjusted for inflation during the last quarter of 1993. From February 1994, the monthly increase is limited to: (i) 1 1/2 percentage points less than price increases at or below the targeted monthly rate of inflation; plus (ii) half of any inflation in excess of the monthly inflation target. A similar formula is applied to wages in the non-economic sector with two exceptions. January wages are limited to 92 percent of the inflation adjusted August-September base wage and increases in subsequent months will be 2 1/2 percentage points less than any price increase at or below the monthly inflation target. These formula ensure that enterprises that granted real wage increases in October-December in anticipation of the wage control law will be forced to roll back such increases.

National Bank's policy of passively rediscounting bank credits to the agricultural and export sectors had been taking place on a scale that made an accommodating monetary policy virtually unavoidable. Parliament has now agreed that the National Bank should terminate such rediscounting from April 1, 1994. National Bank officials emphasized that the new rediscount credits to selective sectors planned for the first quarter of 1994 were minimal and well within the permissible increase in National Bank credits.

The phasing out of selective credits is being accompanied by the introduction of market-based instruments and procedures for allocating National Bank credits and bills. The first auction of credits took place in November, 1993. Once the auction mechanism becomes fully effective, the discount rate will be adjusted in line with the interest rate determined at the auction. In the meantime, the discount rate will be guided by the annualized average inflation rate during the most recent two months, plus a 5 percent real component, in order to achieve positive real interest rates.

National Bank officials cautioned that market-determined interest rates will not ensure an efficient allocation of National Bank credits because banks' decision-making remains distorted by impaired assets and dependency on large loss-making enterprises. Moreover, weak financial discipline makes enterprises relatively insensitive to changes in interest rates. Therefore, as a temporary measure until banks have been rehabilitated, the National Bank has imposed ceilings on each bank's access to credit in the auctions as well as on individual bank's extension of credits. The permissible increase in commercial bank credits of 29 percent during the first half of 1994 is considerably below the targeted rate of inflation of about 40 percent during the same period. National Bank officials warned, however, that financially weak enterprises may respond to a tightening of monetary policy by stopping interest payments. Officials expressed concern that such forced interest capitalization could limit the usefulness of bank credit ceilings. 1/

National Bank officials explained that monetary policy would have to be conducted in the context of a flexible exchange rate policy, particularly given the currently low level of international reserves and the likelihood of further external shocks. The National Bank intends to refrain from resisting market trends if the balance of payments turns out less favorably than anticipated. While the authorities believe that the exchange market mainly faces a downside risk in 1994, they noted the large build-up of foreign exchange holdings outside the official banking system in recent months, which could lead to an inflow of short-term capital with the programmed tightening of monetary policy during the early months of the program. Such inflows could require a build-up of international reserves to prevent an unwarranted temporary appreciation of the currency, but the National Bank officials emphasized that the inflows would be sterilized

---

1/ They also emphasized that enforcement of bankruptcy procedures would be key to prevent an increase in interenterprise arrears from undermining monetary policy.

until there was firm evidence that they were associated with a permanent increase in the demand for money.

4. Public sector policies

In view of the anti-inflationary thrust of their program, the authorities emphasized that the primary objective of fiscal policy in 1994 was to stop the explosive growth in arrears and to continue avoiding public sector recourse to the banking system. They took note of staff projections suggesting that the general government budget deficit would reach 13.5 percent of GSP in 1994 without corrective measures. The 1994 Budget and accompanying laws would entail a significant tightening of policies, generating incremental revenues and expenditure cuts totaling 9.4 percent of GSP (Table 4). Taking into account the much needed additional resources for unemployment compensation and bank rehabilitation of 2.5 percent of GSP, the general government budget deficit will be limited to 6.6 percent of GSP in 1994 compared to 10.9 percent of GSP in 1993 (Table 5).

a. Central Government

The Central Government budget deficit is to be limited to 5.0 percent of GSP in 1994, as compared with a projected deficit of 8.5 percent of GSP in the absence of corrective measures. 1/ Revenue collections are to be increased by 2 percent of GSP and current expenditures are to be reduced by 4 percent of GSP, while additional resources in the amount of 2.5 percent of GSP are to be directed at structural reforms, mainly in the banking sector.

The expenditure reductions of 4 percent of GSP reflect changes in three areas. First, agricultural subsidies are to be reduced by 2.1 percent of GSP (from 3.9 to 1.8 percent of GSP). This reduction reflects mainly a decline in interest subsidies equivalent to 1.6 percent of GSP, but includes also savings on account of the elimination of subsidies for export promotion and reduced subsidization of fertilizer and seeds. The authorities emphasized that the decision to cut agricultural subsidies had been difficult because the agricultural sector had still not recovered from last summer's drought, the worst in recent history. Second, the low coefficient used for partial indexation of wages in the non-economic sector (largely equivalent to the public sector) entails a reduction in the Central Government wage bill of 1.1 percent of GSP in 1994. Third, the 1994 Budget limits a large number of discretionary expenditures by 0.8 percent of GSP.

While the modalities and budgetary cost of bank rehabilitation are still unknown, the program for 1994 includes an estimate of the cost of such rehabilitation during the second half of 1994 of 2 percent of GSP,

---

1/ The Central Government deficit shown in Table 1 includes transfers to extrabudgetary funds. Such transfers are excluded from the Central Government deficit shown in Table 5 for the purpose of calculating the consolidated deficit of the general government.

consistent with the timing of external assistance for bank rehabilitation. This highly tentative estimate will be reviewed at mid-year when the bank rehabilitation program is expected to be further advanced. As to social programs, the authorities explained that the 1994 Budget provides increased appropriations of 0.5 percent of GSP and that the use of such resources is being improved with a shift from an untargeted to a targeted bread subsidy.

The sharp drop in revenues during the last two years reflected the lack of a resilient revenue base and deteriorating tax compliance. The main focus of tax policies will now be on reducing exemptions, unifying taxes, and improving the capacity to tax the emerging private sector. The most important tax change involves the sales tax, where the number of rates has been reduced from 21 to 3. 1/ Moreover, importers will be required to pay sales tax on imports at the time of the entry rather than at the time of domestic sale. In addition, excise taxes on oil derivatives, alcohol, cigarettes, and automobiles have been increased. Changes in the sales and excise taxes, which were implemented on January 1, 1994, are in line with the recommendations of a Fund technical assistance mission. Their revenue impact was estimated to amount to 2 percent of GSP.

The revenue base will be broadened as a result of the consolidation of the present nine personal income taxes into a single tax and the elimination or curtailment of a number of exemptions (effective April 1, 1994). A significant improvement in tax collection is also expected following the merger of the existing tax collection functions of the Ministry of Finance and the Social Accounting Office into an Internal Revenue Service within the Ministry. These two changes could challenge the still limited administrative capacity of the Ministry of Finance; consequently the program assumes that the changes would not yield any significant revenue increase in 1994.

The authorities explained that the Central Government budget has been burdened by considerable debt servicing payments as a result of the break-up of the former SFRY. About US$0.9 billion of foreign currency deposits, which were a liability of the federal government of the former SFRY, have become a liability of the FYRM Central Government. However, lack of budgetary resources, in conjunction with the limited public confidence in the banking system and the low level of foreign reserves, have forced the authorities to freeze such deposits. Looking to the precarious budgetary outlook, the authorities explained that the prospects for resuming servicing of these deposits were not encouraging. 2/ As to foreign debt, the Central Government may ultimately be faced with assuming debt servicing

---

1/ There is now to be a general rate of 25 percent; a rate of 5 percent for food and certain other items; and a rate of 10 percent for most services.

2/ The authorities plan to allow the public to use such deposits to acquire assets through the programs for privatization of socially-owned enterprises and apartments.

responsibility on debt of up to US$700 million, including arrears. Total domestic and foreign debt to be serviced by the Government amounted to almost 100 percent of GSP at end-1993.

Taking into account expected foreign financing, the Central Government will need a one-time credit from the National Bank equivalent to US$40 million for the purchase of foreign exchange to clear arrears to the World Bank. This credit will be reduced to the equivalent of US$31 million by end-March and will be reduced further by any higher-than-programmed foreign borrowing. The Central Government will not borrow from the domestic banking system for other purposes.

Except for the above-mentioned arrears in respect of frozen foreign currency deposits, the Government will incur no new domestic arrears in 1994. The authorities undertook to review the financial position of the Central Government, in consultation with the Fund, before end-June 1994 with the aim of taking corrective measures to offset any unanticipated developments that might threaten the commitment to avoid further recourse to the banking system and accumulation of domestic payments arrears. 1/

b. The Pension Fund

Delays in payments by the pension fund, which have increased from one month to almost three months in 1993, could lengthen to at least five months by the end of 1994 without corrective measures. The program contains the following three measures that would improve the financial position of the pension fund by about 3 percent of GSP, reducing the deficit to 2.9 percent of GSP in 1994: (i) by indexing pensions to the increase in average wages in the non-economic sector (rather than to economy-wide wages), pensions will be reduced by about 22 percent in real terms in 1994; (ii) the existing schemes for early retirement, which have allowed the number of retirees to surge by about 20 percent during the last 18 months, have been abolished; and (iii) payroll contributions to the pension fund have been increased from 18 to 20 percent of the wage bill.

These changes will not close the deficit in the pension fund. The authorities have, therefore, decided to gradually increase the retirement age from 60 to 63 for men and from 55 to 58 for women. Moreover, the base for calculating pensions will be changed in stages to the total lifetime income of the retiree (compared to the current practice of using the 10-year period with the highest income). The authorities have undertaken to review the benefit structure and the funding mechanism of the pension fund and to

---

1/ This review will take into account: (i) a clarification of the legal status of payment arrears in respect of wages and social transfers carried over from 1993; and (ii) the Government's capacity to collect from domestic enterprises payments that will initially be made from the Central Government budget in order to ensure timely servicing of nongovernment debt owed to multilateral creditors.

implement measures, before end-June 1994, that will eliminate the deficit in the pension fund in 1995.

5. External policies

The authorities indicated that external sector policies must facilitate a re-orientation of exports to new markets and increase access to external financing. They explained that this was particularly the case due to the loss of transfers and markets associated with the break-up of the former SFRY. A flexible exchange rate policy and an early normalization of relations with external creditors are key to achieving these objectives. Owing to the loss of access to the large foreign reserves that had been held by the former National Bank of Yugoslavia at the time of the break-up, the program has targeted a further increase in foreign reserves.

The authorities underscored the particularly adverse impact that the UN sanctions against the Federal Republic of Yugoslavia were having on the FYRM. In addition to loss of markets, the sanctions had interrupted main transshipment routes, forcing resort to costly alternative routes, including very rudimentary East-West links. The authorities pointed to commitments from the international community to alleviate the impact of the sanctions through external assistance. They feared that the program for 1994 would become unsustainable without such assistance.

As to the balance of payments outlook for 1994, an early export recovery was considered unlikely unless an easing of the regional conflict permitted renewed use of traditional transshipment routes and partial restoration of access to former markets. With no immediate prospect for such an easing, the program assumes that exports will remain broadly unchanged in 1994. It also projects only a minor import recovery. A reduction in imports of intermediate and consumer goods, reflecting the stabilization measures and the output decline, is expected to be largely offset by an increase in imports of capital goods, resulting from the reforms and the anticipated development assistance. As a result, the current account deficit is projected to be largely unchanged from 1993 at about US$50 million, a level well below the deficit of US$400 million that prevailed in 1990, before the break-up of the SFRY (Table 6).

In line with the objective of an early normalization of relations with external creditors, debt service payments to the World Bank were resumed in October 1993 and an estimated US$107 million of arrears to the Bank will be cleared before the end of February 1994. 1/ At that time, the authorities will also resume current payments to all other multilateral creditors. Arrears to such creditors, which stood at US$34 million at end-December 1993, will be reduced to at most US$25 million before end-June 1994 and will be fully eliminated before end-1994.

The authorities have begun discussions with Paris Club creditors. Regularizing relations will require understandings on several outstanding issues, including the FYRM's share of the debt of the former SFRY due to official bilateral creditors that cannot be allocated according to the residency of the original borrower. Pending a final agreement between the former Yugoslav republics on a division of unallocated debt, the Paris Club has proposed to apportion such debt on a temporary basis according to the key that was used to divide the former SFRY's assets and liabilities in the Fund. Provided such understandings are reached, Paris Club creditors have indicated their willingness to consider a rescheduling on the basis of a stand-by or similar Fund arrangement. Given the FYRM's acute balance of payments problems, some further accumulation of arrears to official bilateral creditors is anticipated under the current program. However, the authorities have committed themselves to a resumption of partial payments on debt not previously rescheduled under Paris Club agreements with the former SFRY.

Discussions with commercial banks are still at an early stage. No payments to banks have been assumed under this program, but will be considered in subsequent Fund supported programs. Commercial banks have argued against the use of the Fund key to divide the bank debt of the former SFRY because, in their view, the "joint and several" clauses contained in commercial bank loan agreements make all republics jointly liable for the entire debt. Bank debt that can be allocated to the FYRM according to the residency of the original borrower amounts to about US$350 million and is currently traded in the secondary market at a discount of about 82 percent. The FYRM has repurchased a small amount of this debt since independence.

The program for 1994 excludes servicing on the FYRM's share of unallocated debt of the former SFRY. The authorities estimate that such unallocated Yugoslav debt to all types of creditors amounts to about US$3 billion. The FYRM's share of total unallocated debt would be less than

---

1/ The decline in the FYRM's foreign exchange reserves as a result of the arrears clearance will be limited to US$22 million due to expected donor support for this clearance of US$35 million, a disbursement under the World Bank's Economic Recovery Loan--within a few weeks of the approval of the loan--of US$32 million against imports pre-dating the approval, and the requested purchase under the STF of about US$17 million. A bridge financing operation by some European central banks is being arranged to allow clearance of the arrears to preceded World Bank disbursement under its Economic Recovery Loan. A break-down of the FYRM's estimated arrears by creditor is shown in Table 9.

US$200 million if the debt was to be divided in accordance with the key that was used to allocate assets and liabilities in the Fund. Debt that can be allocated to the FYRM according to the residency of the original borrower amounts to about US$1,000 million at end-1993, including arrears. The authorities are committed to following a prudent debt management policy with regard to both short- and long-term debt.

The program projects a financing gap of US$217 million in 1994, assuming US$35 million support under the STF, US$35 million support from donors for the clearance of arrears to the World Bank, and US$120 million of IDA/IBRD blend financing from the World Bank under an Economic Recovery Loan and an EFSAL (Tables 7 and 8). This financing gap points to the need for additional exceptional balance of payments support during 1994, including a Paris Club rescheduling. A rescheduling with terms and coverage similar to the 1988 Paris Club rescheduling with the former SFRY would provide an estimated US$126 million in 1994; it would exclude US$50 million of arrears in respect of non-rescheduable debt. There would thus remain a residual financing gap of about US$91 million. The potential sources of additional balance of payments assistance include a follow-up arrangement with the Fund and further support from official bilateral creditors, including export credits. Identified balance of payments support is sufficient to close the financing gap during the first half of 1994. The financing need for the second half of 1994 will be reviewed when determining benchmarks for this period at the time of the request for the second purchase under the STF.

The foreign exchange system introduced in May 1993 is functioning well. 1/ The exchange rate is determined freely in the market, with no taxes or subsidies on foreign exchange transactions, and with few restrictions on the use of foreign exchange at either the wholesale or retail levels. The authorities do not intend to introduce or intensify any exchange restrictions or multiple currency practices, or conclude any bilateral payments arrangements that are inconsistent with the Fund's Articles of Agreement.

The authorities are committed to maintaining an open trade system to facilitate structural reforms and encourage competition within the now truncated domestic market. The system inherited from the former SFRY has been modified to remove or reduce most unnecessary restrictions on trade and, at present, 90-95 percent of trade categories are freely importable and exportable without licenses. The main exceptions relate to imports of certain agricultural and metal products that are subject to high tariffs, and exports of some food items in short domestic supply that are subject to a temporary restriction. The authorities will not impose any new import restrictions for balance of payments purposes, and they intend to review remaining trade restrictions and administrative procedures before June 1994 with the aim of further reducing formal and informal barriers to trade.

1/ The exchange system is described in detail in the report on Recent Economic Developments (SM/93/178, 8/13/93).

Turning to the medium-term outlook, while the debt and debt service ratios are relatively low, available financing is unlikely to be sufficient to replace the loss of transfers from the former SFRY. Thus, an increase in imports from the current depressed levels will hinge on a recovery in exports. The prospect for such a recovery is highly dependent on events associated with the regional crisis. The medium-term balance of payments outlook presented in Table 10 assumes that the policies followed by the authorities will promote export growth and that the effects of the regional crisis will gradually mitigate. The outlook also assumes that project financing from development agencies will be maintained through 1998 at about US$55 million annually and that reserves are slowly increased to the equivalent of two months of imports. Under these assumptions, the outlook suggests that imports could grow by about 30 percent in real terms by 1998, a rate likely to satisfy the anticipated import need associated with the implementation of broad-based reforms.

However, as indicated by the projected financing gaps, the FYRM is likely to continue to need exceptional balance of payments support during the coming years. The level and declining trends of these gaps, combined with the moderate level of foreign indebtedness, suggest that the support necessary to close the financing gaps could be available. Rescheduling of debt to official creditors could provide financing amounting to US$20-30 million annually over the 1995-98 period. The authorities recognize that the realization of all such policy-based financing, and the underlying assumption of a strong export performance, depend on the sustained implementation of stabilization policies and structural reforms. The alternative scenario (Table 10) illustrates that failure to secure a recovery in exports and to attract policy-based lending will result in imports being constrained to levels that will pose an obstacle to a recovery in economic activity. 1/

The outstanding use of Fund resources of only 6 percent of quota (Table 11), the moderate level of foreign indebtedness, and the projected increase in reserves, indicate that the FYRM should be able to continue repaying the Fund on a timely basis. However, notwithstanding the

---

1/ Servicing by the FYRM of its share of the debt of the former SFRY that cannot be allocated according to the residency of the original borrower will affect the medium-term outlook. Without prejudice to negotiations on the allocation of this debt, the medium-term scenario assume an allocation in line with the key used to divide the former SFRY's assets and liabilities in the Fund. The projections include interest payments on such debt, but no principal payments. The projected financing gap for 1995 includes financing required (US$87 million) for an assumed buy-back of the FYRM's commercial bank debt at the present secondary market discount of 82 percent. Given the acute nature of the country's economic and balance of payments problems, debt reduction and repurchase would appear to be the most suitable mechanism for resolving the FYRM's commercial bank debt and arrears problem over the medium term.

authorities' commitment to prudent policies, there are inevitably uncertainties and risks associated with the early phases of the transformation process and with the present situation in the region.

6. Structural reforms

The authorities consider the lack of fundamental structural reforms to have been the root cause of the high inflation and economic stagnation characteristic of the former SFRY and they were mindful that little progress had been made in implementing such reforms in the FYRM since independence. Looking to 1994, the authorities intend to launch a comprehensive bank rehabilitation program and expect a large number of enterprises to prepare privatization programs.

The privatization law approved in June 1993 requires majority ownership, but allows new owners to take immediate control while paying for shares in installments over several years. This feature of the law is intended to reconcile the objective of achieving an early improvement in accountability with that of avoiding privatization at unacceptably large discounts. The required down-payment is considered sufficient by the authorities to overcome the risk of asset-stripping by the new owners, lessening the potential moral hazard problems.

The law pertains to social enterprises with 250,000 employees. 1/ Large- and medium-sized enterprises have until end-1995 to voluntarily prepare privatization plans before being subjected to mandatory privatization under the auspices of the newly established privatization agency. Small enterprises are given until end-1994 to prepare voluntary plans. A more accelerated timetable is not possible because of the still rudimentary nature of the institutions and procedures for overseeing the implementation of the privatization program. In particular, there are currently an insufficient number of experts to evaluate enterprises properly. The authorities undertook to review the prices at which the privatization agency is approving sales of assets if the process proves to be unexpectedly sluggish. 2/

1/ About 80,000 employees in banks, monopolies, and cooperatives are not covered by the law. Banks will be privatized in the context of the bank rehabilitation program, and monopolies and cooperatives will be privatized under separate laws at some stage in the future.

2/ About half of the enterprises (in terms of employees) covered by the new law had already started privatization under the old Law on Social Capital. Widespread irregularities have prompted a review of all privatizations under this former law. The validity of such privatizations must be verified by the Social Accounting Office before the end of 1994 and enterprises for which the earlier privatization is invalidated must initiate privatization procedures under the new law.

There is considerable excess employment in social enterprises, despite the already high rate of unemployment. Although the problem has been exacerbated by the loss of markets in the former SFRY, it clearly pre-dates this event. Privatization of social enterprises will be key to reducing the informal restrictions on lay-offs and real wage rigidities. The authorities have also undertaken to review formal restrictions on lay-offs to ensure that enterprise restructuring is not being hampered by excessively expensive redundancy costs. They emphasized that the needed labor shedding depends on the availability of incremental resources for unemployment compensation.

The interdependence of banks and enterprises has seriously impaired the efficient allocation of capital, and the illiquidity of a large segment of the banking system is seen as a threat to the sustainability of an anti-inflationary monetary policy. The extent of the bad loan problem and the details of the <u>bank rehabilitation</u> program can be determined only after a careful audit of the principal commercial banks, which will be completed during the course of 1994. The bank rehabilitation program is being prepared in close cooperation with the World Bank. Any fundamental solution to the banking crisis presupposes a break in the linkage between enterprises and banks, and a substantial one-time write-down of assets. The goals are to achieve arms-length lending to social enterprises and to increase incentives to lend to the private sector. Until the audits have been completed, the licensing of new banks will continue to be restricted. The National Bank intends to strengthen its regulatory capacity for supervising the banking sector and is preparing to upgrade loan classification and provisioning requirements.

The authorities emphasized that they are undertaking a number of measures to improve their <u>capacity to analyze and implement policies</u>. The effectiveness of fiscal policy will be improved by the above-mentioned unification of tax collection functions of various existing institutions; the centralization within the Ministry of Finance of responsibility and control of expenditures and revenues; a more timely accounting of the financial position of various ministries and institutions; and the introduction of a new budget classification system. Monetary policy will be strengthened by improving instruments and procedures for market-based allocation of National Bank credits and bills; compiling banking statistics directly from original sources and by publishing a timely monetary survey in the standard internationally accepted format; and, in the longer term, introducing a new plan of accounts for the National Bank and the commercial banks in order to improve supervisory and control functions. In the external sector, the capacity to monitor developments will be much improved by new procedures for compiling customs-based import and export statistics and by centralizing responsibility for the collection of balance of payments statistics in the National Bank. The authorities emphasized the importance of further technical assistance from the Fund.

IV. Staff Appraisal

During 1993, there was a further deterioration of the FYRM's economic performance. The clearest manifestations of this deterioration were the increase in inflation to the verge of hyperinflation levels, the further drop in output to about half of its 1989 level, and the rise in the rate of unemployment to 28 percent. While, in part, these acute imbalances have their origin in the regional crisis, they were also being severely compounded by lax policies and by deep-seated structural weaknesses in the labor and financial markets.

The authorities' program for 1994 is correctly focused on achieving sharply lower inflation and halting the explosive growth in public sector arrears in order to stabilize the economy as a necessary precondition for successful economic reforms. The targeted reduction in monthly inflation to less than 2 percent by end-1994 is ambitious. The staff believes, however, that the inflation target is realistic considering that the program's emphasis on wage control, phasing out of selective credits, and significant fiscal tightening signals a major, broadly-based tightening of macroeconomic policies.

An important change in macroeconomic policies is the authorities' determination to refocus monetary policy toward inflation control and away from enterprise liquidity and sectoral support. The staff welcomes, in particular, the discontinuation of selective credits from the National Bank, which should significantly improve the National Bank's control over the monetary aggregates. However, considering the stop-and-go practice that has characterized monetary policy to date, it will take time to build confidence in the credibility of a non-accommodating monetary policy stance. Inflationary expectations will be sticky downward, reacting only with delay to a decline in inflation, and the authorities should expect to have to maintain high real interest rates and tight credit conditions throughout 1994 in order to achieve a sustainable decline in inflation.

A further major plank in the stabilization policy is the introduction of a wage control law. Such a law provides the only effective counter-weight to the inherent tendency of worker-managed enterprises to protect real wages and it should be maintained until privatization has hardened budget constraints. There is clear evidence that, as long as the remnants of self-management remain, a restrictive monetary policy cannot be sustained without an effective incomes policy. The staff is concerned that the close relationship between social enterprises and the Social Accounting Office, which will be responsible for enforcing the wage law, could undermine the law's effectiveness.

The decision to take fiscal measures yielding savings and incremental revenues of 9 percent of GSP will lend crucial support to the anti-inflation program by stopping the rapid growth in arrears and avoiding recourse to the domestic banking system. The staff welcomes the emphasis on the curtailment of generous entitlement programs that have become unaffordable due to the loss of transfers from the former SFRY and the contraction of the revenue base. The decisions to cut agricultural subsidies and to sharply curtail pensions and public sector wages are particularly bold. As to revenues, rather than accepting calls for large increases in the already high payroll taxes, the focus is appropriately on eliminating exemptions, unifying taxes, and strengthening tax administration in order to broaden the tax base. The authorities should consider the early introduction of a value added tax.

The budget situation will remain precarious despite the changes in fiscal policy. There is a risk that a further unexpected drop in output, or failure to stem the rapid deterioration in tax compliance, will cause a revenue shortfall. The authorities should identify contingency measures so as to be ready to offset such a shortfall. Moreover, weak expenditure control could lead to an increase in arrears now that appropriations are being cut significantly across the board. Expenditure control must be moved from individual line ministries to the Ministry of Finance.

Looking beyond the immediate future, budgetary resources for structural reforms and for programs to alleviate the social cost of such reforms are clearly insufficient and a key challenge facing fiscal policy must be to mobilize incremental resources for these purposes. The focus should be on further curtailing the public sector's demand on resources for consumption. Such consumption remains high despite the planned reduction in entitlements, reflecting vestiges of the only recently abolished self-management communities for collective consumption. The authorities should also take measures to further broaden the tax base by improving the capacity to tax the emerging private sector.

Experiences with stabilization in the FYRM and other republics of the former SFRY have shown that wage controls and a restrictive monetary policy cannot be sustained without measures to correct structural weaknesses in two areas. First, there is an urgent need to rehabilitate the large number of insolvent banks and to reduce their dependency on loss-making enterprises in order to prevent the elimination of selective credits from causing a liquidity crisis in the banking system. Priority should be given to early implementation of a bank rehabilitation program--developed in cooperation with the World Bank--in order to underpin the sustainability of the anti-inflation policies. Second, wage controls are only sustainable for a limited period and the lifting of such controls before privatization has hardened budget constraints in social enterprises is likely to spark a wage surge. In this regard, the staff is concerned that social enterprises are given up to two years to prepare voluntary privatization plans. The authorities should reconsider their strategy for privatization if sufficient progress is not achieved during the first half of 1994.

The fragile balance of payments position and the need to facilitate a redirection of exports to new markets preclude the use of the exchange rate as a nominal anchor at this juncture. A further real depreciation could become necessary in the coming months and the National Bank must refrain from using scarce foreign exchange resources to stabilize the currency.

Mindful of the close correlation between exchange rate changes and inflation, the staff shares the authorities' concern that a shortfall in foreign financing could trigger a significant real depreciation and attendant inflationary pressures. The authorities' effort to normalize relations with the World Bank and other multilateral creditors are to be commended as a crucial first step towards unlocking much needed external support. The authorities should seek a similar normalization of relations with Paris Club creditors and commercial banks in order to gain the broadest possible access to external financing.

The program's focus is in line with previous policy recommendations by the staff and the Executive Board. To the extent possible, care has been taken in designing the program to minimize the associated risks, but these remain clearly considerable. They arise from the unpredictable economic impact of the still unfolding regional crisis, particularly the implications for trade flows; the rudimentary institutions for monitoring and implementing economic policies; the uncertainty about the effect of policies due to the deep-seated structural problems in the labor and financial markets; and the potential social pressures associated with a further reduction in the already dramatically reduced real incomes. The authorities are fully aware of these risks and have embarked on the program only after a period of reflection. The staff has taken note of the authorities' commitment to the intentions laid out in the Policy Statement and of their resolve to adjust policies in light of unforeseen developments. Accordingly, the staff considers the program fully deserving of support by the Fund under the STF.

The authorities intend to seek early agreement with the Fund on a comprehensive program that can be supported by a stand-by or similar Fund arrangement. Key to such support will be firm implementation of stabilization policies in the months ahead and sufficient progress in the critical areas of bank rehabilitation and enterprise privatization.

V. Proposed Decision

The following draft decision is proposed for adoption by the Executive Board:

Request for Purchase Under the Systemic Transformation Facility

1. The Fund has received a request by the Government of the former Yugoslav Republic of Macedonia for a purchase equivalent to SDR 12.4 million under the Decision on the Systemic Transformation Facility (Decision No. 10348-(93/61) STF, adopted April 23, 1993).

2. The Fund approves the purchase in accordance with the request.

Table 1. FYRM: Main Economic Indicators

	1990	1991	1992	1993 Est.	1994 Prog.
Real economy		(Change in percent)			
Real GSP	-9.9	-10.7	-14.7	-15.2	-8.0
Industrial production	-10.6	-17.2	-16.1	-17.2	-11.3
Retail prices					
(December over December)	608.4	114.9	1,690.7	244.0	70
Unemployment rate (average) 1/	23.5	25.7	27.9	28.7	...
Public finance		(Percent of GSP)			
General government deficit	...	3.6	7.2	10.9	6.6
General government expenditures	...	40.4	36.1	45.0	48.0
General government revenues	...	36.8	28.9	34.0	41.4
Central government expenditures 2/	...	--	5.6	6.8	5.0
Central government expenditures 2/	...	18.2	19.6	25.2	28.1
Central government revenues	...	18.2	14.0	18.4	23.1
Money and credit		(Change in percent)			
NFA of the National Bank (U.S. dollar, end-of-period)	...	...	59.8	124.6 4/	135
NDA of the banking system (million denar, end-of-period)	...	...	19,857	45,754	53,311
Domestic credit (monthly average)	...	...	16.3	16.9	2.4
Denar M2 (monthly average)	...	...	15.2	23.2	6.7
Short-term lending rate	...	...	1,100-2,355 3/	185-508 4/	...
Discount rate	...	...	250.0 3/	170 4/	...
Balance of payments		(In millions of U.S. dollars)			
Exports 5/	1,113	1,150	1,199	1,009	1,008
Imports	-1,531	-1,375	-1,206	-1,056	-1,061
Trade balance	-418	-225	-7	-47	-54
Current account balance	-400	-262	-10	-52	-43
Reserve ratio (reserves in months of imports)	...	...	0.6	1.3	1.5
External debt (end-year) 6/	828	806	848	844	948
Arrears (end-year) 7/	19	59	225	390	...
Debt service ratio 8/	15	11	15	16	14
Memorandum items:					
Official exchange rate (end-of-period):					
denar per U.S. dollar	11.3	19.7	509.1	42.7 9/	72.6
Official exchange rate (period average)					
denar per U.S. dollar	...	...	...	23.2 9/	62.0
Parallel market exchange rate:					
denar per U.S. dollar (end-of-period)	...	...	...	45.0	...
Real exchange rate (12/89 = 100)	182.7	217.5	146.0	145.2	145.2
changes (in percent) 10/	82.7	19.0	-33.0	-1.0	--
Selected social indicators					
Country size (in sq. km)	25,713	...	...	...	...
Population	2,132	2,153	2,172 11/	2,191 11/	...
Life expectancy					
Male	70.1	...	...	...	...
Female	74.0	...	...	...	...
Infant mortality (per 1,000 live births)	31.6	29.28	27.6	...	...
Consumption selected goods (in kg)					
Meat	34.5	33.0	33.6	...	...
Cereals	59.1	68.0	67.0	...	...
TV subscribers	330,984	337,035	345,465	...	...

Sources: The FYRM authorities; and staff estimates.

1/ These data may overstate the unemployment rate by as much as 2-5 percent, reflecting that some of the registered unemployed may work in the private sector or as part of the active agricultural population.

2/ Includes transfers to extrabudgetary funds.

3/ End-December, 1992.

4/ End-September 1993.

5/ The gradual inclusion of exports to other republics of the former SFRY from 1991 results in a discontinuity in this series for total exports. Data on exports excluding interrepublican exports are shown in Table 12, Appendix II.

6/ Estimated stock of debt, excluding interest arrears, penalty interest, and the FYRM's share of the unallocated debt of the former SFRY.

7/ Estimated principal and interest arrears on the stock of allocated debt only.

8/ Scheduled debt service on the allocated stock of debt in percent of exports of goods and services.

9/ Expressed in new denar (= 100 old denar).

10/ Based on the official exchange rate. A minus sign denotes a depreciation.

11/ Refugees not included (who represent 30-60,000).

Table 2. FYRM: Monetary Survey

	1993				1994	1994	1994	1994
	July	August	September	Q4 est.	Q1 prog.	Q2 prog.	Q3 prog.	Q4 prog.
	(In millions of denar, end of month) 1/							
Net foreign assets	-8,683	-7,801	-9,364	-9,734	-11,040	-10,747	-8,855	-8,493
Foreign assets (MA)	3,274	3,330	3,807	3,437	2,131	2,424	4,316	4,678
Foreign liabilities (MA)	716	639	566	566	566	566	566	566
Foreign assets (DMB)	3,663	4,322	4,350	4,350	4,350	4,350	4,350	4,350
Foreign liabilities (DMB)	14,904	14,814	16,955	16,955	16,955	16,955	16,955	16,955
Net domestic assets	38,082	37,805	42,758	45,754	48,832	50,173	50,654	53,311
Domestic credit	20,886	21,274	25,139	28,678	32,606	34,669	34,671	36,834
Claims on the Government	6,203	6,096	7,073	7,207	8,888	9,010	7,572	7,697
in denar	125	133	194	194	1,756	1,756	194	193
in foreign currency	6,078	5,963	6,879	7,013	7,132	7,254	7,378	7,504
Claims on the social and private sector	14,683	15,178	18,066	21,472	23,718	25,659	27,099	29,142
in denar	7,794	8,321	10,164	13,416	15,525	17,327	18,624	20,523
in foreign currency	6,889	6,857	7,902	8,056	8,193	8,333	8,475	8,619
Other items, net 1/	17,196	16,531	17,619	17,076	16,226	15,504	15,983	16,472
M3	29,399	30,004	33,394	36,020	37,791	39,426	41,799	44,818
M1	4,485	4,692	4,682	6,003	6,915	7,714	9,048	10,848
Currency in circulation	2,012	1,905	2,437	3,124	3,599	4,015	4,709	5,647
Demand deposits	2,473	2,787	2,245	2,878	3,316	3,699	4,338	5,202
M2	15,518	16,109	17,402	19,403	20,824	22,095	24,090	26,716
Quasi money	11,041	11,425	12,728	13,400	13,909	14,381	15,042	15,868
Denar quasi money	1,299	1,468	1,618	2,074	2,390	2,666	3,127	3,749
Foreign currency M2	9,742	9,957	11,110	11,326	11,519	11,716	11,915	12,119
Nonmonetary deposits 2/	13,873	13,887	15,984	16,617	16,968	17,331	17,709	18,102
Denar	,554	613	675	747	827	915	1,013	1,121
Foreign currency	13,319	13,383	15,568	15,870	16,141	16,417	16,697	16,981
	(Percent change from previous period)							
Domestic credit	1.7	1.9	18.2	14.1	13.7	6.3	--	6.2
of which: to the social and private sector	1.9	3.4	19.0	18.9	10.5	8.2	5.6	7.5
M1	37.1	4.6	-0.2	28.2	15.2	11.6	17.3	19.9
Denar M2	34.4	6.5	2.3	28.2	15.2	11.6	17.3	19.9
Memorandum items:								
Denar M2	5,784	6,160	6,300	8,077	9,305	10,379	12,174	14,597
Real M1 (12/91=100) CPI defl.	49.7	47.3	43.3	37.4	35.9	34.9	36.5	39.8
Real Denar M2 (12/92=100) CPI defl.	49.2	47.8	44.8	38.7	37.2	36.0	37.8	41.2

Sources: National Bank of Macedonia; and staff estimates.

1/ Foreign reserves and foreign liabilities valued at constant end-September 1993 exchange rate. Flows valued at current exchange rate.

2/ Contains unsettled claims from the break-up of the former SFRY.

Table 3. FYRM: National Bank Accounts

	1993 July	1993 August	1993 September	1993 Q4 est.	1994 Q1 prog.	1994 Q2 prog.	1994 Q3 prog.	1994 Q4 prog.
	(In millions of denar)							
Net foreign assets	2,558	2,691	3,241	2,871	1,565	1,858	3,750	4,112
Net domestic assets	421	376	9	948	2,908	3,134	2,101	2,891
Domestic credit	810	819	823	1,762	3,722	3,948	2,915	3,705
Credit to banks	746	755	759	1,698	2,096	2,323	2,851	3,641
Credit to the Government	64	64	64	64	1,626	1,626	64	64
Other net items	-389	-443	-814	-814	-814	-814	-814	-814
Instruments	-415	-513	-620	-373	-430	-479	-562	-674
Compulsory reserves	-331	-400	-492	-373	-430	-479	-562	-674
Compulsory treasury subscription	-84	-113	-128	--	--	--	--	--
Reserve money	2,564	2,554	2,630	3,446	4,043	4,514	5,288	6,328
Currency in circulation	2,012	1,905	2,437	3,124	3,599	4,015	4,709	5,647
Deposit money banks' cash	58	64	69	82	98	113	127	139
Banks' free reserves	494	585	124	240	346	386	452	542
	(Change as percent of reserve money at beginning of period)							
Net foreign assets	...	5.2	21.5	-14.1	-37.9	7.3	41.9	6.8
Net domestic assets	...	-1.8	-14.4	35.7	56.9	5.6	-22.9	14.9
Domestic credit	...	0.4	0.2	35.7	56.9	5.6	-22.9	14.9
Credit to banks	...	0.4	0.2	35.7	11.6	5.6	11.7	14.9
Credit to the Government	...	--	--	--	45.3	--	-34.6	--
Other net items	...	-2.1	-14.5	--	--	--	--	--
Instruments	...	-3.8	-4.2	9.4	-1.6	-1.2	-1.8	-2.1
Compulsory reserves	...	-2.7	-3.6	4.5	-1.6	-1.2	-1.8	-2.1
Compulsory treasury subscription	...	-1.1	-0.6	4.9	--	--	--	--
Reserve money	...	-0.4	3.0	31.0	17.3	11.6	17.2	19.7

Sources: National Bank of Macedonia; and staff estimates.

Table 4. FYRM: Summary of Fiscal Measures 1/

(In percent of GSP)

Total impact in 1994 on the Central Government budget and extrabudgetary social funds	6.9
Expenditure savings	5.4
Central Government	
Reduction in agricultural subsidies	2.1
Reduction in public sector wages	1.1
Other discretionary expenditures	0.8
Extrabudgetary funds	
Pension fund	1.4
Increased expenditures for reforms and social programs	-2.5
Central Government	
Bank rehabilitation	-2.0
Social programs	-0.5
Additional revenues	4.0
Central Government	
Change in sales and excise taxes	2.0
Consolidation of income taxes	--
Extrabudgetary funds	
Pension fund	1.5
Unemployment compensation fund	0.5

Sources: FYRM authorities; and staff estimates.

1/ The effect in 1994 of fiscal measures compared to the projected outcome for 1994 without such measures.

Table 5. FYRM: Summary of General Government Operations, 1991-94 1/

	1991	1992	1993 Est.	1994 Prog.	1991	1992	1993 Est.	1994 Prog.
	(In millions of denars)				(In percent of GSP)			
Total revenue and grants	418	4,639	24,282	60,681	36.8	28.9	34.0	41.4
Central Government	207	2,238	13,112	33,890	18.2	14.0	18.4	23.1
Tax Revenue	196	2,193	11,375	31,328	17.3	13.7	15.9	21.4
Non-tax revenue	11	45	1,737	2,562	1.0	0.3	2.4	1.7
Foreign grants	--	--	--	--	--	--	--	--
Extrabudgetary funds	208	2,376	10,996	26,406	18.3	14.8	15.4	18.0
Pension fund	97	1,116	5,764	16,189	8.5	7.0	8.1	11.1
Health-care fund	56	683	3,556	8,703	4.9	4.3	5.0	5.9
Employment fund	6	57	342	1,344	0.5	0.4	0.5	0.9
Other funds	50	520	1,334	170	4.4	3.2	1.9	0.1
Local budgets	3	25	174	386	0.3	0.2	0.2	0.3
Total expenditure and net lending	459	5,793	32,066	70,294	40.4	36.1	45.0	48.0
Central Government	207	3,135	16,950	36,846	18.2	19.6	23.8	25.2
Current expenditures	197	3,020	16,525	36,289	17.3	18.8	23.2	24.8
Capital expenditures	7	100	320	396	0.6	0.6	0.4	0.3
Reserves	3	15	105	161	0.3	0.1	0.1	0.1
Extrabudgetary funds	249	2,628	14,936	33,076	21.9	16.4	20.9	22.6
Pension funds	114	1,337	9,542	20,483	10.0	8.3	13.4	14.0
Health-care fund	79	702	3,557	8,703	6.9	4.4	5.0	5.9
Employment fund	6	69	504	1,355	0.5	0.4	0.7	0.9
Other funds	50	520	1,334	2,534	4.4	3.2	1.9	1.7
Local budgets	3	30	180	372	0.3	0.2	0.3	0.3
Overall deficit (accrual)	-41	-1,154	-7,784	-9,613	-3.6	-7.2	-10.9	-6.6
Central Government	--	-897	-3,837	-2,957	--	-5.6	-5.4	-2.0
Extrabudgetary funds	-41	-252	-3,941	-6,670	-3.6	-1.6	-5.5	-4.6
Pension fund	-18	-221	-3,778	-4,295	-1.6	-1.4	-5.3	-2.9
Health-care fund	-23	-19	--	--	-2.0	-0.1	--	--
Employment fund	--	-12	-162	-12	--	-0.1	-0.2	--
Other funds 2/	--	--	--	-2,364	--	--	--	-1.6
Local governments	--	-5	-6	14	--	--	--	--
Financing	41	1,154	7,784	9,613	3.6	7.2	10.9	6.6
Foreign financing	--	145	1,332	2,606	--	0.9	1.9	1.8
Inflow	--	145	1,332	15,786	--	0.9	1.9	10.8
Outflow 3/	--	--	--	-13,180	--	--	--	-9.0
Domestic financing	41	1,009	6,452	7,007	3.6	6.3	9.0	4.8
Inflow	41	1,009	6,452	7,007	3.6	6.3	9.0	4.8
Outflow	--	--	--	--	--	--	--	--
Memorandum item:								
Primary deficit	-41	-587	-4,701	-2,771	-3.6	-3.7	-6.6	-1.9

Sources: FYRM authorities; and staff estimates.

1/ Excludes transfers from the Central Government to extrabudgetary funds.

2/ The main revenue source of some extrabudgetary funds--i.e., levies on oil derivatives--was replaced by the sales tax at the beginning of 1994. From then on, expenditures of these funds will be financed by transfers from the Central Government.

3/ The weak system of expenditure control, in combination with uncertainties related to the amount and due dates of government debt servicing obligations, precludes estimates of arrears for 1991-93.

Table 6. FYRM: Balance of Payments, 1990-94

(In millions of U.S. dollars)

	1990	1991	1992	1993 Est.	1994 Prog.
Current account	-400	-262	-10	-52	-43
Trade balance	-418	-225	-7	-47	-54
Processing trade 1/	133	120	67	-20	--
Other trade	-551	-345	-74	-27	-54
Exports 2/	1,113	1,150	1,199	1,009	1,008
Processing exports 1/	536	489	310	98	90
Other trade	577	661	889	911	918
Imports	-1,531	-1,375	-1,206	-1,056	-1,061
Processing imports 1/	-403	-369	-243	-118	-90
Other trade	-1,128	-1,006	-963	-938	-971
Services, net	-66	-9	-33	-54	-44
Of which: interest, net	-56	-32	-63	-66	-58
Transfers, net	84	-28	30	49	55
Private, net	84	-28	30	25	20
Official, net	...	...	...	24	35
Capital account	-53	-189	-179	-106	-154
Medium- and long-term capital	-63	-90	-113	-107	-146
Disbursements 3/	60	14	9	--	228 4/
Amortization 3/	-123	-104	-122	-107	-88
Repayment of arrears	--	--	--	--	-286
Multilateral creditors	--	--	--	--	-141
Official bilateral creditors	--	--	--	--	-145
Short-term capital, net	10	-99	-66	1	-8
Errors and omissions, net 5/	434	411	83	49	--
Overall balance	-19	-40	-106	-109	-197
Change in net official foreign assets 6/	...	...	-60	-55	-20
Assets	...	...	-60	-55	-53
Liabilities	...	...	...	...	33
Ex-post accumulation of arrears 7/	19	40	166	164	...
Ex-ante financing gap	...	...	...	...	217
Memorandum items:					
Trade balance (in percent of GSP)	-16.3	-9.7	-0.4	-2.8	-3.5
Current account balance (in percent of GSP)	-15.6	-11.3	-0.5	-3.1	-2.8
Reserve ratio (reserves in months of imports)	...	...	0.6	1.3	1.5

Sources: Data and estimates provided by the authorities; staff estimates and projections.

1/ Goods imported for processing and subsequent export according to contracts with foreign enterprises.

2/ The gradual inclusion of exports to other republics of the former SFRY from 1991 results in a discontinuity in this series for total exports. Data on exports excluding interrepublican exports are shown in Table 12, Appendix II.

3/ Excluding the IMF.

4/ Disbursements in 1994 include a US$40 million disbursement under an EFSAL planned by the World Bank, and the suspension of US$56 million in debt service payments due in 1994 to commercial banks and other commercial creditors.

5/ The large size of the net errors and omissions item partly reflects the sizeable transfers from the former SFRY that allowed the FYRM to finance large external current account deficits through 1991.

6/ End-of-period; increase in assets denoted by a minus sign; includes IMF.

7/ Arrears on stock of allocated debt only.

Table 7. FYRM: Sources and Uses of Foreign Exchange in 1994

(In millions of U.S. dollars)

	Sources	Uses
Current account deficit	...	-43
Of which interest payments to: 1/		
Multilateral creditors	...	(-22)
Official creditors	...	(-14)
Pre-December 1982	...	[-11]
Post-December 1982	...	[-3]
Commercial banks	...	(-22)
Others	...	(-5)
Official multilateral creditors:		
Disbursements (excluding IMF):	138	...
IBRD 2/	(120)	...
EBRD	(18)	...
Principal payments (excluding IMF)	...	-36
Reduction in arrears:	...	-141
IBRD	...	(-107)
Other multilaterals	...	(-34)
Official bilateral creditors	35	-168
Bilateral donor support	(35)	...
Principal payments	...	(-23)
Pre-December 1982	...	[-17]
Post-December 1982	...	[-5]
Arrears reduction 1/	...	(-145)
Pre-December 1982	...	[-98]
Post-December 1982	...	[-48]
Commercial Banks 3/	49	-27
Principal payments	...	(-27)
Suspension of principal payments	(27)	...
Suspension of interest payments	(22)	...
Other, net	...	-4
Net official reserves	...	-20
Residual financing gap	217	...
Total	439	-439

Sources: Data and estimates provided by the authorities; and staff estimates.

1/ Includes estimates of interest on arrears on allocated debt stock only.

2/ Includes a US$40 million disbursement under an EFSAL planned by the World Bank for the second half of 1994.

3/ All payments to commercial banks are assumed to remain suspended in 1994.

Table 8. FYRM: Balance of Payments--Quarterly Projections, 1994

(In millions of U.S. dollars)

	1994 Program 1/				
	Q1	Q2	Q3	Q4	Total
Current account	-4	-10	-14	-14	-43
Trade balance	-7	-12	-18	-18	-54
Processing trade 2/	--	--	--	--	--
Other trade	-7	-12	-18	-18	-54
Exports	252	252	252	252	1,008
Processing exports 2/	23	23	23	23	90
Other trade	229	229	229	229	918
Imports	-259	-264	-270	-270	-1,061
Processing imports 2/	-23	-23	-23	-23	-90
Other trade	-236	-241	-247	-247	-971
Services, net	-9	-13	-11	-11	-44
Of which: interest, net	-13	-17	-14	-14	-58
Transfers, net	12	15	15	15	55
Private, net	5	5	5	5	20
Official, net	7	10	10	10	35
Capital account	-46	8	-62	-55	-154
Medium- and long-term capital	-44	12	-60	-55	-146
Disbursements 3/ 4/	96	51	45	36	228
Amortization 3/	-33	-16	-23	-16	-88
Repayment of arrears	-107	-23	-82	-75	-286
Multilateral creditors	-107	-23	-9	-2	-141
Official bilateral creditors	--	--	-73	-73	-145
Short-term capital, net	-2	-4	-2	--	-8
Errors and omissions, net	--	--	--	--	--
Overall balance	-50	-2	-76	-69	-197
Change in net official foreign assets 5/	40	-5	-50	-5	-20
Assets	23	-4	-67	-4	-53
Liabilities	17	-1	17	-1	33
Ex-ante financing gap	10	7	126	74	217

Sources: Data provided by the authorities; and staff estimates.

1/ Totals may not add due to rounding.
2/ Goods imported for processing and subsequent export according to contracts with foreign enterprises.
3/ Excluding the IMF.
4/ Disbursements in 1994 include a US$40 million disbursement under an EFSAL planned by the World Bank, and the suspension of US$56 million in debt service payments due in 1994 to commercial banks and other commercial creditors.
5/ End-of-period; increase in assets denoted by a minus sign; includes the IMF.

Table 9. FYRM: Estimated External Arrears by Creditor at end-1993 1/

(In millions of U.S. dollars)

	Principal Arrears	Interest Arrears 2/	Total Arrears
Official creditors	...	...	286
Multilateral	...	...	141
IMF	--	--	--
IBRD	...	...	107
IFC	...	...	9
EIB	...	...	12
EUROFIMA	7	3	10
European Fund for Reintegration	2	1	3
Bilateral	113	32	145
Rescheduled debt 3/	72	25	98
Non-rescheduled debt	41	7	48
Private creditors	38	65	104
Commercial banks	--	51	51
Others	38	14	53
Total	...	...	390

Sources: Data and estimates provided by the authorities; and staff estimates.

1/ Arrears on identified medium- and long-term debt only, excluding arrears on the FYRM's share of the unallocated debt of the former SFRY.
2/ Including estimated penalty interest.
3/ Debt rescheduled under previous agreements between the Paris Club and the former SFRY.

Table 10. FYRM: Illustrative Medium-Term Balance of Payments Scenarios, 1993-98

(In millions of U.S. dollars)

	Estimate	Projections				
	1993	1994	1995	1996	1997	1998
Baseline Scenario						
Current account	-52	-43	-75	-79	-64	-47
Trade balance	-47	-54	-90	-98	-82	-62
Exports	1,009	1,008	1,090	1,189	1,310	1,443
Imports	-1,056	-1,061	-1,180	-1,287	-1,392	-1,505
Services, net	-54	-44	-40	-36	-37	-40
Of which: interest, net	-66	-58	-54	-51	-54	-62
Transfers, net	49	55	55	55	55	55
Capital account	-106	-154	-59	16	24	9
Medium- and long-term capital, net	-107	-146	-79	-4	-6	-21
Disbursements 1/	--	228 2/	63	56	55	55
Amortization 1/	-107	-88	-142	-60	-61	-76
Repayment of arrears	--	-286	--	--	--	--
Non-financial private capital, net	...	--	20	20	30	30
Short-term capital, net	1	-8	--	--	--	--
Overall balance	-109	-197	-134	-63	-40	-38
Change in net foreign assets 3/	-55	-20	-20	-30	-30	-30
Financing gap	164	217	154 4/	93	70	68
Memorandum items:						
Current account (in percent of GSP)	-3.1	-2.8	-4.6	-4.6	-3.5	-2.4
Export volumes (annual percent change)	...	-0.5	6.0	7.0	8.0	8.0
Import volumes (annual percent change)	...	1.0	9.0	7.0	6.0	6.0
Reserve ratio (reserves in months of imports)	1.3	1.5	1.6	1.7	1.9	2.0
Debt service (in percent of exports of goods and services) 5/	16.4	14.2	9.9	9.3	8.9	9.6
External debt (in percent of GSP) 6/	68.8	77.5	62.9	65.1	65.6	64.9
Low-Export-Growth Scenario						
Current account	-52	-43	-19	-20	-37	-36
Trade balance	-47	-54	-42	-50	-68	-60
Exports	1,009	1,008	1,018	1,059	1,102	1,158
Imports	-1,056	-1,061	-1,060	-1,109	-1,170	-1,218
Services, net	-54	-44	-32	-25	-24	-31
Of which: interest, net	-66	-58	-47	-40	-90	-47
Transfers, net	49	55	55	55	55	55
Capital account	-106	-154	-59	16	34	31
Medium- and long-term capital, net	-107	-146	-79	-4	4	1
Disbursements 1/	--	228 2/	63	56	55	55
Amortization 1/	-107	-88	-142	-60	-51	-54
Repayment of arrears	--	-286	--	--	--	--
Non-financial private capital, net	...	--	20	20	30	30
Short-term capital, net	1	-8	--	--	--	--
Overall balance	-109	-197	-78	-4	-3	-5
Change in net foreign assets 3/	-55	-20	-20	-30	-30	-30
Financing gap	164	217	98 4/	34	33	35
Memorandum items:						
Current account (in percent of GSP)	-3.1	-2.8	-1.2	-1.3	-2.3	-2.2
Export volumes (annual percent change)	...	-0.5	--	2.0	2.0	2.0
Import volumes (annual percent change)	...	1.0	--	2.0	2.0	2.0
Reserve ratio (reserves in months of imports)	1.3	1.5	1.8	2.0	2.2	2.5
Debt service (in percent of exports of goods and services) 5/	16.4	14.2	10.0	9.5	8.5	9.0
External debt (in percent of GSP) 6/	68.8	77.5	58.9	59.6	60.7	61.7

Sources: Data and estimates provided by the authorities; and staff projections.

1/ Excluding the IMF.

2/ Disbursements in 1994 include a US$40 million disbursement under an EFSAL planned by the World Bank, and the suspension of US$56 million in debt service payments due in 1994 to commercial banks and other commercial creditors.

3/ Increase denoted by a minus sign; includes net purchases from the IMF.

4/ Includes US$87 million as the cost of an assumed commercial bank debt repurchase operation.

5/ Estimated debt service on allocated debt only, including payments to the IMF, excluding the repayment of arrears in 1994, and excluding the one-time payment included in amortization in 1995 for an assumed repurchase of commercial bank debt. Debt service projections are subject to upward revision as available debt service information is incomplete.

6/ Estimated stock of debt, including arrears, penalty interest, a working assumption regarding the FYRM's share of the unallocated debt of the former SFRY calculated on the basis of the Fund key and, from 1995, including the effect of an assumed commercial bank debt reduction and repurchase operation.

Table 11. FYRM: Indicators of Fund Credit, 1993-98 1/

	1993	1994	1995	1996	1997	1998
			(In percent)			
Outstanding Fund credit relative to:						
Quota	5.7	53.2	51.8	50.6	50.0	45.8
Exports	0.4	3.7	3.3	3.0	2.7	2.2
Reserves 2/	3.4	27.4	23.2	19.0	16.1	13.0
Total external debt 3/	0.4	2.9	3.4	3.1	2.9	2.5
Fund charges and repurchases relative to:						
Quota	0.2	4.7	4.8	4.3	3.7	7.2
Exports	--	0.3	0.3	0.3	0.2	0.4
Reserves 2/	0.1	2.5	2.2	1.7	1.3	2.0
Total external debt 3/	--	0.3	0.3	0.3	0.2	0.4
			(In millions of U.S. dollars)			
Memorandum items:						
Fund purchases	--	34.7	--	--	--	--
Fund repurchases	0.1	1.7	1.0	0.8	0.4	2.9
Fund charges	--	1.7	2.4	2.2	2.2	2.1
SDR/US$ exchange rate	1.4	1.4	1.4	1.4	1.4	1.4

Source: Fund staff estimates.

1/ Assuming purchases of SDR 12.4 million under the STF in January 1994 and July 1994.

2/ Net international reserves.

3/ Estimated stock of debt, including a working assumption regarding the FYRM's share of the unallocated debt of the former SFRY calculated on the basis of the Fund key and, from 1995, including the effect of an assumed commercial bank debt reduction and repurchase operation.

Skopje, January 14, 1994

Mr. Michel Camdessus
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. Camdessus:

As you know, the Government of the former Yugoslav Republic of Macedonia (FYRM) has been engaged in discussions with the Fund staff for some time on policies to deal with the acute economic problems facing the FYRM. While the design of such policies has been complicated by the severe drop in real incomes that has resulted from the political crisis in the region, we have decided, after a period of reflection, to launch an ambitious economic program. This program is described in the attached Policy Statement. By focusing on achieving a significant reduction in inflation and on launching reforms that will enhance our capacity to implement and sustain comprehensive stabilization policies, we believe that the present program will create the conditions necessary to soon embark on a broader-based program of macroeconomic stabilization and systemic reform.

The Government intends to request two purchases under the Systemic Transformation Facility (STF) in the aggregate amount of SDR 24.80 million (50 percent of quota) in support of the economic program for 1994 described in the Policy Statement. It is intended that the first purchase of SDR 12.40 million (25 percent of quota) would be made on the date of its approval by the Fund and the second purchase in the same amount will be made as soon as the conditions for this purchase are met. The Government also intends to reach understandings as soon as possible with the Fund on a comprehensive adjustment program that could be supported by a stand-by arrangement in the upper credit tranches or by a similar Fund arrangement.

Sincerely yours,

Ljube Trpeski
Minister without Portfolio

Borko Stanoevski
Governor
National Bank of the FYRM

Attachment: Policy Statement

Skopje, January 14, 1994

Policy Statement of the Government of
the former Yugoslav Republic of Macedonia

Objectives and Strategy

1. The overriding objective of the Government's program for 1994 is to pull the economy away from the brink of hyperinflation. The anti-inflationary thrust of the program has three main components: (1) the restoration of wage discipline through strict implementation of a wage control law; (2) the refocusing of monetary policy from sectoral support to inflation control; and (3) an ambitious package of fiscal measures, centered on curtailment of entitlement programs that have become unaffordable with the sharp contraction in output and the loss of transfers from the former Yugoslavia. On the basis of these policies, our program targets a reduction in monthly inflation to below 10 percent in early 1994, 5 percent in the middle of the year, and 2-3 percent by end-1994, entailing annual inflation of approximately 70 percent (December to December).

2. We believe that this decisive reduction in inflation, together with a broad-based program of structural reforms--emphasizing privatization, banking sector rehabilitation, and institutional changes to improve our policy implementation capacity--will lay a firm basis for sustainable growth. In the short term, however, the U.N. sanctions against the Federal Republic of Yugoslavia will further reduce output, and GSP is expected to decline by around 8 percent in 1994, falling to about half of its pre-crisis level.

Incomes Policy and Financial Discipline

3. Uncontrolled wage growth has caused a surge in the number of illiquid and insolvent enterprises, a major factor hindering past attempts at sustained implementation of an anti-inflationary monetary policy. To underpin monetary policy and break the wage-price spiral, we have adopted a wage control law. This law, which was passed on December 22, 1993, also specifies limits on benefits and payments in kind. It applies only to enterprises with social capital, which account for 83 percent of total employment, in order to encourage such enterprises to complete privatization early.

4. Under the law, net personal income payments per employee in enterprises in the economic sector paid in January, 1994 (for the month of December 1993) will be limited to 95 percent of the average income payments in these enterprises for August-September 1993, plus an adjustment for inflation in October-December. During the remainder of 1994, the maximum monthly increase in incomes paid will be limited to 1 1/2 percentage points below actual monthly price inflation for inflation up to the targeted inflation

rate and to only one half of any inflation above the monthly target (see Attachment). Net personal income per employee in enterprises in the noneconomic sector paid in January 1994 will be limited to 92 percent of the inflation-adjusted August-September base. During the remainder of 1994, the maximum monthly adjustment in these incomes will be 2.5 percentage points below actual price inflation up to the targeted inflation rate and only one half of any inflation above the monthly target. The law will allow for a special adjustment to the August-September base for enterprises where net personal income per employee is less than 75 percent of the average base wage in the economic sector. In determining the adjustment formulas, we have taken into account the existing gap between real wages and labor productivity, the expected further decline in output in 1994, and the 25 percent relative increase in wages in the noneconomic sector since 1990.

Monetary and Exchange Rate Policies

5. The Government recognizes that its ambitious inflation objective will require a tight monetary policy, consistent with the fundamental shift in the focus of monetary policy from sectoral support to inflation control. It will conduct monetary policy in the context of a flexible exchange rate regime. Velocity is expected to remain unchanged during the first half of 1994 and to start declining only from midyear. The increase in reserve money, which will be the prime intermediate objective of monetary policy, will be limited to 17 percent during the first quarter and to 12 percent during the second quarter of 1994. Should unanticipated large inflows of foreign exchange threaten to give rise to an unwarranted appreciation of the currency, the National Bank will resort to sterilized intervention until there is firm evidence that the inflows are associated with a permanent increase in the demand for money. However, should balance of payments trends turn out less favorably than anticipated, the National Bank will not resist market trends.

6. The Government has recently taken steps to strengthen significantly the National Bank's control over reserve money. New rediscounting by the National Bank of commercial banks' agricultural credits were sharply reduced in the last quarter of 1993. We intend to limit such rediscounting to denar 140 million during the first quarter of 1994 and to halt new rediscounting completely by end-March 1994. Thereafter, the National Bank will no longer provide selective credits of any sort.

7. The phasing-out of selective credits is being accompanied by the introduction of procedures and instruments for market-based allocation of National Bank credits and bills; the first auction of credits took place on November 10, 1993. However, market-based interest rates alone will not ensure an efficient allocation of credit because banks' decision-making is currently distorted by a high level of impaired assets, and because weak financial discipline makes enterprises insensitive to interest rates. We intend, therefore, to impose maximum limits both on individual bank's access to National Bank credits and on each bank's extension of credits. The increase in denar credits by banks to the nongovernment sector will be limited to 16 percent in the first quarter and 12 percent in the second

quarter of 1994. We are concerned, however, that the effectiveness of this instrument could be eroded by further interest capitalization on loans to troubled enterprises. The effectiveness of credit ceilings will be reviewed in consultation with the Fund staff before end-June 1994.

8. Once the auctioning of National Bank credits becomes fully effective, the National Bank's discount rate will be adjusted in line with the interest rate fixed in the auction so as to ensure that all National Bank credits are provided on comparable market-based terms. In the meantime, the discount rate, which is currently fixed at 295 percent, will be set at a level that is clearly positive in real terms, with the annualized average inflation rate during the most recent two month period plus a 5 percent real interest rate component serving as a guideline. The discount rate will not be adjusted for seasonal changes in the monthly inflation rate.

9. In line with the monetary and exchange rate policies described above, and taking into account projected foreign exchange flows, financial benchmarks under the program for net domestic assets of the banking system, credit to the Central Government, and net foreign assets of the National Bank are set out in the attached Appendix.

Public sector policies

10. The dramatic contraction in economic activity has caused a surge in the deficit of the general government. This deficit increased from 3.6 to 10.1 percent of GSP between 1991 and 1993, and is projected to reach 13.5 percent of GSP in 1994 in the absence of corrective fiscal measures. Bold steps are clearly needed to prevent explosive growth in arrears, while redeploying available funds towards programs for structural reforms. We have adopted a package of measures yielding incremental revenues of about 4.0 percent of GSP, expenditure cuts of 5.4 percent of GSP, and providing additional resources of 2.5 percent of GSP for social programs, unemployment compensation, and banking sector rehabilitation. These measures are expected to limit the projected deficit for the general government to 6.7 percent of GSP in 1994.

11. As to expenditures by the Central Government, our program contains three key measures that are projected to yield savings of 4.0 percent of GSP in 1994: (1) agricultural subsidies will be limited to denar 2,625 million, which will entail a reduction of such subsidies from 3.9 to 1.8 percent of GSP; (2) wages in the noneconomic sector will be reduced by 15 percent relative to wages in the economic sector as a result of the measures described in paragraph 4 above. This will reduce the wage bill by about 1.1 percent of GSP; and (3) the 1994 Budget limits other current expenditures (i.e., excluding wages, agricultural subsidies, interest payments, and expenditures for social programs) to denar 7,510 million, a reduction of about 0.8 percent of GSP.

12. Our program provides a considerable increase in public resources for structural reforms: (1) the Central Government budget contains additional appropriations for social programs of about 0.5 percent of GSP. Moreover,

we have improved the targeting of such programs by replacing the general bread subsidy with a special subsidy for low-income households; (2) outside the Central Government budget, resources for the unemployment compensation fund have been increased by 0.5 percent of GSP through an increase in earmarked taxes from 0.8 to 1.5 percent of payrolls; (3) while the modalities of our bank rehabilitation program remain to be worked out, implementation is expected to commence in the middle of 1994 at a cost to the Budget that has been projected generously at 2 percent of GSP in 1994. Should the appropriation for bank rehabilitation prove to be too high, unspent funds will be diverted to social programs, the funding of which remains low relative to the potential increase in the demand on these resources.

13. The sharp contraction of revenues in recent years reflects the negative impact of the collapse of output on the revenue base and our still limited ability to tax the emerging private sector. The program contains a number of measures aimed at broadening the revenue base and improving tax collection: (1) the number of sales tax rates has been reduced from 21 to 3, with a general rate of 25 percent; a rate of 5 percent for food items, equipment, children's clothing, liquid gas, and banking services; and a rate of 10 percent on other services. We are also requiring the payment of sales tax on imports at the time of entry into the country rather than at the domestic point of sale; (2) the excise taxes on oil derivatives, alcohol, cigarettes, automobiles, and other items have been increased; (3) the existing tax collection functions of the Social Accounting Office and the Ministry of Finance have been integrated into an Office of Public Revenue in the Ministry; and (4) the present nine personal income taxes will be consolidated into a united tax with progressive rates, and a number of exemptions will be eliminated, before April 1, 1994. The changes to the sales tax and the increase in excise taxes, which became effective on January 1, 1994, are expected to yield additional revenues of around 2 percent of GSP in 1994. We have conservatively assumed that the changes in the personal income tax and the consolidation of tax administration functions will be revenue neutral in 1994.

14. The financial position of the Central Government will remain difficult despite the above-mentioned expenditure savings and increases in revenues. A major burden on the budget are the large foreign liabilities that have been assumed by the Central Government following the break-up of the former Yugoslavia. Our projections suggest that the programmed expenditures for 1994, including the planned clearance of all arrears to multilateral creditors and the timely servicing of current payments to such creditors in 1994, are unlikely to be fully covered from revenues and expected foreign financing. It will, therefore, be necessary for the Central Government to receive a one-time credit from the National Bank of denar 2,045 million in order to purchase US$40 million for the clearance of arrears to the World Bank. This credit will be reduced to denar 1,562 million by end-March 1994. The Central Government will receive no other credits from the domestic banking system and we expect no further increase in domestic arrears, except for arrears on frozen foreign currency deposits. We intend to review the fiscal position of the Government, in consultation with the IMF, before end-

June 1994, with the aim of taking corrective measures to offset any unanticipated developments that might threaten our commitment to avoid further recourse to the banking system and accumulation of domestic payment arrears.

15. Delays in payments from the Pension Fund have increased from 1 month at the beginning of 1993 to 2 1/2 months at present, and projections suggest that such delays will lengthen to five months by the end of 1994 in the absence of corrective measures; the deficit in the Pension Fund would increase to 5.9 percent of GSP in 1994. It has become urgent to take the following measures, which will yield expenditure savings of 1.4 percent and revenue increases of 1.5 percent of GSP: (1) pensions will be increased at the same rate as average wages in the noneconomic sector, which are programmed to decline by 22 percent in 1994. The proposed change will reduce the ratio of the average pension to the average wage from the present level of about 82 percent, which is high by international comparisons, to about 74 percent at the end of 1994; (2) the existing two schemes for early retirement, which caused a surge in the number of retirees of 20 percent during the last 18 months, have been abolished; (3) contributions to the Pension Fund have been increased from 18 to 20 percent of payrolls; (4) the retirement age has been increased by half a year annually to achieve a gradual increase in the retirement age from 60 to 63 for men and from 55 to 58 for women; and (5) the base for calculating pensions has been changed in stages to the total lifetime income of the retiree, rather than the current practice of using the ten year period with the highest income. These measures, which became effective on January 1, 1994, are projected to improve the financial position of the Pension Fund by 2.9 percent of GSP in 1994, reducing the deficit to 3.0 percent of GSP. The deficit could be even lower if a number of measures to strengthen the collection of payroll contributions from the private sector bear early fruit. We intend to commission a comprehensive review by independent actuarial experts of the benefits and financial position of the Pension Fund with the aim of implementing, before end-June 1994, measures that could eliminate the deficit of the Pension Fund in 1995. In the meantime, further increases in the contribution rates for payroll taxes earmarked for the Pension Fund or in the Pension Fund's use of short-term credits from the banking system will not be undertaken.

External Policies

16. The projected balance of payments flows indicate that exchange market equilibrium will be consistent with a largely unchanged real effective exchange rate and an increase in National Bank reserves of US$20 million in 1994. However, since the economy is still in the process of adjusting to the external shocks that have occurred already, and taking into account uncertainty about the impact of the recent intensification of U.N. sanctions against the Federal Republic of Yugoslavia, balance of payments trends could be less favorable than projected. There could, therefore, be a further real depreciation.

17. Early normalization of relations with external creditors is essential in order to unlock the foreign assistance that will be a key to the success of our program. As to official multilateral creditors, we resumed payment of all current debt servicing obligations to the World Bank from October 1, 1993. We intend to clear the outstanding stock of arrears to the Bank of US$107 million by end-February 1994 and expect support in the amount of US$35 million for such a clearance from a Donor Group. Following this clearance, current debt servicing payments to all other multilateral creditors (including the IFC) will be made as they fall due. Outstanding arrears to such creditors, which were estimated to amount to US$41 million at the end of 1993, will not exceed US$25 million by end-June 1994 and will be cleared by end-1994. We have initiated a dialogue with the Chairman of the Paris Club, and have made known our intentions to seek a rescheduling. In the meanwhile, recognizing the importance of bilateral creditors in providing financial support for our program, we intend to resume partial payment of debt service obligations on not previously rescheduled debt falling due in 1994 to bilateral creditors, pending the outcome of the rescheduling discussions. The Government also stands ready to commence negotiations with commercial banks. We intend to follow a prudent debt-management strategy, and limits on the contracting of new external debt are set out in the Appendix.

18. The Government is committed to maintaining a liberal exchange and trade system, both to encourage competition within the now truncated domestic market and to promote exports. To this end, we intend to review before June 1994 remaining import and export taxes, quotas, and administrative procedures with the aim of reducing restrictions inherited from the former Yugoslavia. During the program period, the Government does not intend to introduce or intensify any exchange restrictions or multiple currency practices, or conclude any bilateral payments arrangements that are inconsistent with the Fund's Articles of Agreement, or impose any new import restrictions for balance of payments reasons. We are particularly concerned that constraints on access to markets in industrialized countries will limit the scope for reorientation of exports and we intend to negotiate, particularly with the EC, on easing such access.

Structural Reforms

19. Our recently adopted privatization law focuses on an early improvement in accountability by requiring majority ownership and allowing new owners to take immediate control while paying for the shares in installments over several years. Under the law, 600 small enterprises with (approximately) 30,000 employees and 125 medium enterprises with 35,000 employees have until end-November 1994 to submit privatization plans, while 30 large enterprises with 35,000 employees must submit such plans before end-November 1995. The Privatization Agency is responsible for approving these plans and will prepare privatization plans for enterprises that fail to submit adequate proposals voluntarily. An additional 400 enterprises with 150,000 employees have been partially privatized already under the privatization law of the former Yugoslavia, and these privatizations must be reviewed by the Social Accounting Office due to widespread irregularities. This review is expected

to invalidate a large number of these former privatizations, and the enterprises in question will be privatized under the new privatization law. We expect that at least 160 enterprises will have submitted privatization plans to the Agency by end-June 1994, excluding those correctly privatized under the previous law. Should the privatization process be proceeding too slowly, we intend to lower the sale price to accelerate the process. The privatization law does not pertain to public utilities, which will be regulated under a new law on public enterprises to be passed by end-March 1994. Monopolies will be privatized under a separate law once the privatization process is well under way. Banks will be privatized in the context of the bank rehabilitation program.

20. The insolvency of a large segment of the banking system and the interdependence of banks and enterprises are seriously distorting the allocation of capital, and there is an urgent need to implement a comprehensive program to rehabilitate the banking system. The preparations for this program, which will be undertaken in close cooperation with the World Bank, are still at an early stage; we will give high priority to an acceleration of this work in the coming months. Special comprehensive audits of the two largest troubled banks based on annual accounts for 1993 will be completed by end-April 1994, with the aim of starting restructuring of these banks before end-June 1994. To prevent troubled banks from becoming seriously illiquid as a result of the tightening of monetary policy, it will be important during the period until the bank rehabilitation program has been completed to monitor closely the operations of such banks. The National Bank will promptly intervene to restrict credit expansion in banks with fundamental liquidity problems and will limit such banks' access to its credits.

21. The establishment of the legal foundations of a market economy is a priority. Much progress has been made already by the passage of laws on the central bank and commercial banks; exchange arrangements, foreign trade, and foreign credits; and leasing and foreign direct investment. These laws replace and improve upon former Yugoslav laws. A revised enterprise law outlining the corporate "rules of the game" will be presented to Parliament early this year, and a commercial code will be submitted by end-June 1994. Legislation is being prepared that will reorganize the Social Accounting Office, revise the existing law on bankruptcy proceedings, and expand the resources of the judiciary. Meanwhile, the Social Accounting Office will strictly enforce existing regulations requiring action to be taken against illiquid enterprises.

22. We intend to improve our policy implementation capacity in both the fiscal and monetary areas. An agency for tax collection will be created within the Ministry of Finance, and the customs service will come under its direct control. The new budget law will require the Social Accounting Office to provide the Ministry of Finance with fuller and more timely information on the financial position of all parts of general government. Responsibility for detailed forecasting of expenditures and revenues will be centralized in the Ministry of Finance, which will also have responsibility for any domestic government borrowing or guarantees. The National Bank is

developing its ability to implement policy in a forward-looking and coordinated manner, with increasing reliance on market-based methods. Besides the new refinance auctions, procedures will shortly be finalized for the auction of National Bank bills to absorb liquidity. The National Bank will, with assistance from foreign experts, improve its capacities in the area of banking supervision.

23. The delayed availability or poor quality of basic macroeconomic statistics, reflecting the earlier processing of statistics at the federal level and our still rudimentary institutions for such processing, complicate the implementation of policies. Initial steps to rectify these problems, incorporating recommendations by IMF technical assistance missions, are as follows: (1) we plan to compile statistics for the banking system directly from original sources, and recently have begun to publish a monetary survey within one month of the end of the reporting period in the standard internationally accepted format. We will also commence work on introducing a new plan of accounts for the National Bank and the commercial banks, which will be designed to be useful for statistical, supervisory, and internal control purposes; (2) a new budgetary classification has been introduced; (3) we will compile and publish customs-based import and export statistics within six weeks of the end of the reporting period. Recently we have processed the backlog of trade data and have published data to end-November 1993. We plan to centralize responsibility for compiling quarterly balance of payments statistics in the National Bank in order to improve the quality and timeliness of such statistics. Finally, we are engaged in an ongoing large-scale project to introduce the System of National Accounts methodology.

Program Monitoring and Review

24. The following prior actions have been adopted: the wage control law, the 1994 monetary program, the 1994 Budget, and the amendments to the Pension Fund law, as described in this Policy Statement. The Government has established a monitoring group made up of relevant officials and Ministers to monitor progress and compliance with the program on a monthly basis, with a view to taking early corrective action should slippages in policy implementation emerge.

25. For the purposes of monitoring implementation of the program, the prior actions, financial benchmarks (end-March and end-June 1994), indicative targets (end-December 1993, end-September 1994, and end-December 1994), and structural benchmarks (through end-June 1994) are contained in the attached table; financial and structural benchmarks for the second half of 1994 will be established in consultation with Fund staff before end-June 1994. The Government will remain in close consultation with the Fund staff, and will provide the Fund with such information as it requests for monitoring progress in program implementation.

Stand-by Arrangement

26. It is the Government's intention to reach understandings with the IMF as soon as possible, and not later than end-June 1994, on an economic program that could be supported either by a stand-by arrangement in the upper credit tranches or by a similar IMF arrangement.

FYRM: Prior Actions, Benchmarks, and Indicative Targets

Prior Actions

Approval by Parliament before end-December 1993:

1. The 1994 Budget of the Republic
2. The Monetary Program for 1994
3. The Wage Control Law
4. The Amendments to the Pension Fund Law

Financial Benchmarks and Indicative Targets 1/

Net domestic assets of the banking system, which stood at denar 42,758 million by end-September 1993, will not exceed: 2/ 3/

Denar 45,754 million	End-December 1993
Denar 48,832 million	End-March 1994
Denar 50,173 million	End-June 1994
Denar 50,654 million	End-September 1994
Denar 53,311 million	End-December 1994

Outstanding credit from the banking system to the Central Government, which stood at denar 7,073 million at end-September 1993, will not exceed: 2/

Denar 7,207 million	End-December 1993
Denar 8,888 million	End-March 1994
Denar 9,010 million	End-June 1994
Denar 7,572 million	End-September 1994
Denar 7,698 million	End-December 1994

Net foreign reserves of the National Bank, which stood at US$123 million at the end-November 1993, will not be lower than: 4/, 2/

US$115 million	End-December 1993
US$75 million	End-March 1994
US$80 million	End-June 1994
US$130 million	End-September 1994
US$135 million	End-December 1994

New non-concessional external medium- and long-term debt contracted or guaranteed by the Government will not exceed US$200 million during 1994.

New external short-term debt contracted or guaranteed by the Government will not exceed US$70 million during 1994.

Structural Benchmarks

Complete actuarial study of Pension Fund, implement recommendations	April 30, 1994, and June 30, 1994, resp.
Review the unemployment compensation system with a view to eliminating disincentives to labor-shedding by enterprises	March 31, 1994
Introduce global personal income tax with progressive rates	April 1, 1994
Submission of plans for privatization by at least 150 enterprises	June 30, 1994
Complete review of ownership status of at least 150 enterprises partially privatized under the former law on Social Capital	April 30, 1994
Complete external, comprehensive audits of the two largest troubled banks in preparation for rehabilitation	April 30, 1994
Complete a review of outstanding liabilities to official creditors, in order to determine payments to be collected by the Government from liable enterprises	March 31, 1994
Produce and publish a monetary survey, and external trade statistics, on a regular monthly basis	January 31, 1994, and January 15, 1994, resp.

Wage Adjustment Formula

The monthly inflation targets mentioned in paragraph 4 are: January 8 percent; February 6 percent; March 5 percent; April 5 percent; May 5 percent; and June 4 1/2 percent.

1/ The targets for end-March and end-June 1994 are financial benchmarks. Other figures are indicative targets.

2/ The benchmarks for end-March and end-June, 1994 for net domestic assets of the banking system and for credit from the banking system to the Central Government will be adjusted downward by any foreign borrowing by the Central Government, and any foreign financial assistance to the Central Government, in excess of US$35 million (excluding borrowing from the World Bank and humanitarian commodity assistance). The net foreign asset floor will be increased for any such excess.

3/ Net domestic assets (NDA) of the banking system are defined as broad money M3 (including currency, demand deposits, quasi-deposits in denar and foreign currency and non-monetary deposits in denar and foreign currency) minus net foreign assets of the banking system. NDA so defined includes all domestic credit to the government and the social and private sectors and all other assets. Foreign currency assets and liabilities outstanding at the end of September 1993 are valued at denar 26 per U.S. dollar.

4/ Net foreign assets of the National Bank are defined as the difference between the National Bank's foreign assets and foreign liabilities plus official holdings of monetary gold. For the purpose of defining this benchmark, international liabilities of the National Bank at the end of November 1993 are assumed to be zero.

Eligibility and Access under the STF

The FYRM's eligibility to use the STF is based on the severe disruption experienced to its traditional trade and payments arrangements with countries of the former CMEA area. The cessation in 1991 of the CMEA trade and payments system, and the attendant shift from significant reliance on trading at non-market prices to multilateral market-based trade, have sharply lowered total export receipts. The FYRM's eligibility to draw under the STF is based on this fall in exports. 1/

Prior to 1991, around 40 percent of the FYRM's exports were to countries within the former CMEA trading area (Table 12), with the former Soviet Union (FSU) accounting for around half of these exports to CMEA countries. 2/ Much of the CMEA trade consisted of goods produced in quantities and qualities that were tailored specifically to Eastern European and FSU markets and which were not readily switchable to Western markets.

As part of the former SFRY, the bulk of the FYRM's trade with CMEA countries was based on annual bilateral trade agreements in which quantities and prices were negotiated at the federal level between the Government of the former SFRY and the Governments of the partner CMEA countries, with the aim of balancing trade. The annual trade agreed with CMEA partners was split into quotas that specified the quantity and value of the goods to be traded. These quotas were allocated to individual republics. Exporters were effectively subject to a high degree of centralized control in fulfilling the trade obligations negotiated at the federal level, and trade did not take place at freely determined market prices.

Following the cessation of the CMEA trade and payments system in 1991, the former SFRY's centralized system for CMEA trade largely fell into disuse. Since the FYRM's independence in 1992, trade with CMEA countries has shifted toward multilateral, market-based trade with payments required in hard currencies. Reflecting these developments, the FYRM's exports to CMEA countries fell by around one half between 1990 and 1993, and the share of CMEA exports in total exports fell to around 28 percent (Appendix Table). Over the same period, total exports declined by almost US$300 million or by more than 300 percent of the FYRM's quota in the Fund, a level well in excess of the threshold required for a member to be eligible for STF support. In the judgement of the staff, the effect of this decline in exports continues to give rise to balance of payments difficulties in an amount equivalent to at least 50 percent of quota.

1/ See paragraph 1 of Decision No. 10438-(93/61) STF of April 23, 1993.

2/ A large proportion (around 60 percent) of the FYRM's trade with CMEA countries comprised goods for processing, where raw materials were imported (e.g., iron slug, textiles), processed by manufacturing enterprises in the FYRM, and exported as manufactured goods (e.g., steel, clothing, footwear).

Table 12. FYRM: Exports, 1990-94

	1990	1991	1992	1993 Est.	1994 Proj.
			(In millions of U.S. dollars)		
Former CMEA countries	452	356	203	229	231
Other countries 1/	661	739	734	586	581
Total exports 1/	1,113	1,095	937	815	812
Cumulative change from 1990:					
(Former CMEA countries)	--	(-96)	(-249)	(-223)	(-221)
(Total exports)	--	(-18)	(-176)	(-298)	(-301)
			(In percent)		
CMEA exports in percent of total exports	41	33	22	28	28
Cumulative change in total exports in percent of current Fund quota	--	-26	-151	-326	-330

Sources: Data provided by the FYRM authorities; staff estimates (fourth quarter, 1993) and projections (1994).

1/ Excluding exports to republics of the former SFRY.

Statistical Issues

Economic analysis is currently hampered by serious deficiencies in the availability and quality of statistical data. These deficiencies stem from two factors: (i) the need to shift from the idiosyncratic accounting of Yugoslav socialism to international statistical standards; and (ii) the dislocations associated with the independence of the FYRM and the need for developing full national data collection and analysis capabilities. These fundamental problems have recently been exacerbated by the deterioration in the quality of data which inevitably accompanies near hyperinflationary conditions.

Missions from the Fund's technical assistance providing departments to discuss statistical issues have already taken place or are planned for the near future. The discussion of statistical problems in this Appendix is consistent with the findings and recommendations of the technical assistance missions.

Real sector

The FYRM national accounts have shortcomings in both coverage and accuracy. Important sectors of the economy are neglected or inadequately recorded in the official output statistics. The magnitude of and the decline in GSP, as well as the composition of output, have all fairly large margins for error.

In coverage, three issues are of overwhelming importance. The first of these is that GSP excludes the value added by government, financial, and some personal services. The data collection methods used also inadequately report income from the private non-agricultural sector. The authorities estimate that GDP, which is not measured in the FYRM, may be 10-15 percent higher than the reported GSP figure. A STA technical assistance mission has advised the authorities on measuring GDP on the basis of the SNA classification. The authorities have developed an ambitious workplan to move to the SNA by 1995. The second problem involves the underground economy. Currently underground economic activity apparently is increasing among socially owned firms in order to avoid taxes, labor regulations, and incomes policy. 1/ Third, the external sector of the national accounts has serious deficiencies. These are discussed below in conjunction with the external sector.

Pending accuracy, the most severe problem is the treatment of stocks in the national accounts. With high inflation, the real value of stocks is seriously understated, which causes overestimation of the value added

---

1/ This problem may also cause real wages to be underreported, as firms make recourse to payments in kind to circumvent restrictions on wages imposed by the Social Accounting Office on enterprises that have incurred arrears.

produced with those stocks. The resulting overstatement of GSP can be as much as 15 percent under present near-hyperinflationary conditions. The problem also affects the expenditure components of GSP. Since stockbuilding is overstated in times of high inflation, consumption, which is a residual, is understated. 1/

At this stage, the staff has not been able to identify whether the omissions from GSP are more significant than the overestimation due to the stock valuation problem.

Fiscal sector

The principal problem in the fiscal sector is that accounting is done on the basis of cash outlays and not in terms of liabilities incurred, with the result that the government accounts are recorded as being always in balance. However, there are substantial obligations which are incurred but not recorded because payment is in arrears. This is the case with foreign debt obligations, payments due on foreign currency deposits held by residents, as well as with the payment of wages and entitlements. Arrears to enterprises by individual ministries may also exist, but there is no simple way of identifying these since the ministries are not presently required to report their liabilities to the Ministry of Finance. The deficits calculated by the staff and referred to in this report would underestimate the true deficits to the extent that there were arrears to enterprises for purchases of goods and non-factor services.

Furthermore, since the FYRM does not have a Treasury under the Ministry of Finance (MOF), fiscal data are not readily available at the MOF itself. Although all government transactions are handled and recorded by the Social Accounting Office, it is not required to report to the MOF in a timely fashion. It also takes some time for the MOF to acquire from the Customs Department revenue figures for import duties. The delay in getting data has hampered the ability of the MOF to effectively control expenditures.

Monetary sector

Monetary sector statistics are deficient for two reasons: (i) the break-up of the former SFRY has disrupted payment relations, for which adequate accounts are still absent. This problem affects both domestic and foreign asset accounting. Commercial banks report large outstanding foreign currency liabilities, backed initially by guarantees from the SFRY, which are now technically guaranteed by the FYRM. However, neither of these guarantees is reflected in the accounts. Domestic assets in the National Bank contain an outstanding claim on the National Bank of Yugoslavia arising

---

1/ In 1992, stockbuilding ostensibly comprised 26 percent of GSP, but the index of physical volume of stocks was in decline.

from the 1992 currency reform. 1/ In addition, about 85 percent of the "other assets" category for the commercial banks consists of the outstanding claims on the National Bank of Yugoslavia from residents' foreign currency deposits. National Bank "other assets" include a variable component of payments in transfer because bank credits have to pass through the Social Accounting Office; and (ii) the plan of accounts used by the National Bank and the commercial banks is ill-suited for the needs of a market economy. With the help of Fund technical assistance, the authorities have included the formulation of a new chart of accounts in their list of priorities. It is hoped that by mid-1994 the analytical quality of monetary data will benefit from this change.

External sector

The break-up of the former SFRY has produced enormous problems in the collection and analysis of data in the external sector. External sector data for 1991-93 are of low quality. Three difficulties are of particular importance: (i) problems with interrepublican trade data; (ii) problems with data on trade with other countries; and (iii) deficiencies in the data and treatment of services and of special trade arrangements (barter and so called processing trade). In addition, there are some problems in the capital account.

Interrepublican trade data were never of good quality but have deteriorated with independence. Prior to independence, trade with other former SFRY republics was estimated only roughly, based on payments through the Social Accounting Office, supplemented by input-output tables produced every four years or so. The last input-output survey was completed in 1987, and the data deteriorated from then on, since payments figures grew increasingly unreliable as the former SFRY began to disintegrate in 1990. The FYRM authorities have not produced full estimates of interrepublican trade on this basis after 1990. 2/ Following the break-up of the former SFRY, customs data began to be collected for trade with other republics, but these data are, so far, less than comprehensive and generally of a low quality.

Data on trade with other countries also suffer from serious deficiencies in quality, coverage and availability. Political independence produced difficulties in obtaining customs information since a customs service had to be built and new international borders monitored. This problem was partially obviated by the use of payments data from the National

---

1/ The National Bank exchanged more Yugoslav currency for FYRM denars than had originally been issued in the FYRM, creating an outstanding claim on National Bank of Yugoslavia assets.

2/ The May 1993 mission constructed estimates of interrepublican trade for 1990-92 using Social Accounting Office payments data plus qualitative information from the authorities and UN sanctions monitors. These staff estimates have a wide margin for error.

Bank of Yugoslavia during late 1991 and early 1992, but the availability of those data ceased with monetary independence in April 1992. No disaggregation of trade data by price or volume is currently available.

Problems also afflict data on services and special trade arrangements. Data for exports and imports of merchandise are distorted by the inclusion of service items (e.g., transportation and leasing services). Some barter transactions may have been omitted from the foreign trade statistics and cannot be separately identified at present. Some private capital transactions have been recorded in the travel and transfers categories of the current account instead of in the capital account. The balance of payments statistics also suffer from poor historical estimates of accrued interest debits, the unavailability of historical data on official transfers, and incomplete data on different types of capital transactions. External debt statistics are incomplete regarding short-term debt and debt to commercial banks.

In some cases, it has been possible to derive staff estimates of balance of payments items (based on supplementary information provided by the authorities) that attempt to correct for these distortions and omissions in the official data. However, given the problems with the external sector statistics, the current external data should be treated as estimates that are subject to future revision.

FYRM: Fund Relations
(As of November 30, 1993)

I. Membership Status: Joined 12/14/92

Succeeded to Membership on April 21, 1993, Article XIV

II. General Resources Account	SDR Million	% Quota
Quota	49.60	100.0
Fund holdings of currency	52.41	105.7

III. SDR Department	SDR Million	% Allocation
Net cumulative allocation	8.38	100.0
Holdings	0.01	0.1

IV. Outstanding Purchase and Loans	SDR Million	% Quota
Stand-by arrangements	2.81	5.7

V. Financial Arrangements

None

VI. Projected Obligations to the Fund (SDR Million; based on existing and prospective use of and present holdings of SDRs):

	Overdue	Forthcoming				
	(12/31/93)	1994	1995	1996	1997	1998
Principal	--	1.2	0.7	0.6	0.3	--
Charges/Interest	--	0.5	0.5	0.4	0.4	0.4
Total	--	1.7	1.2	1.0	0.7	0.4

VII. Exchange Arrangement

The currency of FYRM is the denar. The FYRM maintains a managed floating exchange rate system, where enterprises and households deal in separate markets. The participation of banks in both markets should prevent the emergence of multiple exchange rates. Whereas households can transact only through commercial banks or through foreign exchange bureaus that act as agents of banks, enterprises can sell foreign exchange to each other in addition to transacting through the banking system. Enterprises must sell export proceeds within 90 days. Commercial banks' holdings are limited to US$38 million. Bureaus can hold overnight foreign exchange positions equivalent to 50 percent of the preceding day's purchases. On December 14, 1993, the official exchange rate was denar 42.7 per U.S. dollar.

VIII. Article IV Consultations

The first consultation mission to the FYRM took place in May 1993. The FYRM is on the standard consultation cycle.

IX. Technical Assistance

June-July 1993:	FAD -- Multitopic mission
August 1993:	STA -- Monetary Accounting and BOP Statistics
September 1993:	FAD -- Expert visit: Budgeting
October 1993:	FAD -- Mission: Budget Preparation
February 1994:	INS -- Introduction to Financial Programming
To be determined:	MAE -- Introduction of Money Market

Relations with the World Bank Group

The FYRM succeeded to the membership of the former SFRY in the World Bank, IDA, and IFC on December 30, 1993, following determination by the Bank that there was a credible plan for the clearance of arrears to the Bank. Prior to membership, discussions were held with the FYRM on an Economic Recovery Loan (ERL). A proposed ERL is expected to be considered by the World Bank's Executive Board on February 8, 1994. The Bank has determined that the FYRM will be partly eligible for financing on IDA terms.

The primary focus of the ERL is to support reforms of the enterprise and financial sectors, including measures to enhance labor market flexibility and bolster the social safety net. Discussions on an Enterprise and Financial Sector Structural Adjustment Loan (EFSAL) are scheduled to commence in the Spring of 1994. This operation, which is expected to be presented to the Bank's Board in the second half of 1994, will focus on bank rehabilitation and reform and on enterprise privatization. A third adjustment loan is envisaged to support the balance of payments and further advance reform. This operation will include a Public Administration Adjustment Loan that will involve an indepth reform of the social safety net. Other projects, including one on health sector restructuring, are currently being considered.

Investment operations focusing on fostering private sector development will be initiated in the second half of 1994. A proposed Private Farmer Support Project will target livestock development and animal health, reform the agricultural extension system to make it more responsive to the needs of private farmers, introduce measures to increase private farmers' access to credit, and improve marketing and distribution of agricultural produce by private farmers. The investment program for FY95 will include the first investment loan in the transport sector, currently under preparation. The main objective will be to upgrade east-west trade routes, including civil works to improve the road corridor and an expansion of facilities at the Albanian port of Durrës. A planned Technical Assistance Credit will address the need for technical assistance in the areas of public investment programming, banking sector restructuring, enterprise sector restructuring and privatization, and social assistance.