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April 29, 1988

To: Members of the Executive Board

From: The Secretary

Subject: Yugoslavia - Letter of Intent

The letter on "Economic Objectives to be Achieved During the Forthcoming Stand-By with the IMF, and the Policies to be Pursued in Support of Those Objectives" outlines the Yugoslav authorities' program for 1988/89 in support of which they have requested assistance from the Fund. The letter is being circulated for the information of the Board following this morning's discussion. If the volume or timing of the financial support differ somewhat from those indicated in the attached letter, but are still consistent with full program implementation, certain technical modifications would be necessary before the request is considered by the Executive Board. In this connection, the Yugoslav authorities have noted that the US$300 million of new money proposed by the steering committee of the banks in the form of a trade and deposit facility is for calendar 1988, and that there is a goodwill clause for additional new money in the first half of 1989.

Ms. Ripley (ext. 8811) or Mr. Bennett (ext. 8873) is available to answer technical or factual questions relating to this paper.

Att: (1)

Economic Objectives to be Achieved During the Forthcoming Stand-By with the IMF, and the Policies to be Pursued in Support of Those Objectives

I. Background to the Request for the Use of Fund Resources

1. In many respects, 1987 proved to be an exceptionally difficult year for the Yugoslav economy, despite an increased policy effort and successes in a number of areas. An intensified effort in the macroeconomic field is reflected in the reduction in the share in GSP of general and collective consumption, from the excessive and rising levels experienced in 1986; adherence to a restrictive credit policy, as measured by a marked decline in credit in real terms; and progress toward adopting more attractive incentives for dinar savings. A more active exchange rate policy and other export promotion policies contributed to the buoyant growth of exports to the convertible currency area. Structural improvements included an important correction of price disparities; increased autonomy of the National Bank in decision-making; the introduction of investment criteria, which should significantly improve efficiency in the allocation of capital; and finally, a strengthening of discipline for banks and for organizations of associated labor.

2. The actual outturn on domestic and external balance was not in line with our expectations. The deepening of our foreign exchange crisis, which was due in part to our large external debt obligations, has led to severe import restraint and an intensification of trade and exchange restrictions. It also made necessary a drawdown in reserves of over US$1 billion in 1987, as well as a standstill on principal repayments to commercial banks which accumulated to some US$350 million by end-year. The policy of severe import restraint has, at the same time, adversely affected activity and contributed to inflationary pressures.

3. For the first time since 1983, real GSP may have declined by about 1/2 percent. And, with a fall in domestic production, the increasing share of the real national product being reserved for the servicing of our external debt has left the scope for investment and consumption severely constrained. Despite efforts to contain nominal personal incomes, payments under the social compacts proved excessive, exerting pressure on prices; and although incomes declined significantly in real terms, nonetheless, they remained above the consumption possibilities of the economy. Efforts to enhance the attractiveness of dinar savings have also been undermined by accelerating inflation, intensifying imbalances in the markets for goods and for foreign exchange. In the event, the rise in the general price level from midyear, in conjunction with the correction of very large price disparities, culminated in an acceleration of inflation by year-end to nearly 170 percent.

4. The main structural features of the Yugoslav economy that have contributed importantly to our unsatisfactory economic performance in recent years were identified in our long-term economic stabilization program of 1983; they have again been addressed in our anti-inflation and stabilization program of November 1987 and our annual Plan resolution for 1988. They include the absence of an integrated national market for goods, services and factors of production (including foreign exchange and capital), lack of competition resulting in distorted prices, laxity in financial discipline and accountability, and an unsatisfactory system of incentives. And though consensus was reached in 1983 on the sources of weaknesses in the economic system, this has still not led to persistence in the implementation of corrective measures. Despite initiatives in a number of areas, the effectiveness of monetary policy has been undermined by negative real yields on dinar assets and financial disintermediation; the value of social capital has been eroded by excessive payments of personal incomes, while its quality has been adversely affected by the strong influence of non-economic criteria on investment decisions.

II. Outline of Strategy and Objectives

5. Although 1987 has proved difficult, it has served an important purpose: it has highlighted the costs of inadequate policy implementation in terms of unsustainable rates of inflation, a loss of present and potential output, and a deterioration in Yugoslavia's living standard. And by making these costs clear to all components of society, it has permitted us to mobilize the consensus necessary to take the requisite corrective measures. We believe that systemic reforms are essential to restore with time Yugoslavia's growth potential, but in the early stages of reform, and until a market-oriented system is in place and is functioning, we recognize that there will be significant economic costs as well.

6. We are firmly determined to give market forces a predominant role in our economy so as to enhance its economic potential to make possible the fulfillment of Yugoslavia's social and economic objectives, and to establish financial discipline and accountability. Our strategy is thus one of moving away from administrative intervention, for example, in the allocation of foreign exchange and credits, and in the setting of prices and of the permissible pattern and level for imports. Scarce resources, including foreign exchange and social capital, must be efficiently allocated and efficiency in performance must be rewarded. We are also committed to the creation of an adequate set of instruments, fiscal and monetary, for the conduct of economic policy at the national level. We attach particular importance to the rationalization of the tax system among regions, and increased tax authority at the Federal level.

7. The more traditional measures of demand management include, in the first instance, those to restrain the growth of domestic costs and of domestic demand in order to curb the rate of inflation and encourage

savings. Thus, we have put in place policies to assure the real value of time deposits long-term loans through the indexation of principal, which will encourage savings and efficient capital allocation, and to restrain growth of money and credit; to limit public consumption; and to limit the growth of personal incomes in line with real possibilities. But it also includes actions to ease supply constraints. Some alleviation of the debt service burden will increase the supply of domestically produced as well as foreign goods on the market.

8. For 1988, we now envisage the real growth of domestic absorption to remain flat, or to decline somewhat; inflation by end-year to decelerate to 90-95 percent; and a current account surplus with the convertible currency area of about US$400 million, which, combined with additional support from our foreign creditors, should enable us to achieve a rebound of imports and a restoration of reserves to more sustainable levels. As indicators of the success of our program in the medium term, we hope to achieve: (a) a debt service ratio equal to 25 percent of our foreign exchange earnings; (b) a share of public consumption in the social product of no more than 30 percent by 1990; and (c) a rate of economic growth of over 3 percent per annum through 1990.

9. We are convinced that the success of our adjustment strategy and our ultimate ability to repay creditors depends importantly on a reduction of our present debt service burden. Such a reduction is necessary to release resources essential to a revival of investment and activity, and to restore reserves to levels that will permit us to remain current on payments. We hereby request a one-year stand-by arrangement from the IMF in an amount equivalent to SDR 306 million in support of the objectives and policies of our economic and financial program and to help us secure the necessary financial assistance from other foreign creditors, including rescheduling and new money in 1988 and beyond.

III. External Financing Requirement and Relations with Foreign Creditors

10. The external financing requirement has been derived under assumptions about imports and reserve accumulation that we consider essential for the sustainability of our program and for its credibility. First, the compression in import volumes from the convertible area of more than 10 percent that we were forced to undertake in response to the difficult balance of payments position in 1987 will have to be partly reversed in 1988 if our objectives of moving towards price and import liberalization in a setting conducive to growth and a deceleration of inflation are to be achieved. Second, with the loss of gross reserves in 1987 of over US$1.0 billion, usable liquid foreign assets have fallen below the minimum level needed to ensure that seasonal and unexpected variations in foreign exchange flows do not trigger an intensification of restrictions on access to foreign exchange. Taking also into account our decision to eliminate administrative intervention in the allocation of

foreign exchange, our program calls for an increase in gross foreign reserves of the banking system of about US$950 million. Assuming further a continuation of the export momentum, a partial recovery of remittances, and amortization payments on medium- and long-term debt of about US$4,400 million, our gross foreign borrowing requirement in 1988 is projected at about US$4,825 million (excluding some US$350 million now under the "standstill" agreement with commercial banks).

11. Some US$1,980 million of this requirement is expected to be covered through rescheduling, and we have approached commercial banks and official bilateral creditors in this regard. Total program lending from multilateral institutions other than the IMF is expected to amount to about US$150 million, mostly on account of an agreement we hope to reach with the World Bank. With import financing assumed to increase in line with imports to about US$1,434 million, this leaves a residual financing gap of about US$1,260 million. Negotiations are in progress with commercial banks and official creditors on additional balance of payments support, which is expected to amount to US$500 million from each of these two groups of creditors, respectively. The remaining gap of about US$260 million can be covered through purchases from the Fund under the requested stand-by arrangement. We fully recognize that implementation of our program and more broadly, the success of our strategy depends on having secured sufficient external financial support at its inception. At the time of the completion of the midterm review, we will examine again with the Fund the adequacy of the financial arrangements for the second half of the program period.

IV. Monetary and Credit Policy

12. We intend to pursue restrictive monetary and credit policies in 1988 so as to support our objective of containing inflation. We expect that strong supporting policies in the field of interest rates and in the areas of personal incomes and public sector expenditure will enhance the efficacy of credit policy and allow progress toward reducing inflation to sustainable levels.

13. We have decided to shift from credit ceilings on commercial banks, as the primary instrument of monetary policy, to reserve money management through more effective control over developments in the net domestic assets of the National Bank of Yugoslavia (NBY). This is because prolonged reliance on credit ceilings at the level of individual commercial banks has prevented the functioning of market signals and has introduced severe rigidities that have adversely affected the efficiency of our financial system. However, such an important policy shift cannot be effected smoothly unless there is a sufficiency of policy instruments to assure the control of reserve money, and also a good understanding of the relationship between reserve money and broader monetary aggregates. We have already taken important steps toward stabilizing the relationships between reserve money and the broader aggregates by adopting a uniform reserve requirement for all dinar deposits and by abolishing a

complicated system of reserve requirements on credits; and toward enhancing control over its net domestic assets (NDA) by the NBY, for example, by giving the NBY the authority to freely set the discount rate, to frequently vary rediscount ratios, and to reduce the role of selective credits. We also intend to rely on NBY bills with market-related interest rates to regulate the liquidity of commercial banks on a more flexible basis. But experience in the use of these instruments and in the targeting of reserve money must be gained. Though we have abolished credit ceilings on banks, we are holding open the possibility of their reintroduction, for a time, to guarantee monetary control of the NDA of the banking system in a transitional period, while indicative targets for the NDA of the NBY will also be established for the same period (Annex A).

14. For the 12-month period December 1987 to December 1988, we intend to limit the growth in the stock of net domestic assets (NDA) of the banking system to 25.5 percent, or from Din 43,441.6 billion at end-1987 to Din 54,500 billion at end-1988 In accordance with this intention, we have decided that the banking system's NDA will not exceed Din 48,460.0 billion at end-June, and Din 50,564.0 billion at end-September 1988 (Annex B). The limits for end-June, and end-September, constitute performance criteria and that for the last quarter of 1988 will serve an indicative target. In addition, we intend to limit the growth of the NDA of the NBY to 15.0 percent or from Din 22,521.3 billion at end-1987 to Din 25,902.0 billion at end-1988. Accordingly, we have established limits on the NDA of the NBY of Din 24,368.0 billion at end-June, and Din 24,996.0 billion at end-September 1988. In this initial phase, these limits will serve as indicative targets. At the time of the midterm review of the program, we will examine the progress made in enhancing the NBY's ability to pursue the tasks of an autonomous central monetary authority as well as the possibility of adopting limits on the NDA of the NBY as performance criteria in lieu of the limits on the NDA of the banking system.

15. Credit policy will be supported by a system of interest rate determination that will enhance the attractiveness of dinar financial assets, particularly when seen against the yields on foreign currency deposits, and will ensure positive real interest rates for a broad range of dinar-denominated assets and liabilities. The transitional system introduced in January 1988 provided for monthly adjustments of nominal interest rates to the annualized rate of inflation in the previous month as measured by the retail price index (RPI). This represented an important step in the right direction, but it does not adequately assure savers that the real value of financial assets will be protected, especially in the context of high and volatile inflation rates. Accordingly, as already envisaged in the Decision on Monetary and Credit Policy approved by the Federal Assembly, we have decided to adopt a system of indexation of the principal of time deposits of maturities equal to or greater than three months and term loans of maturities of at least one year. Under this system, which will come into effect on May 1, 1988, and which is described in Annex C, the principal of such

deposits and loans will be revalued monthly by the rise in the RPI recorded for the concurrent month. Interest rates will be calculated, monthly, on the revalued principal and recorded promptly in the banks' balance sheets. The minimum interest rates on the revalued principal of three-month deposits will be at least 5 percent; correspondingly higher rates will be applied on deposits of longer maturities. We intend to publicize the advantages to savers of the new scheme and to ensure its smooth functioning with a view to strengthening the incentives for financial savings and dampening demand for goods and foreign exchange. As inflation is gradually brought under control and expectations are stabilized, we expect that there will be increased scope for non-indexed assets and that these assets will become increasingly attractive, assuming a dominant role in the financial system.

16. The backward-looking interest rate formula introduced in January 1988 will continue to be used for determining the nominal interest rate on one-month time deposits and as a guide for the NBY discount rate. However, we intend to vary the discount rate flexibly so as to contain NBY lending within targeted limits and to discourage recourse to credit from the NBY in lieu of reliance on deposits with commercial banks. The NBY will generally lend at market interest rates, with the exception of selective credits, and will not subsidize commercial banks through other direct or indirect means so as to allow them to lend at lower than market rates. It is also our intention to phase out the NBY preferential interest rates for selective credits by the time of the midterm review; where transitional provisions are essential, direct fiscal subsidies will be considered in lieu of preferential interest rates.

V. Fiscal Policy

17. In 1987 we adopted a policy of strictly controlling the growth of a subsector of public expenditures and experienced considerable success in attaining our objectives. Our program for 1988 is designed to simultaneously combat inflation and release resources for investment by reducing further the share of public consumption in the social product. To this end, we have adopted a broad cash limit on total expenditures for general and collective consumption. In our Resolution, it has been determined that, apart from the Federal budget and pensions and disability payments and a number of other items (see Annex D), all such expenditures must grow by at least 10 percentage points less in nominal terms than income in the social economy in 1988. This will be achieved by an intervention law that sets a cash limit on these expenditures based on the projected growth of nominal social economy income during the year, less 10 percentage points. The Resolution also stipulates that the Federal budget will be unchanged in real terms. On the basis of the projected growth of prices in 1988, therefore, the Federal budget will be subject to a cash limit that is consistent with this objective. The pressure on the federal budget will be eased considerably by the decision taken by the Presidency of the SFRY to contain the outlays for the Yugoslav Peoples Army. A cash projection for other exempt items,

apart from pensions and disability payments, will be devised on the assumption that these items remain collectively unchanged in real terms. Finally, pensions and disability payments per person will be consistent with the requirement of the Annual Resolution and will be limited to the growth of personal incomes per employee. This objective will be met by deriving a cash limit for these outlays based on the projected growth of nominal incomes through the year. These cash projections will sum to the global cash limits which will become our targets during the year. These global cash limits for expenditures, for the period January-June and January-September 1988 which constitute performance criteria, are set out in Annex D. A margin of error of 0.4 percent will be acceptable in relation to this global cash limit.

18. Public expenditures will be monitored as public sector revenue plus the decrease (or minus the increase) in the net asset position of the public sector with the banking system. In addition to ensuring that public spending, as defined on this basis, conforms with our target, we will also control the net asset position of the public sector with the banking system. We will continue our practice of returning revenues and contributions in excess of our expenditures, thereby reducing tax rates and contributions of the economic sector. The growth of net assets with the banking system will be consistent with the monetary program and will follow the range described in Annex E to this Memorandum, the lower limit of which will constitute a performance criterion for June and September 1988.

19. In the coming year we also propose to introduce a number of tax reforms. These reforms will be comprehensive, rationalizing the system of indirect taxation and providing for greater equity in the fields of personal and enterprise taxation. The aim will be to improve the efficiency and fairness of the fiscal system, and to encourage savings. Our goal is to create a unified basis for the fiscal system within Yugoslavia and for joint fiscal policies.

VI. Incomes Policy

20. The adoption from early 1987 of realistic accounting practices in the enterprise sector, of new social compacts on wages from mid-1987 and, finally, the firm implementation of revised laws on rehabilitation and bankruptcy, represented important steps toward establishing financial discipline and assuring an adequate growth in the capital stock of the enterprise sector. Incomes policy will be strengthened in 1988 in two principal ways. First, we have decided to raise the average accumulation rate in the economic sector in percent of fixed and working capital, from an outturn of 2.9 percent in 1987 to 3.5 percent in 1988, and to strictly enforce the existing laws on financial discipline, thereby voiding excessive cost rises and encouraging investment and economic growth.

21. A second set of measures will aim at addressing the problem of spillover between sectors on account of important adjustments in relative prices, including exchange rate adjustments, and to contain inflationary expectations by introducing a crucial uniform nominal anchor in the system of incomes determination. To this end, we have decided to extend the coverage and duration of the present intervention law, which covers personal incomes in selected sectors, by specifying the permissible increase of nominal gross personal incomes per employee (including workers' collective consumption) in the entire economic sector (Annex F). A special provision in the law will permit larger increases in gross personal incomes per employee for enterprises with above average economic performance in their respective sectors, provided that the provisions of the social compacts on personal incomes are satisfied. The intervention law will remain in place until social compacts have been revised in line with the proposal in our annual resolution to eliminate their inflationary bias. Accordingly, we intend to limit the increase in the average gross personal income 1/ in the economic sector compared in all cases to the corresponding periods of 1987 to 145.0 percent in January-June 1988; to 137.0 percent in January-September 1988; to 121.9 percent in January-December 1988. The former two limits will constitute performance criteria, while that for December will serve as an indicative target. To the extent that the rate of inflation as measured by the RPI, significantly exceeds its targeted levels, implying an unexpected decline in real personal incomes, partial corrective adjustments will be granted with a six-month lag. At the time of the midterm review we will reach understandings with the Fund regarding an assessment of the operation of the intervention law; progress toward amending the social compacts so as to eliminate any inflationary bias; determination of whether continued reliance on the intervention law to contain nominal incomes is necessary; and establishment of performance criteria for end-December 1988 and end-March 1989 covering personal income developments in January 1988-March 1989.

VII. Exchange Rate

22. The exchange rate was depreciated by about 20 percent in real terms during 1987, and the effectiveness of this instrument was reflected in the very strong growth of exports to the convertible currency area. To permit the liberalization of the exchange and trade system to progress as envisaged without causing imbalances on the exchange market, we envisage some further exchange rate action. Within the context of the new exchange rate system described in paragraph 24, we will continuously adjust the exchange rate.

1/ Including income payments under the special provision of the intervention law.

VIII. Structural Reforms

23. Improvements in efficiency in the use of resources through competition, further significant progress in the integration of the national market for goods, services, and factors of production, and enhanced financial responsibility and accountability, are essential for the realization of Yugoslavia's growth potential, as is the containment of inflationary pressures. To these ends, the broad-based structural reform program laid down most recently in our anti-inflation program will be rigorously pursued. Constitutional amendments are under active consideration and among these we attach particular importance to those designed to ensure the autonomy of commercial banks vis-à-vis enterprises, and of bank and enterprise management vis-à-vis local authorities. Our reform program will include, inter alia, three key components, as described below. In pursuing these reforms, we intend to work closely with the World Bank as well as the Fund.

24. Foreign Exchange Allocation System

To deal with the severe imbalance between supply and demand for foreign exchange, we have invoked Article 110 of the Foreign Exchange Law since 1986, according to which all foreign exchange payments must be effected in a sequential order prescribed by the Federal Executive Council. This measure has been supplemented with the bank certificate requirement scheme, which prevents enterprises with import rights from placing import orders unless their banks provide assurances that foreign exchange cover will become available. We recognize that administrative interventions are not an efficient means of balancing demand with supply in the foreign exchange markets, and reliance on Article 110 and on the bank certificate requirement will be terminated before the inception of the program. In the future, we will follow a flexible exchange rate policy, using exchange rate changes together with appropriately tight fiscal and monetary policies to balance supply and demand for foreign exchange in a setting of increasing import liberalization (Annex G). We also believe that daily interbank meetings shall provide an appropriate institutional framework for the market determination of the exchange rate. The foreign exchange system has been operating on the basis of a unified exchange rate applicable to all transactions and we will not introduce any multiple currency practices. In any case, the operation of the foreign exchange system will be reviewed with the Fund at the time of the midyear review of the program.

25. Import System

The liberalization of imports is an important means for achieving an efficient domestic structure of production. Consistent with the anti-inflation program, the government intends to accelerate the pace of liberalization by shifting commodities now on the quota (K) and license (D) and conditionally free (LBO) lists to the free import (LB) list. Before the inception of the program the LB list will be expanded to include goods amounting to at least 40 percent of total imports, compared to 26 percent in 1987, and to 35 percent of imports from the convertible currency area, compared with 18 percent in 1987. A further expansion of the free import list to at least 50 percent of total imports will occur by January 1, 1989. These changes are expressed on the basis of 1987 import weights. We will reach understandings with the Fund on a methodology and timetable for further action at the time of the midterm review, and, in any case, the trade liberalization program will be completed in 1990.

26. Price Decontrol

We recognize that the price measures of November 1987 must necessarily be temporary; more generally, continued reliance on price controls distorts the structure of relative prices and promotes inefficiencies in investment and trade. The precise timing of the liberalization of prices will be coordinated with the proposed liberalization of the foreign trade system. Up to November 14, prices accounting for 53 percent of the IPPI fell into the groups (i) "freely formed"; (ii) subject to 3 days post-notification; (iii) subject to 30 days pre-notification; and (iv) common elements. This group is considered to be broadly free by the Yugoslav authorities. Consistent with our strategy of enhancing the influence of market forces, the price measures introduced in November 1987 will not be prolonged beyond May 15, 1988. In any event, before Board discussion of the requested stand-by arrangement prices amounting to at least 60 percent of prices in the industrial producer prices index will be in the broadly free categories, excluding the common elements, including more than 39 percent in the "freely formed" category; 7.1 percent for those subject to 3-day post-notification and the remainder in the not more than 30-day pre-notification category. By January 1, 1989 prices in the broadly free categories (excluding common elements) referred to above will be increased to not less than 70 percent, of which at least 49 percent will be "freely formed," and not less than 56 percent will be freely formed or subject to 3 days post notification (all figures relate to 1987 weights). At the time of the midyear review we will reach understandings with the Fund on the methodology and timetable for completing price liberalization in 1990.

IX. Debt and Reserve Management

27. In line with the targeted increase in reserves of about US$950 million and taking into account some increase in short-term borrowing by the banking system and transactions with the Fund, net foreign assets of the banking system, which stood at minus US$1,543 million by the end of December 1987, will not be less than minus US$1,667 million by the end of June 1988 and not less than minus US$392 million by the end of September 1988 (Annex H). These limits will constitute performance criteria under the program. An indicative target for end-December 1988 of minus US$300 million has been set. Moreover, in order to limit the debt servicing burden and facilitate the restoration of a viable balance

of payments position, total external borrowing, excluding purchases from the Fund and the short-term borrowing by the banking system but including rescheduling, will not exceed US$2,400 million during January-June 1988, US$3,700 million during January-September, and US$5,100 million during January-December 1988. These limits will constitute performance criteria under the program (Annex I). (These amounts include the expected rescheduling of some US$350 million carried over into 1988 under the standstill agreement with commercial banks.)

X. Consultations with the Fund

28. The Government of Yugoslavia believes that the measures set forth in this letter are adequate to achieve the objectives of the program for 1988. However, it is prepared to take any further measures that may become appropriate for this purpose and will consult with the Fund on the adoption of any such measures in accordance with the Fund's policies on such consultations. The Yugoslav authorities and the Fund will complete the review of economic developments and policies and set performance criteria for the second half of the program period not later than the end of November 1988.

ATTACHMENT
ANNEX A

Subject: Technical Note on Instruments of Monetary and Credit Control

The NBY can, if necessary, reintroduce credit ceilings. At least until the midterm review, the NBY will reintroduce credit ceilings for the remainder of the quarter if the expansion in net domestic assets of the banking system recorded in the first month of that quarter exceeds the planned growth rate. Thus, if the banking system's net domestic assets grow faster in April or May than planned, strict credit ceilings will be introduced through June. If, however, such a development occurs in July or subsequent months, credit ceilings will be adopted through the completion of the midterm review.

ATTACHMENT
ANNEX B

Subject: Technical Note on the Net Domestic Assets (NDA) of the Banking System

1. NDA of the banking system

a. The banking system is defined as the consolidated accounts of the national banks and basic and associated banks. The net domestic assets (NDA) of the above-mentioned banks are calculated to equal the sum of the following items in the monetary survey.

	End-December 1987
	(in billions of dinars)
Net foreign liabilities	15,612.7
Plus M2 (money and quasi-money)	29,418.5
Minus public sector deposits	1,589.6
Net domestic assets	43,441.6

b. In setting the ceilings for NDA of the banking system, the effects of changes in the exchange rates from the base date (end-December 1987) on the net foreign liabilities of the banking system, and on the foreign currency liabilities which are included in quasi-money, are excluded by applying the necessary valuation adjustment (cumulative from end-December 1987). Details on these calculations including information on the currency composition of foreign currency denominated assets and liabilities, will be provided to the Fund staff. It is understood that the foreign exchange proceeds of any special assistance will be shown both as an asset and a foreign exchange liability of the National Bank of Yugoslavia.

c. The indexed component of quasi-money will be revalued at the end of each month on the basis of the actual rate of inflation as measured by the retail price index (RPI), which becomes available at the beginning of the following month. For monitoring purposes, since the actual rates of inflation will not be known before the test-date at the end of each quarter, the targeted rather than the realized monthly rate of inflation will be used for the last month of the quarter for revaluing the principal of indexed deposits at the end of each current quarter. (Thus, the actual rates of inflation will be always used for monitoring developments in the 1st and 2nd months of the current quarter as well as for all other past dates.)

d. If, on the basis of data for the two preceding months, the monthly actual rate of inflation has exceeded the targeted rate of inflation, the revaluation in the last month of the current quarter would be based on the targeted rate of inflation for the last month of the quarter plus the excess of the actual over the targeted monthly rate of inflation in the two preceding months. Symmetrical adjustments will be made if the actual monthly rate of inflation in the preceding two months has fallen short of the targeted rate of inflation for these months. For instance, if the monthly targeted rate of inflation is 2 percent in April-May and 4 percent in June, but the actual monthly rate of inflation turns out to be 3 percent in April-May, the revaluation at the end of June will be made on the basis of an inflation rate of 5 percent. The targeted monthly rates of inflation are roughly estimated as follows:

1988	
April	8.0
May	8.0
June	8.0
July	4.2
August	4.2
September	4.2
October	5.4
November	5.4
December	5.4

2. NDA of the National Bank of Yugoslavia

a. The net domestic assets (NDA) of the National Bank of Yugoslavia are calculated to equal the sum of the following items in the accounts of the national banks.

	End-December 1987
	(in billions of dinars)
Net foreign liabilities	3,531.9
Plus reserve money	19,207.1
Minus public sector deposits	193.0
Minus voluntary NBY bills	24.7
Net domestic assets	22,521.3

b. As in the case of the NDA of the banking sytem, the effects of changes in the exchange rates from the base date (end-December 1987) on the net foreign liabilities of the National Bank of Yugoslavia, and on the foreign currency liabilities to residents which are included in reserve money, will be excluded by applying the necessary valuation adjustments (cumulative from end- December 1987). The NBY will promptly inform the Fund staff about any changes in the required reserve ratios and other major monetary policy instruments.

ATTACHMENT
ANNEX C

Subject: Procedure for the Revaluation of the Principal of Term Loans and Time Deposits

1. With the objective of moving to concurrent indexation of financial assets and liabilities beyond a certain term of maturity, concurrent indexation will be taken to mean the revaluation of the monetary value of the asset/liability in line with the movement of the price level (RPI) in the same month for which the revaluation applies. Thus, a three-month deposit placed on March 1 which matures on June 1 will be revalued in line with the movement of prices as measured for March, April and May. While the movement of the price index will be known at the time of maturity for March and April, it will not be known for May. When the index is known, the depositor will be entitled to return to the bank to collect the May revaluation as a dinar payment. This will include also the interest payment for May, expressed as a percentage of the revalued principal. A depositor who places his three-month deposit in mid-February will be entitled to the revaluation due for March and April, plus half that recorded for February and half that recorded for May. He will thus receive a weighted average. He will have to wait longer for his final payment in early June (when the May index is known) since his deposit matures in mid-May, but he will receive only one half the May revaluation published at this time. Thus, the longer the delay involved in the final payment, the smaller the relevant proportion involved.

2. This indexation will apply to dinar deposits of maturities of three months or greater and likewise to term loans of one year or more in maturity.

ATTACHMENT
ANNEX D

Subject: Technical Note on Public Sector Spending Ceiling

1. Public sector spending for the purpose of this ceiling is defined to comprise revenue for general consumption plus revenue for collective consumption, which totaled Din 14,558.6 billion in 1987, less the change in net assets of the public sector with the banks (Annex E) which amounted to Din 681.3 billion in 1987. The base value for December 1987 shall be adjusted by Din 958.7 billion, being equivalent to the duties on oil previously unrecorded but as from January 1988 to be collected and recorded as turnover tax. Total spending on this definition in 1987 was therefore Din 14,836.0 billion. Cumulative quarterly limits on public sector spending in 1988 will apply for the periods shown below.

	Cumulative Public Sector Spending
	(In billions of dinars)
1988	
Second quarter	14,054
Third quarter	23,314
Fourth quarter	34,167
1989	
First quarter	(1.828 times recorded figure for first quarter 1988)

2. This objective will be met by means of an intervention law which will stipulate allowable spending in dinars in a cumulative fashion based on the projected growth of nominal income in the social economy, less 10 percentage points. Exemptions to this intervention law will comprise the federal budget, pension and disability payments, contributions by the republics and autonomous provinces for intervention in the economy at the federal level, the share of income from the basic turnover tax on trade in petroleum derivatives, budgetary resources of the sociopolitical communities for merchandise reserves, and budgetary revenue from the resources of the people. The federal budget is to be

allowed to grow according to the projected growth of retail prices. Pension and disability payments are to grow in line with the projected path of nominal personal incomes. The sum total of all the other exempt items are assumed to grow by no more than the projected growth of retail prices. These planned spending targets imply the cumulative totals shown above. A margin of error of 0.4 percent will be acceptable in relation to these cumulative totals.

ATTACHMENT
ANNEX E

Subject: Technical Note on the Net Assets of the Public Sector with the Banking System and the Blocking of Excess Revenue

1. The net assets of the public sector with the banking system are defined as total deposits of the Federal Government, other sociopolitical communities and communities of interest for collective consumption with the national banks and basic and associated banks, minus credits (including purchases of bonds and notes) extended by these banks to the said public sector entities. The transfer of Din 568 billion of liabilities from the NBY to the Federal Government recorded in January 1987 may be excluded from these calculations. For 1988, the transfer of Din 101.5 billion of liabilities from the NBY to the Federal Government in January may also be excluded. Excess public sector revenue blocked in the National Bank of Yugoslavia in 1987 and after is included in the assets of the public sector. The net asset position of the public sector with the banking system is calculated to equal the sum of the following items in the monetary survey:

	End-December 1987 (In billions of dinars)
1. Deposits of Federal Government, other sociopolitical communities and communities of interest for collective consumption with NBY	204.8
2. Excess public sector revenue blocked in accounts with the NBY (excluding deposits of citizens)	0.2
3. Deposits of Federal Government, other sociopolitical communities and communities of interest for collective consumption with basic and associated banks	1,384.8
4. Total public sector deposits (= 1 + 2 + 3)	1,589.8
5. NBY credit (including bonds) to Federal Government, excluding Din 568 billion recorded in January 1987	152.4

6. NBY credit (including bonds) to other sociopolitical communities and communities of interest for collective consumption	6.6
7. Basic and associated bank credit (including bonds) to the Federal Government, other sociopolitical communities, and communities of interest for collective consumption	99.2
8. Total public sector credit (= 5 + 6 + 7)	258.2
9. Net asset position of the public sector with the banking system (= 4 - 8)	1,331.6

2. It is agreed that the net asset position of the public sector with the banking system on this definition at the end of December 1988 shall be equal to Din 2,263.7 billion, compared with Din 1,331.6 billion at the end of December 1987. Further, the authorities will ensure that the net position of the public sector with the banking sector shall be equal to Din 1,655.1 billion at the end of June 1988 and Din 1,757.5 billion at the end of September 1988. A range of plus or minus 5 percent of the net asset target will be acceptable.

ATTACHMENT
ANNEX F

Subject: Technical Annex on the Main Features of the Intervention Law on Gross Personal Incomes in the Economic Sector and on the Envisaged Modification of the Social Compacts

1. An intervention law to regulate payments of gross personal incomes per employee in the economic sector will be introduced before Board discussion of the requested stand-by arrangement, and will remain in effect until a satisfactory modification of social compacts is effected so as to remove their inflationary bias.

2. The intervention law will supplement and strengthen the provisions of the social compacts currently in effect. In accordance with the two crucial policy variables set for each sector by the federal and republican/provincial authorities (target average gross personal income and target accumulation rate) each enterprise will determine the total amount of gross personal income payments ("wage bill") consistent with the provisions of the social compacts and related self-management enactments. 1/ A main provision of the intervention law will specify the maximum percentage increase in the gross personal incomes per employee in the accounting periods January-June 1988, January-September 1988, and January-December 1988, compared in all instances with the corresponding periods of the previous year. Taking into account changes in the number of employees, the maximum increase in the wage bill per enterprise can be determined in each accounting period. If the wage bill determined on the basis of the social compacts exceeds the maximum wage bill set by the intervention law, the difference will be set aside temporarily. Another provision of the intervention law will specify the conditions under which a portion of the set aside can be distributed as wages in the following accounting period. In general, a firm will be allowed to allocate up to one half of the set aside as gross personal incomes, provided that its accumulation rate has exceeded the actual (as opposed to targeted) accumulation rate for the relevant sector by 100 percent. A proportionally smaller portion of the set aside will be allocated, if the excess of the firms's accumulation rate over that of the sector is less than 100 percent. The portion of the undistributed set aside in such instances, as well as the whole set aside in cases of enterprises with below average savings performance, will be channeled into accumulation. The value of the set aside will depend, inter alia,

1/ According to these provisions, an enterprise can distribute gross personal incomes in excess of the officially specified average gross personal income for the sector provided that it raises its accumulation rate over its targeted level by a proportionally larger amount.

on the two policy variables set by the federal and republican/provincial authorities: the higher is the target rate of accumulation, and the lower is the specified average gross personal income, the lower is, ceteris paribus, the level of distributable personal incomes under the social compacts, and, hence, the set asides. The authorities intend to adjust these two variables so as to facilitate the achievement of the program objectives in the area of incomes policy.

3. The (partial) distribution of set asides will take place once the SDK has processed all interim accounts of the enterprise sector. Thus, distribution of set asides on the basis of the interim accounts for January-June 1988 is expected to take place in late August, for January-September 1988 in late November, and for January-December 1988 in late February 1989.

4. The gross personal income payments that are made out of set asides on the basis of good savings performance will be excluded from the maximum increase in gross personal incomes specified by the main provision of the intervention law. However, such income payments would still be taken into account in determining the allocation of enterprise net income into savings and gross personal incomes in accordance with the social compacts on wages (i.e., before the intervention law is applied).

5. Under the existing laws on Total Revenue and Income, and on Rehabilitation and Liquidation of Enterprises, enterprises that (i) have losses in their interim accounts, (ii) fail to observe the proportions of the social compacts, and (iii) are illiquid, or subject to income payments restrictions. According to these laws, such enterprises may effect payments of net personal incomes in each accounting period of up to 80 percent of the average net personal income payments in each enterprise in the corresponding period of the previous year augmented by the rise in the Yugoslav cost of living index. The intervention law will supersede these laws in the area of income payments restrictions. It will provide, inter alia, that the above-mentioned proportion will be reduced from 80 percent to 70 percent and that enterprises with healthy economic performances as evidenced by their most recent interim accounts and their state of liquidity, can make payments of gross personal incomes of up to 80 percent of the levels registered in the corresponding period of 1987, augmented by the rise in the Yugoslav cost of living index, even if such payments are in excess of the allowable increase under the main provision of the intervention law.

6. It is envisaged that, through a modification of the social compacts on personal incomes, the substantive provisions of the intervention law on wages will become a permanent feature of the system of incomes determination in Yugoslavia. In particular, the modified social compact should enable the federal authorities to specify a general rule for maximum increases in gross personal incomes in the economic sector and to specify the conditions under which set asides can be partially distributed to the most efficient enterprises. Until the

modification of the social compacts is effected, the intervention law will remain in effect.

7. Monitoring will be based on data on gross personal incomes per employee in the economic sector (including workers' collective consumption) that are compiled by the SDK on the basis of enterprise interim and annual accounts. The comparable data for 1987 were as follows:

(in dinars)

January-June	187,498
January-September	212,745
January-December	254,230

ATTACHMENT
ANNEX G

Subject: Technical Annex on the Understandings that have been Reached on the Liberalization and the Functioning of the Exchange and Trade Systems

1. The understandings reached with the Fund regarding the adoption of a flexible exchange rate policy before Executive Board discussion of the requested stand-by arrangement for Yugoslavia will require the revocation of both the emergency provisions of Article 110 of the Foreign Exchange Law and of the Bank Certificate Requirement at least five working days before that date; and that the revoked provisions will be replaced immediately by an arrangement whereby supply and demand for foreign exchange will have to be balanced without any other forms of administrative interference, relying only on frequent adjustment of the exchange rate supported by appropriately tight financial policies. This includes an intention not to intensify import restrictions for balance of payments purposes.

2. It is understood that the existing interbank market for foreign exchange can provide an appropriate setting for implementation of the flexible exchange rate policy, providing that the following agreed procedures are adhered to. Each enterprise presents its request for foreign exchange to its commercial bank which determines if the demand is bona fide as defined by the exchange and trade regulations. Apart from this controlling function, the bank will act as an intermediary only and is not empowered to refuse a bona fide request for foreign exchange. The banks transmit the demand for foreign exchange to the interbank market through the banks authorized to participate in this market. Aggregate demand in the interbank market on any given day must be fully satisfied, either through the foreign exchange available from banks that are net suppliers to the market on that day, or through drawing on the foreign exchange reserves of the NBY. The NBY can also acquire foreign exchange from the market to build up its reserve position. For the purpose of monitoring the operation of the interbank market for foreign exchange, the Fund will be provided with monthly information on the value of purchases and sales of foreign exchange between participants in the market. During the period of the stand-by arrangement, no major changes to the foreign exchange system will be implemented without prior consultation with Fund management.

3. The NBY will decide on the exchange rate each morning after the interbank meeting has taken place, taking into account prospective supply and demand as well as the binding requirement to meet the NFA target under the program. The new exchange rate is announced the same morning, and this is the rate at which banks must purchase foreign exchange from exporters during the day and the rate at which they accept

to acquire foreign exchange from the interbank market meeting the following morning. The commercial banks are allowed to hold prescribed working balances of foreign exchange, which can be used to satisfy bona fide demand for foreign exchange during the day and which can be replenished at the interbank session the next day.

4. The body competent for the exchange rate policy in Yugoslavia is the Federal Executive Council (FEC) and the responsibility for determination of the real effective exchange rate will remain with the FEC. To safeguard this competency but at the same time to enable the NBY to implement a flexible exchange rate policy on a day-to-day basis, the FEC will authorize the NBY to change the nominal exchange rate of the dinar in such a manner as to entail a significant real margin from the level established by the FEC. Before this margin is exhausted, however, the FEC will reestablish it so as to allow the continued implementation of a flexible exchange rate policy.

5. In order to prevent speculative pressures on the exchange rate from building up following the revocation of the emergency provision of Article 110 of Foreign Exchange Law and of the bank certificate requirement and following the liberalization of the import system, it has been decided to implement before the Board's discussion of the proposed SBA a flexible exchange rate policy, but it is also understood that the real effective exchange rate (on the basis of the retail price index and similarly on CPI indexes for partner countries) will not be allowed to appreciate from the level that will be reached at the start of the program. This policy is entirely consistent with the commitment to a flexible exchange rate policy, and it reflects the understanding that, given the low level of liquid reserves, unexpected favorable balance of payments developments should lead to an acceleration of the accumulation of external reserves rather than to pressures to appreciate on the real effective exchange rate.

6. As far as the liberalization of the import regime is concerned, the number of items that can be freely imported under the LB regime will be increased. Using 1987 import weights, the list of goods eligible for import under the LB regime will be expanded to the equivalent of 40 percent of total import and to 35 percent of convertible imports. This change will have been implemented before the above Board Meeting.

7. Understandings on a timetable for the completion of the liberalization process will have to be reached at the time of the midterm review, and will entail increasing the share of LB imports in total imports as defined above to at least 50 percent by January 1, 1989. The liberalization process will be completed in 1990. The final stages of the liberalization program will be built on production weights as well as import weights, and the authorities will make the necessary preparations in this regard.

ATTACHMENT
ANNEX H

Subject: Technical Note on Definition of Net Foreign Assets

For purposes of monitoring performance under the program, net foreign assets of the banking system will be defined to include all assets and liabilities shown in the attached table except for the holdings of the National Bank of Yugoslavia (NBY) shown in lines I.4.b and I.4.c. Bridge financing (i.e., short-term liabilities incurred in any quarter in anticipation of new financial medium- and long- term credits other than from the Fund identified at the outset of the program to be disbursed in the same or previous quarters) is excluded from this definition. Gold will be valued at US$42.22 per troy ounce and the U.S. dollar equivalent of foreign reserves and liabilities will be derived using the cross rates prevailing as of December 31, 1987. Defined in this manner, net foreign assets of the banking system stood at minus US$1,543 million at the end of December 1987.

Yugoslavia: Foreign Assets and Short-Term Liabilities of the Banking System in 1988

(In millions of U.S. dollars)

		December 31 1987
I.	National Bank of Yugoslavia assets	776
	1. Gold	78
	2. Securities	7
	3. Banknotes and coins	--
	4. Holdings kept in accounts	691
	(a) in 31 centers	(543)
	(b) outside 31 centers	(18)
	(c) with our firms	(130)
II.	Authorized bank's assets	980
	5. Banknotes and coins	180
	6. Holdings kept in accounts	800
III.	National Bank of Yugoslavia liabilities	2,013
	7. Short-term liabilities	162
	8. IMF credits	1,851
IV.	Authorized banks' short-term liabilities	1,138

ATTACHMENT
ANNEX I

Subject: Technical Note on Ceiling on Disbursed External Borrowing

For purposes of monitoring performance under the program, external loan disbursements in 1988 are defined to include all disbursements from foreign loans in convertible currency except the liabilities included in net foreign assets of the banking system as defined below. The ceiling will include amounts rescheduled, including amounts falling due in 1988 that are covered by existing rescheduling agreements, as well as rescheduling of payments that originally fell due in 1987 but were delayed under the stand- still agreement with the banks. The U.S. dollar value of external borrowing will be derived using the cross rates prevailing as of December 31, 1987.