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Yugoslavia

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

→ Yug.

DATE: May 30, 1986

TO: Files BGK for

FROM: Vinod Dubey, Director, CPD

EXT.: 60061

SUBJECT: YUGOSLAVIA - Country Study: Growth Scenario for Highly Indebted Middle Income Country - Minutes of the OPSC Meeting of May 8, 1986

Present: Members: Messrs. Stern (Chairman), Alisbah, Dherse, Husain, Lerdau, Michalopoulos, Pfeffermann, Shakow, Wapenhans, Wood, Yenal

Others: Messrs. Dewey, El Serafy, Farsad, Fernandes, Grais, Harrison, Hasan, Kopp, Lari, Lysy, O'Brien, Roger

1. Several members mentioned that while the policy recommendations in the report were appropriate, they should be more specific, particularly on the sectoral side. The policy matrix is set in general terms and provides little basis for discussing specific SAL II conditionalities. Regarding projections, it was mentioned that specific measures are not sufficiently linked to their effects. For instance, export growth rates are similar in both scenarios for the first two years, and timing of policy changes should therefore be more explicit, particularly in the case of the exchange rate. One member stressed the importance of coordinating reforms of price policy, foreign exchange policy, and the trade regime if the trade reforms were to be successful. Questions were raised regarding the source of MLT borrowing of $1.2 billion projected for 1986, especially if commercial banks would not lend voluntarily. It was also mentioned that scenario A showed a quasi-stagnation situation with no pressure on the authorities for a change.

2. The Region responded that credit on commercial terms included government guaranteed credit as well as credits from commercial banks. In the case of scenario A mobilization of credit on commercial terms, as mentioned in the paper, would be difficult. But even in that case the country would have a current account surplus, build up reserves, and reduce its debt service burden. Commercial banks may not find it too risky, therefore, to start lending to Yugoslavia, probably around 1988. Scenario A, however, will not provide the necessary cushion to absorb external shocks. It was decided that in the next version of the paper the risks and negative implications of scenario A should be emphasized, and the advantages of scenario B highlighted in terms of a less dependent economy, better able to deal with external shocks.

3. With respect to providing more detail on proposed policy reforms, the Region referred to the content of the SAL II Initiating Memorandum which covers the areas of pricing, investment, financial discipline, foreign trade, foreign exchange, and interest rates. The Region stressed that agreement has

not been reached yet on trade liberalization and interest rate issues. The Government has adopted a number of legislative measures in the areas of pricing and financial discipline, but it will be necessary to reach agreement on monitoring their implementation. As regards investment planning, the Yugoslavs have delayed the finalization of sectoral investment programs for power, transport and telecommunications because of difficulties in reaching the necessary consensus among Republics/Autonomous Provinces. The Region has not yet been able to obtain Government approval for a review of the financial sector, but it hopes to get agreement to start this review in January 1987. It is intended that this country study will be discussed with the new Government that assumes office in mid-May. However, the Government may need time to consider its conclusions. The ongoing discussions on SAL II should somewhat clarify the Government's position.

4. The Chairman concluded that the report be sent to the IMF for review, and a condensed version (without short-term forecasts and financing plans) be sent to Yugoslavia for discussion with the Government.

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: April 30, 1986

TO: Operations Policy Sub-Committee

FROM: Vinod Dubey, Director, CPD VDubey

EXT.: 60061

SUBJECT: YUGOSLAVIA: Growth Scenario for Highly Indebted Middle Income Country - OPSC Meeting

A meeting of the OPSC is scheduled for Thursday, May 8, 1986 at 2:30 p.m. in Room E-1208 to discuss the attached draft country study prepared by the EMENA Region.

Attachment

CONFIDENTIAL

April 9, 1986

YUGOSLAVIA: Country Study

Growth Scenario for Highly Indebted Middle Income Country

INTRODUCTION

To cope with the balance of payments deficit and rising external debt that emerged after the second oil price increase, Yugoslavia adopted stabilization policies, with the IMF's support, in the early 1980s. Those policies, combined with administrative allocation of foreign exchange, reduced the balance of payments deficit and decelerated the increase in indebtedness. However, investment and growth have remained depressed, and inflation has become increasingly severe. Yugoslavia now needs to implement policy measures to resume growth and reduce inflation while continuing the orderly servicing of its external debt. This paper assesses the prospects for attaining these objectives and the amount and type of financial assistance Yugoslavia will need to do so.

Even without major policy reform, Yugoslavia would be able to achieve a low growth rate and gradually reduce its debt burden, provided it is able to attract the required international financial support. The slow pace of growth and continuing inflation, however, would put strains on the country's political and social fabric. With appropriate policy reforms, Yugoslavia could achieve significantly faster growth, have better access to international financial markets, and manage its external debt with no major difficulty. These reforms will have short-term adjustment costs that should be weighed against the benefits of long-term economic stability and a better standard of living. Rapid introduction of an appropriate package of policy reforms will depend heavily on the degree of political will within Yugoslavia to implement such a program. Recent experience indicates that it may not be feasible politically to reach a consensus at the federal level on a set of measures needed to create conditions precedent to the occurrance of a higher growth performance.

I. INITIAL CONDITIONS

1. The Yugoslav economy, led by a rapid increase in fixed investment, grew at an average annual rate of over 6 percent in the 1970s. However, this high growth rate was achieved at substantial cost. An overvalued exchange rate and a heavily protected domestic market, together with distorted commodity and factor prices, created a structure of production with little flexibility and hindered the development of the sectors producing tradables.

2. These domestic rigidities, compounded by the oil price increases, disrupted the high growth of the Yugoslav economy in the late 1970s. While the rigidities distorted resource allocation, the second oil price increase precipitated a balance of payments crisis. Because of the inflexible production structure and inappropriate exchange rate policy, the economy was not able to counteract the external shock by stepping up exports. Moreover, instead of reducing domestic absorption to cushion the effects of the shock, Yugoslavia continued its investment drive: fixed capital formation remained roughly around 34 percent of GSP 1/ in the late 1970s. Finally, easy credit and monetary policy accelerated the rate of inflation to nearly 40 percent in 1980.

3. The second oil price increase contributed to a trade deficit of US $7.2 billion (11.7 percent of GSP) and a current account deficit of $3.7 billion (6 percent of GSP) in 1979, financed through heavy external borrowing and a decline in foreign reserves of $1.3 billion. The external debt rose rapidly, doubling between 1978-81 to reach almost $20 billion. Consequently, the debt rose from 23.5 percent of GSP in 1978 to 31.5 percent in 1981. During the same period, the debt service ratio in convertible currencies increased from 18 percent to 31 percent. 2/ Similarly, the rate of debt to exports increased from 99 percent in 1978 to nearly 116 percent in 1981.

4. As the need for borrowing increased, greater reliance was put on commercial sources of funds, particularly short-term obligations. By 1980, close to 80 percent of new loans were being obtained on commercial terms, and mostly with maturities of 2 to 3 years. The slowdown of the world economy, with its adverse effects on Yugoslav exports, and the increase in world interest rates soon caused a heavy burden on the country's external finances.

5. The result of these various factors was that Yugoslavia became externally illiquid. By 1982, it could no longer service its debt on time, and by 1983 its convertible currency foreign exchange reserves could cover only one month of imports.

1/ Gross Social Product (GSP) is the basic Yugoslav concept for national income accounts. It is close to GDP, but excludes certain service activities. Our estimates indicate that GSP is about 10-12 percent smaller than GDP.

2/ The total debt service ratio increased from 17.7 percent to 23.4 percent.

The Response

6. To deal with the crisis, the Yugoslav Government initiated in 1981 stabilization and control measures to restore domestic and external equilibrium. At the end of 1982, when these efforts proved insufficient to cope with the debt burden, Yugoslavia requested a debt relief arrangement from its creditors. Meanwhile, a major reform of the framework of incentives was begun.

7. The main stabilization measures, supported by the IMF, were restrictive fiscal and monetary policies and more active use of the exchange rate. The share of public sector expenditures1/ in GSP declined from 37 percent in 1980 to an estimated 32 percent in 1985. The budget of the consolidated public sector, which ran a deficit until 1980, yielded a surplus in subsequent years. The stringent fiscal policy was accompanied by a monetary policy that placed ceilings on the net domestic assets of the banking system and raised interest rates. While nominal lending rates were adjusted, they remained highly negative, but the interest rates on term deposits moved closer to positive levels in real terms.2/ By far the most important response was the adjustment in the exchange rate. Between September 1982 and June 1984, the real effective exchange rate was depreciated by 35 percent.3/ Since July 1984, the nominal effective exchange rate has been adjusted regularly to keep the real effective exchange rate roughly constant.

8. In 1983, a major financial support package was put together, under the umbrella of an IMF program, to relieve Yugoslavia's debt burden. It consisted of $4.4 billion in medium- and long-term commitments and included refinancing by Governments and commercial banks. As part of this package, the World Bank provided a structural adjustment loan (SAL) of $275 million. Another financial package totalling $3.2 billion was put together for 1984 by the IMF, Governments and commercial banks. For 1985 through May 15, 1986, Government creditors agreed to reschedule 90 percent of the original maturities falling due, and agreed to consider annual rescheduling of the debt after May 15, 1986, provided there exists a satisfactory arrangement between Yugoslavia and the IMF. Similarly, in 1985, Yugoslavia and the commercial banks reached an agreement for a multi-year rescheduling arrangement to cover the original maturities falling due between 1985 and 1988. The original maturities amounted to $5.7 billion ($3.6 billion of which is owed to commercial banks). The agreement with commercial banks is also dependent on enhanced monitoring by the IMF through 1991.

9. The Government also undertook other longer term policy reforms, in line with the objectives of the Long Term Program of Economic Stabilization adopted in July 1983 and supported by the Bank's first structural adjustment loan. Aimed at reforming the system of economic incentives, the reforms included adoption and revision of a number of laws and regulations governing

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1/ Includes budgetary expenditures at all levels of local and federal government.

2/ The rate for three-month time deposits is now 73 percent.

3/ The real effective exchange rate depreciated by 25 percent in 1983 alone.

the criteria for investment selection, prices, financial discipline, planning, banking, joint ventures, fiscal policy, foreign credit, foreign trade, and the foreign exchange allocation system.

The Results

10. The current account deficit turned into a surplus in 1983. In 1985, that surplus was $0.8 billion (of which $370 million were in convertible currencies). However, export performance has been erratic (para. 16). Moreover, due in part to the structure of the maturities, the burden of the external debt has remained large: debt service payments to convertible currency areas ran about 43 percent of convertible currency export earnings in 1985, a level that drops to about 27 percent when the rescheduled maturities are excluded.

11. The stabilization efforts have met with limited success in terms of economic performance. There are several reasons for this result. The stabilization efforts have been unbalanced, focusing on the reduction of imports and fixed investment, and they have not constituted a timely, coordinated and mutually reinforcing package. The reduction of imports through administrative rationing of foreign exchange has circumvented the use of market incentives to channel resources toward the tradable sectors.

12. In the first half of the 1980s, the decline in domestic absorption was made possible by a substantial cut in fixed investment: gross fixed investment declined by about 8.5 percent a year in real terms between 1980 and 1985. The decline was faster, however, between 1983 and 1985. As a result, fixed investment, which was about 36 percent of GSP in 1979, dropped to about 22 percent of GSP in 1985. While most of the investments of the late 1970s were not based on efficiency considerations, available data suggest that the cutbacks have been across the board, instead of being directed at inefficient investments of the past.1/

13. The decline in fixed investment was associated with a substantial increase in inventory accumulation, the result in part of negative real interest rates and the enterprises' ability to finance the unsalable production. It also reflects inflationary expectations caused by a succession of price freezes and liberalizations. The continuous increase in inventory accumulation, however, reflects the ineffectiveness of the policies directed at reducing domestic absorption and the lack of tight budget constraints on enterprises.2/

1/ The sectoral composition of investment shows little change between 1979-83.

2/ Official estimates show inventory accumulation amounted to 20 percent of GSP in 1985 and has been a rising portion of GSP throughout the 1980s. There is considerable uncertainty attached to these estimates, with some evidence that they substantially overstate stockbuilding. If so, for the national accounts to remain consistent, either GSP was lower than estimated, or some other component of GSP, most likely consumption, was higher. The uncertainty here, on the order of 10-15 percent of GSP, calls for caution when providing recommendations for resource mobilization.

14. The slowdown in growth has been longer and more severe than expected. Since 1980, the annual rate of growth of GSP has averaged less than 1 percent a year in real terms (Annex Table 1). Inflation, driven by demand pull and cost push factors, has persisted and even worsened, reaching 80 percent in 1985. The restrictive monetary policy was not successful in controlling inflation, as it was not followed by timely implementation of hard budget constraints on loss-making enterprises. The tight credit policy was also overtaken by other forms of credit creation, particularly inter-enterprise credit arrangements.

15. The significant increase in inflation and the slow growth in output have resulted in a substantial and extended decline in real wages--by June 1985, they were about one-third lower than in 1980. Over the same period, private consumption fell by about 1 percent annually.

16. Yugoslavia's export performance in the past five years has been erratic, despite the preferential access to credit and foreign exchange and the substantial depreciation of the real effective exchange rate vis-a-vis convertible currencies. On the whole, growth of exports to convertible areas in nominal terms has been about 3 percent since 1981. The reason for this poor performance has been an insufficient switch in the relative price of tradables and non-tradables. Some improvements in exports have taken place since 1984, a reflection in part of the unofficial premium firms were able to realize on foreign exchange earnings under the previous foreign exchange allocation system that ended in 1985. This premium seems to have encouraged the expansion of exports, even those with low value-added content. Nevertheless, Yugoslavia's share in the industrial country markets has not changed significantly since the impact of the devaluation was felt in 1983.

17. As for the longer term policy reforms, they have proceeded too slowly, except in the area of price liberalization. However, by January 1986, new regulations governing most of the areas of reform were partially in place, though in some cases the regulations appear inadequate or even counterproductive.

II. MEDIUM-TERM ECONOMIC PROSPECTS

18. Following the crisis of the early 1980s and the emergence of the adjustment problems in the economy, Yugoslavia is now planning for a period of recovery and sustained growth. This aspiration is reflected in the 1986-90 development plan, which aims at a growth rate in GSP of 4 percent a year. Resumption of growth is needed in order to avoid the grave social consequences of growing unemployment and inflation and the declining trend in real wages. However, the potential for sustained growth and substantial improvement in living standards will not be achieved in an environment marred by economic distortions and imbalances that cause inefficient resource use.

Constraints on Growth

19. Policies to address the economic distortions have been hampered by competing regional interests and a cumbersome consensual decision-making process in Yugoslavia. The effectiveness of policies in addressing the structural problems facing the economy has been impaired by a tendency to rely mainly on administrative measures instead of market forces to correct the imbalances. Economic policies and growth objectives have been over-ridden by strong regional interests and delays in action caused in reaching consensus. Moreover, the lack of coordination of investment activities among the Republics and Autonomous Provinces has prevented cost-effective investments and limiting the scope for improved productivity and faster growth.

20. Resumption of growth is also constrained by the limited availability of external resources, the slow export performance, and a heavy debt service payment. These in turn, jointly with the allocation of domestic savings to inventory accumulation and to the financing of loss-making enterprises, exacerbate the curtailment of fixed investment. In addition, inadequate mobility of capital and labor among regions limits increases in production. If these constraints are not reduced, recovery and a sustainable rate of growth of the economy will be difficult to achieve.

21. Even though Yugoslavia's foreign debt is not particularly large in comparison with many high debt countries,1/ its high debt service burden has caused a deterioration in the standard of living and has eroded some of the gains of the development drive of the 1970s. Yugoslavia's debt service payments to convertible currency countries in 1985 would have been about 43 percent of the export earnings from these areas in the absence of the rescheduling agreements. Total interest payments were about 5 percent of GSP. Interest payments in convertible currencies were about 16 percent of the exports to convertible currency areas.

22. The maturity structure of the Yugoslav debt profile is especially unfavorable. Even after the recent rescheduling (para. 8), Yugoslavia will have to amortize 75 percent of its debt between 1986-90. With the IMF financial program in Yugoslavia terminating this year, Yugoslavia will have to repay about 2.0 billion to the IMF by 1991.

23. The high level of debt repayment and limited capital inflows make it necessary for Yugoslavia to maintain a large current account surplus. With so much of the country's foreign exchange earnings being pre-empted by the debt repayments, a shortage of foreign exchange has emerged that has led in turn to restricted imports. The restriction of imports has required a slowdown in investment and growth. It has also adversely affected exports that depend on imports and has further exacerbated the shortage of foreign exchange. Further curtailing of fixed investment to restrain domestic absorption will retard economic growth. It will also jeopardize the proper maintenance of existing capital stock and erode the competitiveness of industrial exports, as funds

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1/ At the end of 1985, Yugoslavia's external debt was estimated to be about $20.2 billion, of which $18.8 billion was in convertible currencies. Of the total convertible currency debt, medium- or long-term (MLT) debt was about $17.8 billion, while short-term debt amounted to about $990 million.

for restructuring and modernization of industry will not be available. However, to improve efficiency, increases in investment should be accompanied by improvements in its allocation towards projects with the highest expected yields. For this purpose, greater enforcement of financial discipline and use of market signals in determining prices will be essential.

24. Yugoslavia's export performance has been poor in recent years. Resumption of growth could be led by exports, but their promotion requires an active exchange rate policy and a market-based allocation of foreign exchange. A new foreign exchange allocation system was introduced in January 1986, which has as its objective the eventual establishment of a foreign exchange market with a freely convertible Dinar. However, in its transitional phase, now being implemented, the system relies heavily on an administrative allocation of foreign exchange and import rights. While a common foreign exchange pool has been created through full surrender by exporters of the foreign exchange they earn, administrative interventions governing the use of the pool and import restrictions are continuing. As a result, it is not clear how the transition toward the objective of a market with a convertible Dinar will be managed.1/ However, the surrender requirement has eliminated the premium previously available to exporters and may, in the absence of appropriate exchange rate adjustments, reduce the incentive to export.

25. Productivity increases cannot be achieved without an increase in the mobility of capital and labor. The uneven pace of development among regions has widened the disparities in income, and the limited mobility of capital and labor has resulted in larger numbers of unemployed in the less developed areas. To resume sustainable growth and reduce unemployment, the obstacles to the internal mobility of the factors of production among the regions should be removed.

26. Factor mobility could be increased by promoting joint ventures among the regions, broadening the scope of banking activity to include a wider allocation of financial resources through the banking system among regions, and encouraging labor mobility through wage and non-wage incentives. Mobility could also be increased by reforming the system of economic incentives (para. 29), a step that would promote efficient allocation of resources and encourage increased mobility of factors across regions.

Objectives of a Medium-Term Strategy

27. The objectives of a medium-term strategy should be to (i) resume growth with sustainable macroeconomic balances; and (ii) increase debt servicing capacity. Attaining these objectives requires a system of economic incentives that ensures efficient resource allocation, as well as prudent and well-coordinated macroeconomic policies that reduce the rate of inflation.

28. More specifically, the medium-term strategy should aim at (i) increasing the rate of growth of exports, particularly to convertible currency areas, and improving the competitiveness of the economy through an appropriate

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1/ There is a continuing discussion on this issue between Yugoslavia and the Bank.

exchange rate policy; (ii) increasing per capita consumption in real terms; (iii) improving efficiency and maintaining a level of investment to support the growth objectives; (iv liberalizing trade and increasing the mobility of factors of production; and (v) improving the system of economic incentives, relying more on market signals to determine prices and allocate resources more efficiently.

29. The implication of this strategy is that Yugoslavia will need to implement major policy reforms in the system of resource allocation and use. Foremost among the reforms are: enforcement of financial discipline; liberalization of the trade and foreign exchange allocation systems; application of economic criteria in investment decision and allocation; and greater reliance on market forces to determine prices. These reforms will have a macro and micro impact on economic performance. They will encourage mobility of factors and will help the economy attain a cost-effective structure of production and pattern of demand that corresponds to its comparative advantage. These reforms should be followed by others relating to the financial sector, regional trade, and encouragement of small-scale private enterprise.

30. One of the most important reforms is to ensure greater financial discipline1/ among social sector enterprises by strengthening incentives for efficiency and enforcing greater accountability for financial losses. A loose budget constraint enables social sector enterprises to pass on losses to others, a situation that discourages efficiency and competition, fuels inflation and puts undue pressure on the balance of payments. Enterprises should be accountable for their losses. Enterprises that are not economically profitable should be restructured and, if need be, closed down. Financial assistance from other enterprises and the community to loss-making enterprises has been limited by recent legislation. This legislation needs to be implemented as planned so that all such assistance is eliminated by 1987 (except for enterprises that are being rehabilitated).

31. Financial indiscipline destabilizes the economy at the micro level, and there are few sanctions to combat it. Improved accounting procedures and implementation of the regulations to restrict income payments to workers in firms that make losses should continue to receive high priority. Easy access of loss-making enterprises to bank credit should be replaced by a mechanism that applies financial and economic criteria. At the macro level, rescuing firms with chronic losses will only reduce the resources available to more efficient firms and/or transfer the losses to the banking system.

32. The past and present Yugoslav foreign exchange allocation systems are essentially based on quantity rationing. The previous system, which was in operation until the end of 1985, did not function efficiently and prevented the emergence of a unified foreign exchange market. The goal of the new system, which has been in operation since January 1986, is a foreign exchange market with a freely convertible Dinar. This objective needs to be achieved as rapidly as possible on a predetermined schedule. Import restrictions need

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1/ A more detailed account of and the timeframe for this and other reform measures is presented in Section V and Annex II.

to be reduced on a parallel schedule. Quantitative restrictions could initially be replaced by tariff-like surcharges to avoid a destabilizing surge of imports. Gradually, these should also be reduced.

33. The allocation of investment and efficiency in use of investment resources are prime determinants of economic growth. The most important need relating to investment policy in Yugoslavia is to coordinate regional investment decisions in the highly capital-intensive sectors and to ensure selection of projects that reflect economic and financial profitability. In this respect, adoption of Joint Development Plans (JDPs) for the infrastructure sectors based on least-cost criteria is an essential element in the coordination of large investment activities. The new Plan calls for JDPs in power, telecommunications and railways. To date, none has been completed. For the non-infrastructure sectors, reliance on the economic rate of return based on the opportunity cost of capital and market prices should be deepened so that investment flows into the more productive ventures and the mobility of capital increases. At the same time, it is essential to implement the recently approved uniform investment criteria and raise interest rates to positive real levels to avoid severe macro instability as well as a gross misallocation of resources.

34. Price controls distort resource allocation by influencing the relative profitability of production. Between 1979-84, Yugoslavia used intense price controls to combat inflation. Since January 1985, most prices in Yugoslavia have been liberalized.1/ To increase the efficiency of resource allocation, the Government needs to continue to allow market forces to determine prices and should make adjustments to close the gap between administered prices and opportunity costs. This reform is especially the case for energy products and electricity.

Alternative Scenarios

35. The policy reforms and economic environment under which the objectives of stabilizing the economy, resuming growth and reducing the external debt burden can be achieved are examined here as two scenarios: Scenario A and Scenario B. The two scenarios are derived through the use of a general equilibrium model that incorporates essential features of the Yugoslav economy and the policy assumptions discussed below.

36. In Scenario A, it is assumed that the Government undertakes no major policy changes. The policy assumptions under Scenario A are therefore limited to the implementation of policy measures already adopted: the transitional phase of the present foreign exchange regime (para. 24) remains; the real effective exchange rate stays constant; under-utilization of present capital stock continues; most administered prices would not reflect their opportunity cost; and domestic inflation would be more than world inflation.

37. In Scenario B, it is assumed that economic reforms would allow improved resource allocation and the benefits of greater flexibility in responding to price signals. More specifically, the policy assumptions are as follows. An auction-type system of foreign exchange allocation is assumed in

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1/ A number of prices, particularly in the areas of energy, transportation, and telecommunications services, are still administered.

1988-90. Beginning in 1991, the economy is assumed to have adjusted enough to allow it to have a freer foreign borrowing policy. After 1991, the exchange rate regime with the convertible areas would be a managed float. Utilization of capital stock would increase. Restrained monetary and fiscal policy combined with greater enforcement of financial discipline would lead inflation to decline and converge with international inflation around 1989. Moreover, administered prices would be adjusted to reflect their opportunity cost.

38. The results under Scenario A indicate that the rate of growth of GSP would remain around 2.7 percent between 1986-90 and would then slow to 2.3 percent between 1991-95 (Table 1 and Annex Tables 2-A). The rate of employment growth would remain around 2 percent. The debt service ratio in convertible currencies would be 33 percent in 1990 before declining to 26 percent in 1995. Export growth would remain sluggish in both the 1986-90 and the 1991-95 periods, averaging about 2.4 percent and 2 percent, respectively.

39. The favorable terms of trade effect of the decline in oil prices would allow the economy to gain additional resources for investment. Investment would rise 2.6 percent on average during 1986-90 and 2.2 percent during 1991-95. However, because of the technological obsolescence of equipment and low use of capacity, the efficiency of investment would deteriorate: the incremental capital output ratio (ICOR) would increase from 7.3 during 1986-90 to 9.2 during 1991-95.

40. Under Scenario B, simultaneous implementation of policies aimed at both stabilization and increased efficiency would lead to accelerated growth. Up to the end of 1987, the Government would continue to emphasize stabilization objectives in order to reduce inflation (para. 47). At the same time, it would implement and extend the reforms relating to the foreign exchange and foreign trade regimes, financial discipline and investment allocation. These steps would reorient the economy toward growth and reduced inflation and unemployment. The prospects for resumed growth are, therefore, tied to both the effectiveness of the stabilization measures and the speed of structural reforms.

41. The key underlying assumption in Scenario B is the political will to implement an effective reform program in 1986-87. Between 1988-90, under this scenario, the result of improvements and reforms in the incentive and resource allocation system would allow the growth rate to accelerate to an average of 4.4 percent a year (Annex Table 2-B) and would allow the economy to become more responsive to price signals. The economy would benefit from a floating exchange rate, and exports would increase by an average of 6.3 percent a year between 1988-90, conditions that would allow a continuous substantial decline in the debt service burden and debt export ratio, even though the absolute size of the debt would remain constant. The convertible debt service burden would fall to 30 percent in 1990 and 21 percent in 1995. Similarly, the ratio of interest payments to GSP will decline to 2.4 percent in 1990 and to 1.2 percent in 1995. Although the decline in the debt service burden up to 1990 is close to that of Scenario A, it would be obtained through better growth performance and higher per capita income. After 1990, the debt service ratios in Scenario B fall much more rapidly than those under Scenario A.

Table 1

Yugoslavia: Average Annual Growth Rates in 1984 Prices
(percent)

	1986-90 Scenario A	1986-90 Scenario B	1991-95 Scenario A	1991-95 Scenario B
GSP	2.7	3.7	2.3	4.1
Agriculture	2.9	2.8	2.0	2.6
Industry	2.6	4.1	2.6	7.0
Energy	3.0	3.0	3.0	3.4
Construction	2.8	2.9	2.4	1.1
Services	2.6	3.8	2.2	3.4
Consumption	3.2	4.0	2.8	4.4
Investment	2.6	4.5	2.1	4.1
Exports (Goods & NFS)	2.4	4.6	2.0	5.8
Imports (Goods & NFS)	3.6	6.5	2.9	6.4

Current Account Balance
(convertible currencies)

Million US$

	1986	1987	1988	1989	1990	1995
(A)	838	798	798	753	753	350
(B)	838	798	350	300	300	10

MLT Debt Outstanding and Disbursed
(convertible currencies)

Billion US$

	1986	1987	1988	1989	1990	1995
(A)	17.4	17.0	16.6	16.2	15.8	15.8
(B)	17.8	17.8	17.8	17.8	17.8	19.5

Debt Service Ratio
(convertible currencies)

Percent

	1986	1987	1988	1989	1990	1995
(A)	39.3	34.2	33.8	36.4	33.1	26.0
(B)	38.1	33.3	32.8	34.8	30.5	21.2

Source: Annex Tables 2A, 2B and 3A, 3B.

42. Under Scenario B, to support the more rapid growth of the economy, particularly the growth of investment and exports, imports would grow at a rate of 6.5 percent a year between 1986-90 (Table 1). Investment would grow at an average annual rate of 4.5 percent in this period. However, because of an increased use of existing capital stock, the efficiency of investment would be higher than in Scenario A, with the ICOR ranging between 5-6. Implementation of reforms in the area of investment allocation (para 33) and greater reliance on market signals would encourage mobility of capital and allow investment to be directed into more efficient sectors. Investment would move toward the industrial sector, which would have a rate of return above the national average.1/ Employment would increase on average by 2.5 percent a year in this period.

43. Under Scenario B, the favorable developments in the economy in the late 1980s would allow a continuation of sustained growth in the 1990s. Between 1991-95, the policy measures adopted earlier would help increase the rate of growth to around 4.1 percent a year. Exports, mostly industrial, would grow by about 5.8 percent a year, supporting the growth of GSP. Investment would grow by 4.1 percent a year between 1991-95. Continuation of investment would allow employment to increase by 3 percent a year between 1991-95. As the economy moves toward more flexibility and maturity in the 1990s, the balance of payments and macro constraints would become less binding, and the economy could comfortably manage servicing the external debt. The flexibility of the economy would also allow it to respond better to future changes in the world economy.

44. While the option represented by Scenario A is feasible, it is basically undesirable. The economy would be able to achieve a low growth rate and gradually reduce its debt burden, but the slow pace of growth would generate little employment and would strain the country's political and social fabric. Capital equipment would remain technologically obsolete and underused. Moreover, under Scenario A, Yugoslavia would face difficulty attracting international financial support (para. 56) and would remain highly vulnerable to future external shocks.

45. In contrast, under Scenario B, the rate of growth would be substantially larger, investment would become more effective and the economy could achieve a higher level of income per capita. Yugoslavia would have a better access to international financial markets and could manage servicing the external debt with no major difficulty. However, experience in Yugoslavia indicates that implementation of an appropriate package of policy reforms would be very difficult, especially if actions have to be taken at a fast pace. The implementation of the proposed reforms and stabilization measures are not politically popular not only because of adjustment costs such as the closing of inefficient enterprises and related unemployment, but also because of interregional conflicts. Even if the reforms were not inhibited by economic constraints and factor market rigidities, they could face resistance from those who would be adversely affected (para. 51). The political and

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1/ The rate of return on capital investment on average would grow by about 9 percent between 1986-90.

economic risks to those advocating reform could be substantial. Nevertheless, these short-term costs should be weighed against the benefits of the long-term economic stability and better standard of living that could be achieved by adhering to the kind of policy package described under Scenario B.

III. POLICY PRIORITIES FOR SUSTAINED RECOVERY

46. In the next two years, the policy priorities should be on two fronts: bringing down inflation without jeopardizing the external balance, and firmly establishing a framework of incentives that will promote the efficient restructuring of the economy. These policies must be implemented with determination if the economy is to resume sustained growth. Such policies will generate adjustment costs and will face political and administrative obstacles. But there are also substantial costs to failing to reform the economy: standards of living and levels of employment will be lower and the economy will be more vulnerable to external shocks.

Macroeconomic Policies

47. While resuming growth, the authorities will need to control inflation. This is the most urgent task. Simultaneously, there is a need to encourage improvement in the efficiency of resource allocation in order to consolidate the external balance, maintain growth on a sound basis and begin tackling unemployment. To complement the stabilization measures and pave the way for resumed growth, the authorities need to implement and extend the major reforms (discussed in Section II). These reforms are essential to restructuring the economy for sustainable growth.

48. To stabilize the economy, macroeconomic policies during 1986-87 should concentrate on continuing fiscal and monetary restraint, with gradual relaxation thereafter. These restrained policies imply a need for greater enforcement of financial discipline on the part of social sector enterprises in order to control the liquidity in the economy effectively and decelerate the rate of inflation. While fiscal policy, as in the past, should aim at controlling the increases in public expenditures in real terms, a restrained credit policy requires unified, positive, floor real lending interest rates by 1987. Credit policy should also take into account the flow of credit among enterprises. In this respect, immediate attention should be focused on allowing only commercial banks to guarantee enterprise credit instruments, instead of the present practice of guarantees being issued by the enterprises themselves or their internal banks. Moreover, the commercial banks should provide incentives in the form of high yielding short-term monetary instruments that would attract enterprises' excess liquidity into the banking system.

49. To supplement the restrained monetary and fiscal policies, there should be an incomes policy to support efficient economic units. Enforcement of the regulation restricting income payments to workers in firms that make losses and the social compact that links wage increases to productivity gains would be positive steps. At the same time, in an environment where the cost elements are indexed to price increases and enterprises pass those cost

increases on to consumers, inflation cannot be tackled only through compression of demand. Therefore, greater competition from imports should be allowed, and competition among firms should be encouraged so that increases in productivity are reflected in lower prices, and not just in higher wages and profits.

Difficulties in Implementing the Policy Reforms

50. Economic recovery in Yugoslavia will require forceful implementation of the reform policies described earlier. However, the preoccupation of the Republics and Autonomous Provinces with economic autarchy has prevented the adoption of effective policies. It has prolonged the decision-making process and prevented the adoption of adequate and effective policy reforms.

51. The reform of the foreign trade and foreign exchange allocation systems, which is difficult and politically sensitive, needs to be completed rapidly. Implementation of this and other reforms will mean facing the issue of limited federal power and the strong regional divisions in Yugoslavia. Introduction and implementation of policy measures, particularly those related to interregional matters, have often been stalemated by the parliamentary veto power of each Republic. Those adversely affected by reforms will exert political pressure and slow the pace of implementation, as has been the case in the past and in other countries. Those parties include loss-making enterprises that depend on outside sources to cover losses; inefficient industries that are protected by the trade regime; regions that realize specific local advantages in various distortions of the incentive structure; and oligopolist enterprises that benefit from a lack of competition.

52. The strong regional differences, together with the decentralized decision-making process, make establishing a nationwide market and designing and carrying out policies within a unified framework difficult. Implementation of the Long Term Program of Economic Stabilization has already suffered from these competing regional interests and the constant struggle for power among the Federal Government and the Republics and Autonomous Provinces. Similarly, the important areas of reform under the first SAL (para. 65), particularly those relating to the foreign trade and foreign exchange regimes and investment planning, have faced long delays and have not met initial expectations. Much resistance and many delays have also been experienced in implementing other measures under the SAL, particularly in the areas of price and tariff adjustments. While Yugoslavia has been aiming at more uniform market signals, a more open economy and a greater integration of its decision-making, actual reform has been slow.

IV. FINANCING REQUIREMENTS

53. Under Scenario A, Yugoslavia would reduce its convertible MLT debt by $400 million a year up to 1990, and then maintain a constant debt. This is a much lower level of debt reduction than what is implied by the $1.2 billion annual current account surpluses projected in the 1986-90 five-year plan.

Average real interest rates paid by Yugoslavia would remain about 3 percent, reflecting the perception by the financial community that the economy remains vulnerable. Under Scenario B, it is assumed that real interest rates would decline to 2 percent.

54. Even after past reschedulings, under Scenario A, Yugoslavia would need to amortize annually about $2.2 billion in convertible MLT debt between 1986-88. With interest payments of about $1.8 billion, the debt service payments of about $4 billion a year would remain a heavy burden on the balance of payments. The convertible debt service payments would become even larger in 1989-90 ($4.8 billion a year), when the present multi-year rescheduling arrangements terminate.

55. Under Scenario A, the required gross convertible capital inflow would amount to $10.8 billion between 1986-90. The average inflow should increase from $1.8 billion a year between 1986-88 to $2.6 billion a year between 1989-90 (Table 2). The bulk of the inflow ($8.2 billion) would be on commercial terms, including loans from governments and their agencies. The inflow on commercial terms should increase from the average of $1.2 billion a year during 1986-88 to $2.2 billion a year during 1989-90. However, commercial banks have been cautious in making MLT loans to Yugoslavia since the early 1980s. Whether this caution will persist will depend upon whether Yugoslavia can regain their confidence by implementing the appropriate economic policies and succeeding in further expanding its foreign exchange earnings.

56. Under Scenario A, there are no major policy changes. Consequently creditors may not be willing to provide the additional financial support to Yugoslavia. In that case, Yugoslavia would find it more difficult to achieve even the low 2.7 percent yearly growth projected under this scenario. It is likely that Yugoslavia would even have to seek additional rescheduling starting in 1989 to manage the increase in debt service payments following the termination of the present rescheduling period.

57. Under Scenario B, convertible MLT debt would stay at the level of 1985 until the early 1990s. However, the debt service burden would not be larger than in Scenario A because of the better performance of exports (para. 43). Under this scenario, the gross convertible capital inflow would be over $13 billion between 1986-90. The average inflow would increase from $2.2 billion a year between 1986-88 to $3.2 billion a year between 1989-90 (Table 2). Of this amount, the gross inflow on commercial terms (from commercial banks and bilateral sources) would be $8.9 billion, or $1.4 billion a year during 1986-88 and $2.3 billion a year during 1989-90.

58. Under Scenario B, Yugoslavia would require about $2.3 billion more external borrowing than under Scenario A between 1986-90.1/ Provided appropriate reforms are introduced, the Bank would be prepared to increase its

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1/ The increased borrowing is reflected in the difference between total gross disbursements in the two scenarios. The difference in net borrowing would be $2 billion (Table 2 and Annex Tables 3-A and 3-B).

Table 2

Yugoslavia: Debt Outstanding and Disbursed
(million $)

	Scenario	1985	1990	Percent Share of Total 1985	Percent Share of Total 1990
Multilateral	A	4,641	2,735	26.1	17.3
	B	4,641	4,263	26.1	23.9
of which (World Bank)	A	2,160	2,064	12.1	13.1
	B	2,160	3,592	12.1	20.2
Bilateral and Private	A	13,160	13,067	73.9	82.7
	B	13,160	13,538	73.9	76.1
Total Convertible MLT Debt	A	17,801	15,802	100.0	100.0
	B	17,801	17,801	100.0	100.0
Total Debt	A	20,205	18,016		
	B	20,205	20,015		

Disbursement and Amortization During 1986-90

(million $)

		1986-88 [1/] (average annl.)	1989-90 (average annl.)	1986-90 (Total)
Disbursements	A	1,825	2,649	10,773
	B	2,224	3,191	13,057
of which (commercial terms)	A	1,257	2,228	8,229
	B	1,401	2,358	8,919
Amortization	A	2,224	3,049	12,773
	B	2,224	3,192	13,057

[1/] Rescheduling period.

Source: Annex Tables 3-A and 3-B.

direct lending to Yugoslavia and provide about $1.6 billion of this additional amount. This level corresponds to total Bank commitments of $3.1 billion (Annex Table 3-B).1/ The rest of the increased borrowing ($700 million), would have to be shared by Governments, commercial banks and other multilateral organizations. The Bank would also enter into cofinancing agreements that would encourage commercial banks to resume MLT lending to Yugoslavia. Under Scenario B, the Bank's share in total debt outstanding and disbursed would increase from 10.7 percent in 1985 to 18 percent in 1990.2/ This level corresponds to an average Bank disbursement of about $600 million annually. This level of exposure would increase the Bank's share in Yugoslavia's total debt service from 7.5 percent in 1985 to 12.7 percent by 1990.3/

59. Despite the increase in the Bank's exposure, the composition of debt would shift with a decline in the share of multilateral organizations. The share of multilateral organizations in total convertible MLT debt would decline from 26 percent in 1985 to 24 percent in 1990 (17 percent under Scenario A). This decline results from the amortization of the debt due to the IMF and the absence of new IMF disbursements beyond the current standby.

V. ACTION PROGRAM AND MONITORING

1986-87 Action Program

60. To improve the resource allocation system, which is the key underlying factor in reducing the rigidities and resuming of sound growth, Yugoslavia needs to implement major reform measures. In the past, initiation and implementation of reforms have faced long delays. To be most effective, Yugoslavia needs to undertake economic policies and reform measures at a much faster pace in the next two years in order to be able to resume growth and improve the incentive and resource allocation systems. During the next two years, the authorities should also concentrate on continuing fiscal and monetary restraint to control inflation (discussed in Section III).

61. The Government has developed a new price liberalization policy, which has been in effect since January 1985. The thrust of the new policy will need to be maintained; resort to administrative controls to combat inflation would be detrimental. The Government's commitment to continued adjustment of the presently administered prices, namely, petroleum and petroleum products, gas, electricity, coal and lignite, as well as railway tariffs and road user charges, would ensure that these prices increase to reach parity with opportunity costs. The Government should also unify the system of floor

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1/ Bank commitments to Yugoslavia would decline in the 1990s, reflecting the country's better access to the international capital markets and possible graduation from Bank borrowing.

2/ The Bank's share in convertible MLT debt increases from 12 percent in 1985 to 20 percent in 1990.

3/ In terms of convertible debt service, the Bank's share increases from 8.2 percent in 1985 to 14.2 percent in 1990.

lending rates by commercial banks and adjust them so they reach positive levels by 1987.

62. In the area of the allocation of foreign exchange, the Government should establish a market-based allocation system not later than 1987. During the same period, it should shift commodities out of the restricted import categories into the free import category in parallel with a managed float of the exchange rate. The reclassification of imports should lead to a decline in the share of the value of imports under quotas and licenses from more than 50 percent of total imports to 15 percent within two years.

63. In the area of financial discipline, the measures adopted since the end of 1984 should be enforced and extended. Until recently, loss-making enterprises in Yugoslavia could avoid or delay sanctions for bad decisions through default on payments due to banks and other firms and through reliance on financial assistance from the community through the use of the Joint Reserve Funds (JRFs). The law on Reserve Funds was amended in December 1984 to limit, and after 1987 prohibit, the use of JRFs for loss coverage under the guise of enterprise rehabilitation. The law on payments amended at the end of 1984 prevents enterprises that default on their obligations from increasing the personal income of workers at rates above the average increase in the economic sector of the region in which they operate. In addition, an amendment to the law on rehabilitation (January 1985) stipulates mandatory bankruptcy proceedings against loss-making enterprises. Another measure has been improvements in the accounting framework so as to provide a better indication of an enterprises' true financial situation. Similarly, a more effective supervision of the banks by the National Bank of Yugoslavia and the Social Accounting Service would improve the efficiency of the banking system's credit allocation among enterprises.

64. To improve the efficiency of investment allocation and avoid duplication of capacities, the Government should implement appropriate Joint Development Programs (JDPs) in the infrastructure sectors, in line with least-cost investment programs. To improve the process of investment selection, the Government should focus on implementation of the recently approved minimum uniform criteria for the selection of investment. An application of appropriate interest rates and prices should also improve the allocation of investment resources. A summary of the annual action program for 1986-90 is presented in a policy matrix in Annex II.

World Bank Support

65. To support Yugoslavia in initiating and implementing the policy reforms, the Bank has included Structural Adjustment Loans (SALs) in its lending program. The first SAL in 1983 supported Yugoslavia's effort to establish the foundation for a more efficient pattern of growth. It supported the recommendations of the Long Term Program of Economic Stabilization in four economy-wide areas: (i) price policies; (ii) foreign exchange allocation and external trade policies; (iii) enterprise decision-making and financial discipline; and (iv) investment planning.

66. Under Scenario B, the Bank would proceed in appraising a possible second SAL to Yugoslavia. The objective of this second SAL would be to consolidate and extend policy changes and reforms that will further promote the restructuring of production and demand patterns so as to allow the resumption of sustainable growth, the alleviation of the debt service burden and a slowdown in inflation. Within the context of an agreed medium-term macroeconomic framework and the more comprehensive program of reforms of the Government, the second SAL would support measures aimed at:

(i) Promoting greater reliance on market forces to determine prices and closing the gap between prices and opportunity costs wherever needed;

(ii) Establishing a market-based mechanism for the allocation of foreign exchange and reforming the foreign trade regime;

(iii) Ensuring a stricter enforcement of budget constraints, including the rehabilitation of ailing business and, where necessary, their closure; and

(iv) Strengthening the processes of investment allocation and selection so as to minimize inefficiencies.

67. If the implementation of reforms and adjustment measures continues, the Bank's future lending program would be heavily based on SALs and sector loans. Should the Government pursue adjustment policies firmly, we would support it through expanding our overall level of lending and increasing its policy based content. The possibilities for policy-based lending after SAL II could include subsequent SALs supporting the removal of the distortions in the financial market, improved factor mobility and elimination of the regional barriers to trade. Concurrent with SAL lending, the Bank would support financial and industrial sector restructuring, energy conservation and reform of investment planning through sectoral and subsectoral lending. Structural adjustment and sector-type lending, however, require a strong commitment on the part of the Government to accelerate the pace of economic reforms and to engage regularly with the Bank in substantive dialogue on macroeconomic and sectoral issues. Given the disappointing implementation of SAL I undertakings and the Government's unwillingness to date to make precise commitments for a SAL II, there is a distinct risk that this will not materialize.

68. Under enhanced monitoring arrangements requested by Yugoslavia and recently approved by the IMF Board, the IMF will monitor macroeconomic parameters and short-run developments closely, within the framework of a viable macroeconomic program. Through this monitoring, it should be possible to identify needed adjustments in policies and in the medium-term macro framework. In addition, under the proposed second SAL, the Bank would review with the Government economic developments at the macro and sectoral levels semi-annually in order to assess the suitability of the policy framework.

Annex Table 1

Yugoslavia: Summary of Key Macroeconomic Aggregates, 1978-85

	1978	1979	1980	1981	1982	1983	1984	1985 [1]
GSP Growth rate (% p.a.)	6.9	7.0	2.3	1.4	0.5	-1.3	2.0	0.5
Debt/Exports of G&S (%) [2]	99.2	104.4	105.8	115.8	131.2	139.4	131.5	130.0
Debt/GSP Ratio (%)	23.5	24.7	30.4	31.5	34.4	46.9	48.4	48.2
Interest Payments/Exports (%)	4.3	5.7	7.1	11.6	13.4	11.5	12.2	12.0
Interest Payments/GSP (%)	1.0	1.3	2.0	3.1	3.5	3.9	4.5	4.5
Debt Service Ratio (%)	17.7	17.8	18.5	23.4	26.3	30.8	33.7	34.3 [3]
Convertible Debt Service Ratio (%)	18.0	19.3	21.9	31.0	35.3	40.0	41.7	43.0 [3]
Total Investment/GSP (%) [4]	42.8	44.5	42.8	44.5	42.0	40.9	43.1	41.9
Fixed Investment/GSP (%)	39.6	36.4	35.1	31.0	29.2	25.3	23.6	21.9
Terms of Trade, 1982=100	100.9	97.3	96.6	94.9	100.0	98.0	90.3	86.7
Export Growth Rate (% p.a.)	1.4	1.6	10.9	-.4	-11.2	1.4	10.1	8.2
Import Growth Rate (% p.a.)	-1.3	18.0	-10.5	-12.3	-13.5	-5.5	-0.4	1.2
Current Account Balance ($mn)	-1,283	-3,661	-2,291	-946	-624	211	439	797
With Convertible Areas ($mn)	-1,272	-3,304	-2,203	-1,821	-1,602	246	800	370
Interest Payments ($mn)	495	821	1,281	1,987	2,049	1,688	1,854	1,997

[1] Preliminary estimates.

[2] Exports of goods and services include net remittances.

[3] Before rescheduling.

[4] There is considerable uncertainty to the estimates of stock accumulation. See footnote 2 on para. 13 of the text.

Annex Table 2-A

Yugoslavia - Projections of Key Variables,[1/] 1986-95, Scenario A
(percentages and US dollars)

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
GSP Growth Rate	2.3	2.7	2.8	2.8	2.8	2.3	2.3	2.8	2.3	1.8
GSP/Capita Growth Rate	1.4	1.8	1.9	1.9	1.9	1.5	1.5	1.9	1.5	1.0
Consumption per Capita Growth Rate	1.5	3.0	2.2	2.5	2.3	2.3	2.2	2.4	1.9	1.1
Total Debt Outstanding and Disbursed (billions of dollars)	19.7	19.3	18.8	18.4	18.0	18.0	18.0	18.0	18.0	18.0
Debt/Exports (percent)	139	128	116	104	94	88	82	75	70	65
Debt/GSP (percent)	47.4	41.3	36.0	31.7	27.9	25.4	23.3	21.3	19.4	18.0
Debt Service (percent)	31.9	28.6	28.3	29.9	27.1	25.5	23.2	22.2	22.0	20.6
Convertible Debt Service (percent)	39.3	34.2	33.8	36.4	33.1	31.3	28.8	27.4	27.7	26.0
Interest/Exports	14.1	13.2	11.7	10.7	8.9	7.8	7.3	6.7	6.2	5.8
Interest Payments/GSP (percent)	4.9	4.3	3.8	3.3	2.6	2.3	2.1	1.9	1.7	1.6
Gross Investment/GSP	32.7	33.0	33.7	33.9	34.1	34.7	34.7	34.8	34.7	34.7
Fixed Investment/GSP	22.0	22.6	23.4	23.9	24.3	25.1	25.3	25.5	25.8	25.9
Domestic Saving/GSP	36.8	36.8	37.0	36.7	36.7	36.5	36.2	36.1	35.9	35.8
Marginal Savings Rate	37.0	37.3	36.0	36.5	34.8	32.9	35.0	34.2	34.7	35.8
National Saving/GSP	35.2	35.2	35.2	35.2	35.2	35.2	35.2	35.2	35.1	35.1
ICOR[2/]	7.3	7.7	8.2	8.2	8.7	9.2				
Export Growth Rate	2.2	2.0	2.5	2.7	2.8	0.7	1.9	2.9	2.3	2.1
Exports/GSP	34.2	32.3	31.1	30.5	29.7	28.8	28.4	28.3	27.9	27.7
Import Growth Rate	.3	6.4	4.2	4.3	3.7	3.6	3.2	3.3	2.7	1.6
Imports/GSP	31.7	30.2	29.1	29.1	28.4	27.8	27.6	28.0	27.4	27.2
Convertible Current Account (US$)	838	798	798	753	753	350	350	350	350	350
Terms of Trade Index [3/]	1.05	1.09	1.09	1.09	1.09	1.09	1.09	1.09	1.09	1.09

[1/] The exchange rate used for projections is based on the 1984 exchange rate of $1 = 152.8 Dinar, as shown in the IFS. The official data for 1984 are based on the "statistical exchange rate" of $1=124.8. This difference should be noted when projected figures are compared with the historical trade figures in current prices.

[2/] Five-year averages, with the initial year the one of the column in which the figure appears.

[3/] 1984 = 100.

Annex Table 2-B

Yugoslavia - Projections of Key Variables,[1/] 1986-95, Scenario B
(percentages and US dollars)

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
GSP Growth Rate	2.3	2.7	4.9	4.1	4.7	4.4	3.6	4.4	3.9	4.2
GSP/Capita Growth Rate	1.4	1.8	4.0	3.2	3.8	3.5	2.8	3.6	3.1	3.4
Consumption per Capita Growth Rate	1.5	3.0	4.5	2.5	3.9	3.8	4.1	3.7	3.1	3.2
Total Debt Outstanding and Disbursed (Billions of Dollars)	20.1	20.1	20.0	20.0	20.0	20.0	20.8	21.2	21.8	21.8
Debt/Exports (percent)	141	133	120	105	93	84	80	73	66	58
Debt/GSP (percent)	48.0	43.0	36.8	33.3	29.7	25.5	22.7	19.6	18.0	16.1
Debt Service (percent)	30.8	27.8	26.9	28.4	24.7	21.3	20.0	18.7	18.0	16.7
Convertible Debt Service (percent)	38.1	33.3	32.8	34.8	30.5	26.8	24.8	21.8	22.8	21.2
Interest/Exports	14.0	12.6	11.4	9.8	7.6	6.0	5.8	5.2	4.8	4.3
Interest Payments/GSP (percent)	4.9	4.1	3.5	3.1	2.4	1.8	1.6	1.4	1.3	1.2
Gross Investment/GSP	32.7	33.0	34.6	34.9	35.0	35.3	35.2	34.4	33.9	33.5
Fixed Investment/GSP	22.0	22.6	24.6	25.3	26.0	26.6	27.0	26.8	26.8	26.8
Domestic Saving/GSP	36.8	36.8	36.9	36.8	36.6	36.4	35.2	34.7	34.4	34.2
Marginal Savings Rate	37.0	36.9	36.5	35.3	34.9	28.5	31.9	32.4	33.3	34.2
National Saving/GSP	35.2	35.2	35.2	35.4	35.5	35.2	34.4	34.0	33.5	33.5
ICOR [2/]	5.1	4.9	5.5	5.6	5.9	6.1				
Export Growth Rate	2.2	2.0	5.3	7.1	6.6	5.7	2.8	7.0	6.7	7.0
Exports/GSP	34.2	32.3	30.7	31.7	32.0	30.2	28.1	27.0	27.2	27.5
Import Growth Rate	0.3	6.4	10.9	7.1	9.0	7.2	6.8	6.2	6.2	6.0
Imports/GSP	31.7	30.2	30.0	31.2	31.5	30.2	29.0	27.5	27.6	27.4
Convertible Current Account (US$)	838	798	350	300	300	-33	-720	-480	-558	10
Terms of Trade Index [3/]	1.05	1.09	1.09	1.09	1.09	1.09	1.09	1.09	1.09	1.09

[1/] The exchange rate used for projections is based on the 1984 exchange rate of $1 = 152.8 Dinar as shown in the IFS. The official data for 1984 are based on the "statistical rate" of $1=124.8. This difference should be noted when projected figures are compared with the historical trade figures in current prices.
[2/] Five-year averages, with the initial year the one of the column in which the figure appears.
[3/] 1984 = 100.

Annex Table 3-A

Yugoslavia: Financing Requirements and Sources
Scenario A
($ million)

Year	1985	1986	1987	1988	1989	1990	1995
World Bank							
Commitments	263	200	200	200	200	200	200
Disbursements	295	294	294	297	233	224	200
Amortizations	156	188	256	297	345	352	343
Net Flows	139	106	38	0	-112	-129	-143
DOD	2,160	2,266	2,303	2,303	2,191	2,064	1,341
IMF							
Commitments	417	0	0	0	0	0	0
Disbursements	275	142					
Amortizations	327	396	425	500	425	260	0
Net Flows	-52	-254	-425	-500	-425	-260	0
DOD	2,089	1,835	1,410	910	485	225	0
Other Multilateral							
Commitments	175	175	175	175	175	175	175
Disbursements	235	236	225	216	208	175	44
Amortizations	236	256	236	211	127	175	131
Net Flows	-1	-20	-11	5	81	0	
DOD	392	372	361	366	447	446	30
Bilateral 1/							
Amortizations	459	613	531	434	619	754	199
Net Flows	-459	-613	-531	-434	-619	-754	-199
DOD	5,368	4,755	4,224	3,790	3,171	2,417	247
Commercial Banks 2/							
Amortizations	258	878	573	702	954	754	459
Net Flows	-258	-878	-573	-702	954	-754	-459
DOD	7,152	6,274	5,701	4,999	4,045	3,291	742
New Credits on Commercial Terms 3/							
Commitments	800	1,167	991	1,596	2,578	2,496	3,516
Disbursements	640	1,260	1,102	1,410	2,165	2,292	3,507
Amortizations				177	536	797	2,619
Net Flows	640	1,260	1,102	1,233	1,629	1,495	888
DOD	640	1,900	3,002	4,235	5,864	7,359	13,446
Total Convertible MLT							
Commitments	1,655	1,542	1,366	1,971	2,953	2,871	3,891
Disbursements	1,445	1,932	1,621	1,923	2,606	2,691	3,751
Amortizations	1,436	2,331	2,021	2,321	3,006	3,092	3,751
Net Flows	9	-399	-400	-398	-400	-402	-0
DOD	17,801	17,402	17,001	16,603	16,203	15,802	15,806

1/ Bilateral debt contracted prior to 12/2/82.
2/ Debt contracted prior to 1/17/83.
3/ Includes government and government guaranteed credits as well as credits from commercial banks.

Annex Table 3-B

Yugoslavia: Financing Requirements and Sources
Scenario B
($ million)

Year	1985	1986	1987	1988	1989	1990	1995
World Bank							
Commitments	263	300	800	800	800	400	200
Disbursements	295	297	627	728	782	502	295
Amortizations	156	188	256	297	353	411	539
Net Flows	139	109	371	431	429	91	-244
DOD	2,160	2,269	2,640	3,071	3,500	3,592	2,746
IMF							
Commitments	417	0	0	0	0	0	
Disbursements	275	142					
Amortizations	327	396	425	500	425	260	0
Net Flows	-52	-254	-425	-500	-425	-260	
DOD	2,089	1,835	1,410	910	485	225	0
Other Multilateral							
Commitments	175	175	175	175	175	175	100
Disbursements	235	236	225	216	208	175	44
Amortizations	236	256	236	211	127	175	131
Net Flows	-1	-20	-11	5	81	0	-87
DOD	392	372	361	366	447	446	51
Bilateral[1]							
Amortizations	459	613	531	434	619	754	199
Net Flows	-459	-613	-531	-434	-619	-754	-199
DOD	5,368	4,755	4,224	3,790	3,171	2,417	247
Commercial Banks[2]							
Amortizations	258	878	573	702	954	754	459
Net Flows	-258	-878	-573	-702	-954	-754	-459
DOD	7,152	6,274	5,701	4,999	4,045	3,291	742
New Credits on Commercial Terms[3]							
Commitments	800	1,870	994	1,474	2,317	2,631	3,850
Disbursements	640	1,656	1,169	1,378	2,148	2,568	3,940
Amortizations				177	660	893	2,958
Net Flows	640	1,656	1,169	1,201	1,488	1,675	982
DOD	640	2,296	3,465	4,666	6,154	7,830	15,767
Total Convertible MLT							
Commitments	1,655	2,345	1,969	2,449	3,292	3,206	4,050
Disbursements	1,445	2,331	2,021	2,322	3,138	3,245	4,279
Amortizations	1,436	2,331	2,021	2,321	3,138	3,247	4,286
Net Flows	9	0	0	1	0	-2	7
DOD	17,801	17,801	17,801	17,802	17,802	17,801	19,553

[1] Bilateral debt contracted prior to December 2, 1982
[2] Commercial banks' debt contracted prior to January 17, 1983.
[3] Includes government and government guaranteed credits, as well as credits from commercial banks.

Sectoral Issues

The purpose of this section is to identify major issues facing each sector and recommend specific policy measures which would address these issues and reduce factors that constrain sector growth.

INDUSTRY

ANALYSIS

The problems of industry are rooted in the static nature of policies and the structure of the economy and the sector. There are major macro-policy difficulties with prices, trade, foreign exchange rate and allocation, investment decision-making and financial discipline. Economic policy has been inward-looking; demand and external competition do not determine production costs and prices; a protectionist trade policy encourages import substitution and has caused a technological gap; the fixed exchange rate does not reflect increasing scarcity; and foreign exchange, because it is administratively allocated, offers no incentive to ration or substitute.

Investment decisions are negotiated among the Republics and Autonomous Provinces (RAPs), and market mechanisms do not play a role. The choice of import substitution industrialization, supported by protectionism, liberal financing, the absence of financial discipline and the lack of competition (domestic or international) have led to rigidity, high-cost output and a reliance on Government subventions.

Regional and federal priorities vary, but in the area of investment, neither is binding on enterprises; investment in priorities instead is induced by the allocation of credit. The allocation of foreign exchange has favored its earners and large-scale priority investments, while non-earners pay informal premia or do without. Banks, because they must guarantee credits for investment, could play a role in rationalizing investment, but they are owned by the enterprises. Underpriced foreign exchange has induced over-borrowing by firms, often sanctioned by the banking system, based on illusory prospects for exports. If repayment out of earnings is not possible, firms can resort the the solidarity funds, without having to undertake financial restructuring.

POLICY RECOMMENDATIONS

The economy needs to be realigned to reflect changes in domestic and external resources and product markets. At the same time, automatic economic and financial mechanisms that permit continuous adjustment, promote efficiency and reduce resource misallocation are needed. The partial adjustments undertaken in price policy, exchange rate policy, investment decision-making and financial discipline need to be carried further and to be accompanied by the liberalization of the foreign exchange market and trade policy. As competition and comparative advantage become more evident, these macro-policy changes will point to new directions for industry. In turn, these will require changes in the scale, location and scope of industry to rationalize the existing sector and promote efficient development.

The Bank should support the needed adjustment and future directions through sectoral and subsectoral lending, including support for an upgrading of the incentive framework, and through broad-based input services (technical, marketing and managerial advisory services). It should do so at a national level. Adjustment should take place in the context of macro-policy changes, although in priority areas such as lending for export industries, particularly for those with performance records, the Bank may undertake some identification work for project and sector improvement issues. Decisions on whether to carry out substantial work toward operations could be taken in the light of our macro dialogue with Yugoslavia.

Even without progress at the macro level, lending for energy conservation and technology development is possible. It may also be possible to consider loans for selected subsectors.

EXPECTED RESULTS

These policy changes, along with rationalization and redirection of industrial subsectors, will allow industry to improve its performance and enhance national economic growth. Specific benefits will be higher operating and financial efficiency, important cost reductions, increased competitiveness, and gains from increased specialization and trade.

ENERGY

ANALYSIS

The energy sector faces a number of problems:

- Rivalry and poor coordination among the Republics and Autonomous Provinces (RAPs) have led to a misallocation of investment, irrational siting of facilities, and an absence of national energy planning, programming and cooperation.

- Pricing distortions have encouraged the use of more costly gas and the underuse of cheaper domestic resources, inattention to conservation, and investment in otherwise financially unviable projects.

- The financial systems and controls of institutions in the energy sector need improvement, along with greater maintenance and operating efficiency, and the federal institutions need greater autonomy and effective leadership.

Despite these and other formidable problems, there has been some coordination: a national electric power transmission system, the beginnings of a national dispatch system, agreements to develop the hydroelectric resources of the Drina basin, an incipient joint power investment plan, and freer inter-RAP operations by oil companies.

POLICY RECOMMENDATIONS

Specific policy actions that need to be taken are:

- Immediate increases in the prices of electricity, domestic natural gas, and coal and lignite, as part of a longer term adjustment of energy prices to economic levels;

- Closer coordination of RAP power and coal investments through a Joint Development Plan and the interconnection of regional gas transmission networks, plus implementation of nationally important projects (the Drina basin hydroelectric and Kosovo lignite resources);

- A program to conserve energy and to encourage use of lower cost fuels;

- Strengthening of sector institutions, particularly through better management information systems, training, maintenance and operating efficiency and modern management techniques.

- Increasing energy prices to economic levels in order to rationalize consumption, along with complementary policies of consumer information and other incentives and greater financial discipline.

These adjustments are closely linked to the implementation of other reforms of the economic system, particularly relating to real interest rates and foreign exchange. Agreement on rational Joint Development Plans will depend on compensation of the RAPs and enterprises for the opportunity costs in terms of foreign exchange of energy traded within Yugoslavia. Without financial discipline, higher energy prices will restrain energy demand, investment and imports will be reduced, and energy enterprises will lack incentives for effective investment and operations.

EXPECTED RESULTS

The policy recommendations of the Bank will: benefit overall macroeconomic objectives, especially the efficiency of investment (incremental capital output ratio), reduce imports, promote regional economic integration, and improve resource allocation on the basis of pricing.

AGRICULTURE

ANALYSIS

The ag-iculture sectors faces structural problems and an adverse policy environment. The sector consists of both social and individual holdings. While the latter, a heterogeneous grouping, dominate, the priority in the allocation of fixed investment, inputs and credit is the social sector, followed by associated farmers and finally those with no production/marketing links to the social sector. The individual sector has been constrained by the resultant inadequate access to inputs, particularly research and extension services, as well as by a ceiling of 10 hectares for land ownership and virtual absence of a land rental market. For its part, the social sector consists of agro-industrial kombinat, which integrate primary production, processing and marketing. These enterprises are inefficient, lack adequate managerial and technical staff, have accumulated arrears with the banks, and are capitalized with only a limited equity base. Moreover, the vertical integration, designed to achieve regional self-sufficiency, combined with the regional segmentation of markets, has resulted in redundant processing capacity.

Another structural problem is the Yugoslav banks. They cannot act as independent financial institutions and often are unable to screen projects properly. Some are financially weak in light of the number of overdue loans in their portfolios and their low equity.

Resource misallocation has been the result in part of long-term pricing policies and negative real interest rates. The compensation payments to processors, as well as the premiums and export subsidies, all necessitated by the price distortions and positive protection, have been very costly.

Finally, agricultural exports have been unstable, in part because of export marketing strategies, high domestic prices and absence of export incentives.

POLICY RECOMMENDATIONS

Policy measures should include:

(a) Freeing up input supply arrangements,, particularly research and extension services to individual farmers;

(b) Instituting a land-rental market and a relaxation of the limits on the size of land holdings;

(c) Improving the efficiency in the social sector, particularly by strengthening managerial information systems and developing standards and performance guidelines;

(d) Training bank staff and improving managerial information systems including portfolio reviews, along with thorough review of the financial sector;

(e) Bringing domestic prices into line with border prices; and

(f) Developing long-term export marketing strategies and evaluating Yugoslavia's comparative advantage in the production of import substitutes.

(g) Improving the operational efficiency and financial performance of the forestry enterprises.

EXPECTED RESULTS

Implementation of these recommendations would correct some policy distortions and reduce structural rigidities. More specifically: (i) untapped potential would be better utilized; (ii) efficiency would be improved; (iii) regional specialization and an optimal crop/product mix would be encouraged; and (iv) the role of the sector in balance of payments support would be increased.

TRANSPORT

ANALYSIS

In addition to providing the backbone to the Yugoslav economy, the primary transport network provides an outlet for export commodities as well as serving a growing demand for international transit traffic. Continued investments are required in the transport sector to alleviate bottlenecks in the main road and rail networks, and rehabilitate existing infrastructure. However, at a time when there have been severe cuts in expenditures for modernization and rehabilitation of the road network, investment in the railway system has continued. While the railways have enjoyed regular real term increases in tariffs, there has been a lag in adjusting road user charges and a major reduction in the available funds for roads. Clearly, a more balanced development of both road and rail transport is required. Decentralization of operations in the transport sector hamper coordinated development, as well as the provision of rational and cost-effective transport services.

POLICY RECOMMENDATIONS

The specific policy objectives which are being pursued by the Bank include: (i) the planning and implementation of balanced investment programs; (ii) stronger inter-regional coordination, particularly through better technical integration in the railways; (iii) improved operational efficiency in the sector, including highway maintenance, as well as operations in railways and ports; and (iv) a sound pricing and fiscal policy, including cost-based railway tariffs and regular adjustments in road user charges.

A sector-lending approach would be the appropriate instrument for tackling sector issues. This type of lending is being pursued under recent operations in both highways and railways, where we have a broad base for continuing with a sector approach. This approach would also enable us to address the inter-regional issues.

EXPECTED RESULTS

Because of the political framework, the sector lending approach generally only provides partial coverage of the sector and there is a need for a more comprehensive overview of developments in transport at the national level. As such, a proposed review of the 1986-90 Transport Investment Program under SAL II would provide the necessary sectoral background, including the broad, general conditions on investment and the longer-term implications of pricing and fiscal policy. Such a strategy should enable the Yugoslav authorities to upgrade the efficiency of the transport system and ensure an appropriate balance of investment among transport modes to provide adequate support for renewed economic growth and the development of foreign trade.

WATER SUPPLY AND SEWERAGE

ANALYSIS

About 69 percent of the population of Yugoslavia has access to a piped water supply, and only 59 percent live in a dwelling unit connected to a waterborne sewage system. Where water service levels are high in the major urban areas, supplies are intermittent and low water pressures are common. Shortages in the major industrial areas such as Belgrade, have led to factory closings and slowing down new construction. Untreated discharges have caused pollution of domestic water supply sources.

The primary responsibility for the sector rests at the local level through locally established water supply and sewerage enterprises. Little is done to properly analyze new projects and establish priorities at the Republic level, and no planning takes place at the Federal level. Lack of adequate financing is a major constraint to improved service levels and pollution control. Communes wishing to improve their systems have no source from which they can obtain long term loans at reasonable interest rates.

POLICY RECOMMENDATIONS

It is recommended that the following actions be taken at the Republic and Federal levels:

(a) Assess sector needs regularly;

(b) Set realistic goals for the sector, taking into account the results of the needs survey and the availability of resources.

(c) Establish a mechanism by which communes can borrow funds for capital improvements for projects which conform to federal and republic goals;

(d) Establish a priority system for the allocation of funds to the sector; and

(e) Establish conditions for borrowing federal funds and institute a monitoring and enforcement mechanism.

EXPECTED RESULTS

In the long term, the following results could be expected from the above actions:

(a) improved water service in urban areas;

(b) increased productivity in areas where inadequate water supplies constitute a development constraint;

(c) lower health care costs;

(d) financial self-sufficiency of the sector.

Yugoslavia: Policy Matrix and Five Year Action Program

Area	Policy Objectives	Actions Taken by the Government	Further Measures Recommended	Proposed Timing 86	87	88	89	90
A. Macroeconomic Framework	Growth with sustainable macroeconomic balance.	Public Sector Budget in surplus and surplus in Current Account of the Balance of Payments.	Monitoring of macroeconomic performance agreement on medium-term plan. Enhanced IMF monitoring. Continuation of cautious macroeconomic policies allowing sustainable macro balances; implementation of reform measures to improve resource allocation.	X	X	X	X	X
B. Price Policy	More efficient resource allocation. Setting administered prices to reflect opportunity costs.	Most prices have been decontrolled since Jan. 1985. The administered prices have been periodically increased.	Closing the gap between administered prices and opportunity cost. Continued implementation of new price law limiting administrative interventions and price subsidies.	X	X	X	X	X
C. Foreign Exchange Allocation System	To establish a market-based mechanism for foreign exchange allocation and maintain international competitiveness.	Exchange rate was substantially devalued in real terms in 1982/84. Laws for improvement in the allocation system have been passed in Jan. 1986.	Establishment of a market based foreign exchange allocation system not later than 1987.	X	X			
D. Foreign Trade	To liberalize imports.		Reduction in the share of the value of imports under quota and licenses from 50 percent in 1985 to 15 percent in 1987.	X	X			
E. Investment Allocation	To improve investment selection and coordination.	Social Compact on investment criteria was adopted by all parties concerned in Sept. 85.	Implementation of social compact and preparing operational guidelines.	X				
			Adoption of joint development programs containing least cost development approaches in major infrastructure sectors.	X	X			
	To ensure economic use of investible resources.	Periodic increases in interest rates.	Increase interest rates to positive real levels and unification of lending rate structure by 1987.	X	X			
	To monitor trends in investment pattern and identify problems.	Poor reporting.	Improve reporting format for monitoring progress in investment and identifying problem areas.	X				

Area	Policy Objectives	Actions Taken by the Government	Further Measures Recommended	86	87	88	89	90
F. Financial Discipline	To reduce transfer of losses to other enterprises or communities.	Legislation has been adopted that restricts income of workers in firms that operate at a loss or default on payments and phases out the use of reserve funds to cover losses.	Implementation of the legislation and adoption of suitable monitoring system. Monitoring of arrears due to banks from enterprises and deferred foreign exchange losses strengthening the role of SDK in initiating bankrupcy proceedings.	X				
	To encourage prudent financial portfolio management by commercial banks.	Adoption of a new law on the basis of the Banking and Credit System.	To limit the share of single borrowers in the total loan portfolio of a bank and limit the share of any single member founder in the bank's equity.	X	X			
G. Financial Sector	To reduce distortions in the financial market and improve efficiency of financial intermediation.		Specific recommendations to be worked out after completion of the review of banks in connection with financial discipline.			X	X	X
H. Regional Development	To improve mobility of factors of production and eliminate the regional barriers to trade.		Specific measures to be worked out in connection with a study on regional development which is part of our economic and sector work program.				X	X

FORM NO. 75
(6-83)

THE WORLD BANK/IFC

ROUTING SLIP	DATE: April 10. 1986

NAME	ROOM NO.
Mr. S. Husain	E-1023
RE: YUGOSLAVIA Country Study	

	APPROPRIATE DISPOSITION		NOTE AND RETURN
	APPROVAL		NOTE AND SEND ON
	CLEARANCE		PER OUR CONVERSATION
	COMMENT		PER YOUR REQUEST
	FOR ACTION		PREPARE REPLY
	INFORMATION		RECOMMENDATION
	INITIAL		SIGNATURE
	NOTE AND FILE		**URGENT**

REMARKS:

The attached paper has had its working level review. We would like to send it on to Mr. Stern after your comments.

FROM:	ROOM NO.:	EXTENSION:
A. Choksi	N538	60063

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: April 9, 1986

TO: Mr. Vinod Dubey, Director, Country Policy Department

FROM: Roberto Fernandes, Chief, EM1DB

EXT.: 3-2440

SUBJECT: Yugoslavia - Country Study

Please find attached a copy of the country study on Yugoslavia. This version incorporates the views expressed at the March 31 review meeting.

cc: Messrs. Wapenhans (o/r), Hasan (EMNVP); Lari, Harrison (EM1DR); Picciotto, Dewey, Liebenthal (EMPDR); Choksi (CPDTA); Selowsky (CPD); EM1DB Staff

MFarsad/slc

April 9, 1986

YUGOSLAVIA: Country Study

Growth Scenario for Highly Indebted Middle Income Country

INTRODUCTION

To cope with the balance of payments deficit and rising external debt that emerged after the second oil price increase, Yugoslavia adopted stabilization policies, with the IMF's support, in the early 1980s. Those policies, combined with administrative allocation of foreign exchange, reduced the balance of payments deficit and decelerated the increase in indebtedness. However, investment and growth have remained depressed, and inflation has become increasingly severe. Yugoslavia now needs to implement policy measures to resume growth and reduce inflation while continuing the orderly servicing of its external debt. This paper assesses the prospects for attaining these objectives and the amount and type of financial assistance Yugoslavia will need to do so.

Even without major policy reform, Yugoslavia would be able to achieve a low growth rate and gradually reduce its debt burden, provided it is able to attract the required international financial support. The slow pace of growth and continuing inflation, however, would put strains on the country's political and social fabric. With appropriate policy reforms, Yugoslavia could achieve significantly faster growth, have better access to international financial markets, and manage its external debt with no major difficulty. These reforms will have short-term adjustment costs that should be weighed against the benefits of long-term economic stability and a better standard of living. Rapid introduction of an appropriate package of policy reforms will depend heavily on the degree of political will within Yugoslavia to implement such a program. Recent experience indicates that it may not be feasible politically to reach a consensus at the federal level on a set of measures needed to create conditions precedent to the occurrance of a higher growth performance.

I. INITIAL CONDITIONS

1. The Yugoslav economy, led by a rapid increase in fixed investment, grew at an average annual rate of over 6 percent in the 1970s. However, this high growth rate was achieved at substantial cost. An overvalued exchange rate and a heavily protected domestic market, together with distorted commodity and factor prices, created a structure of production with little flexibility and hindered the development of the sectors producing tradables.

2. These domestic rigidities, compounded by the oil price increases, disrupted the high growth of the Yugoslav economy in the late 1970s. While the rigidities distorted resource allocation, the second oil price increase precipitated a balance of payments crisis. Because of the inflexible production structure and inappropriate exchange rate policy, the economy was not able to counteract the external shock by stepping up exports. Moreover, instead of reducing domestic absorption to cushion the effects of the shock, Yugoslavia continued its investment drive: fixed capital formation remained roughly around 34 percent of GSP 1/in the late 1970s. Finally, easy credit and monetary policy accelerated the rate of inflation to nearly 40 percent in 1980.

3. The second oil price increase contributed to a trade deficit of US $7.2 billion (11.7 percent of GSP) and a current account deficit of $3.7 billion (6 percent of GSP) in 1979, financed through heavy external borrowing and a decline in foreign reserves of $1.3 billion. The external debt rose rapidly, doubling between 1978-81 to reach almost $20 billion. Consequently, the debt rose from 23.5 percent of GSP in 1978 to 31.5 percent in 1981. During the same period, the debt service ratio in convertible currencies increased from 18 percent to 31 percent.2/ Similarly, the rate of debt to exports increased from 99 percent in 1978 to nearly 116 percent in 1981.

4. As the need for borrowing increased, greater reliance was put on commercial sources of funds, particularly short-term obligations. By 1980, close to 80 percent of new loans were being obtained on commercial terms, and mostly with maturities of 2 to 3 years. The slowdown of the world economy, with its adverse effects on Yugoslav exports, and the increase in world interest rates soon caused a heavy burden on the country's external finances.

5. The result of these various factors was that Yugoslavia became externally illiquid. By 1982, it could no longer service its debt on time, and by 1983 its convertible currency foreign exchange reserves could cover only one month of imports.

1/ Gross Social Product (GSP) is the basic Yugoslav concept for national income accounts. It is close to GDP, but excludes certain service activities. Our estimates indicate that GSP is about 10-12 percent smaller than GDP.

2/ The total debt service ratio increased from 17.7 percent to 23.4 percent.

The Response

6. To deal with the crisis, the Yugoslav Government initiated in 1981 stabilization and control measures to restore domestic and external equilibrium. At the end of 1982, when these efforts proved insufficient to cope with the debt burden, Yugoslavia requested a debt relief arrangement from its creditors. Meanwhile, a major reform of the framework of incentives was begun.

7. The main stabilization measures, supported by the IMF, were restrictive fiscal and monetary policies and more active use of the exchange rate. The share of public sector expenditures1/ in GSP declined from 37 percent in 1980 to an estimated 32 percent in 1985. The budget of the consolidated public sector, which ran a deficit until 1980, yielded a surplus in subsequent years. The stringent fiscal policy was accompanied by a monetary policy that placed ceilings on the net domestic assets of the banking system and raised interest rates. While nominal lending rates were adjusted, they remained highly negative, but the interest rates on term deposits moved closer to positive levels in real terms.2/ By far the most important response was the adjustment in the exchange rate. Between September 1982 and June 1984, the real effective exchange rate was depreciated by 35 percent.3/ Since July 1984, the nominal effective exchange rate has been adjusted regularly to keep the real effective exchange rate roughly constant.

8. In 1983, a major financial support package was put together, under the umbrella of an IMF program, to relieve Yugoslavia's debt burden. It consisted of $4.4 billion in medium- and long-term commitments and included refinancing by Governments and commercial banks. As part of this package, the World Bank provided a structural adjustment loan (SAL) of $275 million. Another financial package totalling $3.2 billion was put together for 1984 by the IMF, Governments and commercial banks. For 1985 through May 15, 1986, Government creditors agreed to reschedule 90 percent of the original maturities falling due, and agreed to consider annual rescheduling of the debt after May 15, 1986, provided there exists a satisfactory arrangement between Yugoslavia and the IMF. Similarly, in 1985, Yugoslavia and the commercial banks reached an agreement for a multi-year rescheduling arrangement to cover the original maturities falling due between 1985 and 1988. The original maturities amounted to $5.7 billion ($3.6 billion of which is owed to commercial banks). The agreement with commercial banks is also dependent on enhanced monitoring by the IMF through 1991.

9. The Government also undertook other longer term policy reforms, in line with the objectives of the Long Term Program of Economic Stabilization adopted in July 1983 and supported by the Bank's first structural adjustment loan. Aimed at reforming the system of economic incentives, the reforms included adoption and revision of a number of laws and regulations governing

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1/ Includes budgetary expenditures at all levels of local and federal government.

2/ The rate for three-month time deposits is now 73 percent.

3/ The real effective exchange rate depreciated by 25 percent in 1983 alone.

the criteria for investment selection, prices, financial discipline, planning, banking, joint ventures, fiscal policy, foreign credit, foreign trade, and the foreign exchange allocation system.

The Results

10. The current account deficit turned into a surplus in 1983. In 1985, that surplus was $0.8 billion (of which $370 million were in convertible currencies). However, export performance has been erratic (para. 16). Moreover, due in part to the structure of the maturities, the burden of the external debt has remained large: debt service payments to convertible currency areas ran about 43 percent of convertible currency export earnings in 1985, a level that drops to about 27 percent when the rescheduled maturities are excluded.

11. The stabilization efforts have met with limited success in terms of economic performance. There are several reasons for this result. The stabilization efforts have been unbalanced, focusing on the reduction of imports and fixed investment, and they have not constituted a timely, coordinated and mutually reinforcing package. The reduction of imports through administrative rationing of foreign exchange has circumvented the use of market incentives to channel resources toward the tradable sectors.

12. In the first half of the 1980s, the decline in domestic absorption was made possible by a substantial cut in fixed investment: gross fixed investment declined by about 8.5 percent a year in real terms between 1980 and 1985. The decline was faster, however, between 1983 and 1985. As a result, fixed investment, which was about 36 percent of GSP in 1979, dropped to about 22 percent of GSP in 1985. While most of the investments of the late 1970s were not based on efficiency considerations, available data suggest that the cutbacks have been across the board, instead of being directed at inefficient investments of the past.1/

13. The decline in fixed investment was associated with a substantial increase in inventory accumulation, the result in part of negative real interest rates and the enterprises' ability to finance the unsalable production. It also reflects inflationary expectations caused by a succession of price freezes and liberalizations. The continuous increase in inventory accumulation, however, reflects the ineffectiveness of the policies directed at reducing domestic absorption and the lack of tight budget constraints on enterprises.2/

1/ The sectoral composition of investment shows little change between 1979-83.

2/ Official estimates show inventory accumulation amounted to 20 percent of GSP in 1985 and has been a rising portion of GSP throughout the 1980s. There is considerable uncertainty attached to these estimates, with some evidence that they substantially overstate stockbuilding. If so, for the national accounts to remain consistent, either GSP was lower than estimated, or some other component of GSP, most likely consumption, was higher. The uncertainty here, on the order of 10-15 percent of GSP, calls for caution when providing recommendations for resource mobilization.

14. The slowdown in growth has been longer and more severe than expected. Since 1980, the annual rate of growth of GSP has averaged less than 1 percent a year in real terms (Annex Table 1). Inflation, driven by demand pull and cost push factors, has persisted and even worsened, reaching 80 percent in 1985. The restrictive monetary policy was not successful in controlling inflation, as it was not followed by timely implementation of hard budget constraints on loss-making enterprises. The tight credit policy was also overtaken by other forms of credit creation, particularly inter-enterprise credit arrangements.

15. The significant increase in inflation and the slow growth in output have resulted in a substantial and extended decline in real wages--by June 1985, they were about one-third lower than in 1980. Over the same period, private consumption fell by about 1 percent annually.

16. Yugoslavia's export performance in the past five years has been erratic, despite the preferential access to credit and foreign exchange and the substantial depreciation of the real effective exchange rate vis-a-vis convertible currencies. On the whole, growth of exports to convertible areas in nominal terms has been about 3 percent since 1981. The reason for this poor performance has been an insufficient switch in the relative price of tradables and non-tradables. Some improvements in exports have taken place since 1984, a reflection in part of the unofficial premium firms were able to realize on foreign exchange earnings under the previous foreign exchange allocation system that ended in 1985. This premium seems to have encouraged the expansion of exports, even those with low value-added content. Nevertheless, Yugoslavia's share in the industrial country markets has not changed significantly since the impact of the devaluation was felt in 1983.

17. As for the longer term policy reforms, they have proceeded too slowly, except in the area of price liberalization. However, by January 1986, new regulations governing most of the areas of reform were partially in place, though in some cases the regulations appear inadequate or even counterproductive.

II. MEDIUM-TERM ECONOMIC PROSPECTS

18. Following the crisis of the early 1980s and the emergence of the adjustment problems in the economy, Yugoslavia is now planning for a period of recovery and sustained growth. This aspiration is reflected in the 1986-90 development plan, which aims at a growth rate in GSP of 4 percent a year. Resumption of growth is needed in order to avoid the grave social consequences of growing unemployment and inflation and the declining trend in real wages. However, the potential for sustained growth and substantial improvement in living standards will not be achieved in an environment marred by economic distortions and imbalances that cause inefficient resource use.

Constraints on Growth

19. Policies to address the economic distortions have been hampered by competing regional interests and a cumbersome consensual decision-making process in Yugoslavia. The effectiveness of policies in addressing the structural problems facing the economy has been impaired by a tendency to rely mainly on administrative measures instead of market forces to correct the imbalances. Economic policies and growth objectives have been over-ridden by strong regional interests and delays in action caused in reaching consensus. Moreover, the lack of coordination of investment activities among the Republics and Autonomous Provinces has prevented cost-effective investments and limiting the scope for improved productivity and faster growth.

20. Resumption of growth is also constrained by the limited availability of external resources, the slow export performance, and a heavy debt service payment. These in turn, jointly with the allocation of domestic savings to inventory accumulation and to the financing of loss-making enterprises, exacerbate the curtailment of fixed investment. In addition, inadequate mobility of capital and labor among regions limits increases in production. If these constraints are not reduced, recovery and a sustainable rate of growth of the economy will be difficult to achieve.

21. Even though Yugoslavia's foreign debt is not particularly large in comparison with many high debt countries,1/ its high debt service burden has caused a deterioration in the standard of living and has eroded some of the gains of the development drive of the 1970s. Yugoslavia's debt service payments to convertible currency countries in 1985 would have been about 43 percent of the export earnings from these areas in the absence of the rescheduling agreements. Total interest payments were about 5 percent of GSP. Interest payments in convertible currencies were about 16 percent of the exports to convertible currency areas.

22. The maturity structure of the Yugoslav debt profile is especially unfavorable. Even after the recent rescheduling (para. 8), Yugoslavia will have to amortize 75 percent of its debt between 1986-90. With the IMF financial program in Yugoslavia terminating this year, Yugoslavia will have to repay about 2.0 billion to the IMF by 1991.

23. The high level of debt repayment and limited capital inflows make it necessary for Yugoslavia to maintain a large current account surplus. With so much of the country's foreign exchange earnings being pre-empted by the debt repayments, a shortage of foreign exchange has emerged that has led in turn to restricted imports. The restriction of imports has required a slowdown in investment and growth. It has also adversely affected exports that depend on imports and has further exacerbated the shortage of foreign exchange. Further curtailing of fixed investment to restrain domestic absorption will retard economic growth. It will also jeopardize the proper maintenance of existing capital stock and erode the competitiveness of industrial exports, as funds

1/ At the end of 1985, Yugoslavia's external debt was estimated to be about $20.2 billion, of which $18.8 billion was in convertible currencies. Of the total convertible currency debt, medium- or long-term (MLT) debt was about $17.8 billion, while short-term debt amounted to about $990 million.

for restructuring and modernization of industry will not be available. However, to improve efficiency, increases in investment should be accompanied by improvements in its allocation towards projects with the highest expected yields. For this purpose, greater enforcement of financial discipline and use of market signals in determining prices will be essential.

24. Yugoslavia's export performance has been poor in recent years. Resumption of growth could be led by exports, but their promotion requires an active exchange rate policy and a market-based allocation of foreign exchange. A new foreign exchange allocation system was introduced in January 1986, which has as its objective the eventual establishment of a foreign exchange market with a freely convertible Dinar. However, in its transitional phase, now being implemented, the system relies heavily on an administrative allocation of foreign exchange and import rights. While a common foreign exchange pool has been created through full surrender by exporters of the foreign exchange they earn, administrative interventions governing the use of the pool and import restrictions are continuing. As a result, it is not clear how the transition toward the objective of a market with a convertible Dinar will be managed.1/ However, the surrender requirement has eliminated the premium previously available to exporters and may, in the absence of appropriate exchange rate adjustments, reduce the incentive to export.

25. Productivity increases cannot be achieved without an increase in the mobility of capital and labor. The uneven pace of development among regions has widened the disparities in income, and the limited mobility of capital and labor has resulted in larger numbers of unemployed in the less developed areas. To resume sustainable growth and reduce unemployment, the obstacles to the internal mobility of the factors of production among the regions should be removed.

26. Factor mobility could be increased by promoting joint ventures among the regions, broadening the scope of banking activity to include a wider allocation of financial resources through the banking system among regions, and encouraging labor mobility through wage and non-wage incentives. Mobility could also be increased by reforming the system of economic incentives (para. 29), a step that would promote efficient allocation of resources and encourage increased mobility of factors across regions.

Objectives of a Medium-Term Strategy

27. The objectives of a medium-term strategy should be to (i) resume growth with sustainable macroeconomic balances; and (ii) increase debt servicing capacity. Attaining these objectives requires a system of economic incentives that ensures efficient resource allocation, as well as prudent and well-coordinated macroeconomic policies that reduce the rate of inflation.

28. More specifically, the medium-term strategy should aim at (i) increasing the rate of growth of exports, particularly to convertible currency areas, and improving the competitiveness of the economy through an appropriate

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1/ There is a continuing discussion on this issue between Yugoslavia and the Bank.

exchange rate policy; (ii) increasing per capita consumption in real terms; (iii) improving efficiency and maintaining a level of investment to support the growth objectives; (iv) liberalizing trade and increasing the mobility of factors of production; and (v) improving the system of economic incentives, relying more on market signals to determine prices and allocate resources more efficiently.

29. The implication of this strategy is that Yugoslavia will need to implement major policy reforms in the system of resource allocation and use. Foremost among the reforms are: enforcement of financial discipline; liberalization of the trade and foreign exchange allocation systems; application of economic criteria in investment decision and allocation; and greater reliance on market forces to determine prices. These reforms will have a macro and micro impact on economic performance. They will encourage mobility of factors and will help the economy attain a cost-effective structure of production and pattern of demand that corresponds to its comparative advantage. These reforms should be followed by others relating to the financial sector, regional trade, and encouragement of small-scale private enterprise.

30. One of the most important reforms is to ensure greater financial discipline1/ among social sector enterprises by strengthening incentives for efficiency and enforcing greater accountability for financial losses. A loose budget constraint enables social sector enterprises to pass on losses to others, a situation that discourages efficiency and competition, fuels inflation and puts undue pressure on the balance of payments. Enterprises should be accountable for their losses. Enterprises that are not economically profitable should be restructured and, if need be, closed down. Financial assistance from other enterprises and the community to loss-making enterprises has been limited by recent legislation. This legislation needs to be implemented as planned so that all such assistance is eliminated by 1987 (except for enterprises that are being rehabilitated).

31. Financial indiscipline destabilizes the economy at the micro level, and there are few sanctions to combat it. Improved accounting procedures and implementation of the regulations to restrict income payments to workers in firms that make losses should continue to receive high priority. Easy access of loss-making enterprises to bank credit should be replaced by a mechanism that applies financial and economic criteria. At the macro level, rescuing firms with chronic losses will only reduce the resources available to more efficient firms and/or transfer the losses to the banking system.

32. The past and present Yugoslav foreign exchange allocation systems are essentially based on quantity rationing. The previous system, which was in operation until the end of 1985, did not function efficiently and prevented the emergence of a unified foreign exchange market. The goal of the new system, which has been in operation since January 1986, is a foreign exchange market with a freely convertible Dinar. This objective needs to be achieved as rapidly as possible on a predetermined schedule. Import restrictions need

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1/ A more detailed account of and the timeframe for this and other reform measures is presented in Section V and Annex II.

to be reduced on a parallel schedule. Quantitative restrictions could initially be replaced by tariff-like surcharges to avoid a destabilizing surge of imports. Gradually, these should also be reduced.

33. The allocation of investment and efficiency in use of investment resources are prime determinants of economic growth. The most important need relating to investment policy in Yugoslavia is to coordinate regional investment decisions in the highly capital-intensive sectors and to ensure selection of projects that reflect economic and financial profitability. In this respect, adoption of Joint Development Plans (JDPs) for the infrastructure sectors based on least-cost criteria is an essential element in the coordination of large investment activities. The new Plan calls for JDPs in power, telecommunications and railways. To date, none has been completed. For the non-infrastructure sectors, reliance on the economic rate of return based on the opportunity cost of capital and market prices should be deepened so that investment flows into the more productive ventures and the mobility of capital increases. At the same time, it is essential to implement the recently approved uniform investment criteria and raise interest rates to positive real levels to avoid severe macro instability as well as a gross misallocation of resources.

34. Price controls distort resource allocation by influencing the relative profitability of production. Between 1979-84, Yugoslavia used intense price controls to combat inflation. Since January 1985, most prices in Yugoslavia have been liberalized.1/ To increase the efficiency of resource allocation, the Government needs to continue to allow market forces to determine prices and should make adjustments to close the gap between administered prices and opportunity costs. This reform is especially the case for energy products and electricity.

Alternative Scenarios

35. The policy reforms and economic environment under which the objectives of stabilizing the economy, resuming growth and reducing the external debt burden can be achieved are examined here as two scenarios: Scenario A and Scenario B. The two scenarios are derived through the use of a general equilibrium model that incorporates essential features of the Yugoslav economy and the policy assumptions discussed below.

36. In Scenario A, it is assumed that the Government undertakes no major policy changes. The policy assumptions under Scenario A are therefore limited to the implementation of policy measures already adopted: the transitional phase of the present foreign exchange regime (para. 24) remains; the real effective exchange rate stays constant; under-utilization of present capital stock continues; most administered prices would not reflect their opportunity cost; and domestic inflation would be more than world inflation.

37. In Scenario B, it is assumed that economic reforms would allow improved resource allocation and the benefits of greater flexibility in responding to price signals. More specifically, the policy assumptions are as follows. An auction-type system of foreign exchange allocation is assumed in

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1/ A number of prices, particularly in the areas of energy, transportation, and telecommunications services, are still administered.

1988-90. Beginning in 1991, the economy is assumed to have adjusted enough to allow it to have a freer foreign borrowing policy. After 1991, the exchange rate regime with the convertible areas would be a managed float. Utilization of capital stock would increase. Restrained monetary and fiscal policy combined with greater enforcement of financial discipline would lead inflation to decline and converge with international inflation around 1989. Moreover, administered prices would be adjusted to reflect their opportunity cost.

38. The results under Scenario A indicate that the rate of growth of GSP would remain around 2.7 percent between 1986-90 and would then slow to 2.3 percent between 1991-95 (Table 1 and Annex Tables 2-A). The rate of employment growth would remain around 2 percent. The debt service ratio in convertible currencies would be 33 percent in 1990 before declining to 26 percent in 1995. Export growth would remain sluggish in both the 1986-90 and the 1991-95 periods, averaging about 2.4 percent and 2 percent, respectively.

39. The favorable terms of trade effect of the decline in oil prices would allow the economy to gain additional resources for investment. Investment would rise 2.6 percent on average during 1986-90 and 2.2 percent during 1991-95. However, because of the technological obsolescence of equipment and low use of capacity, the efficiency of investment would deteriorate: the incremental capital output ratio (ICOR) would increase from 7.3 during 1986-90 to 9.2 during 1991-95.

40. Under Scenario B, simultaneous implementation of policies aimed at both stabilization and increased efficiency would lead to accelerated growth. Up to the end of 1987, the Government would continue to emphasize stabilization objectives in order to reduce inflation (para. 47). At the same time, it would implement and extend the reforms relating to the foreign exchange and foreign trade regimes, financial discipline and investment allocation. These steps would reorient the economy toward growth and reduced inflation and unemployment. The prospects for resumed growth are, therefore, tied to both the effectiveness of the stabilization measures and the speed of structural reforms.

41. The key underlying assumption in Scenario B is the political will to implement an effective reform program in 1986-87. Between 1988-90, under this scenario, the result of improvements and reforms in the incentive and resource allocation system would allow the growth rate to accelerate to an average of 4.4 percent a year (Annex Table 2-B) and would allow the economy to become more responsive to price signals. The economy would benefit from a floating exchange rate, and exports would increase by an average of 6.3 percent a year between 1988-90, conditions that would allow a continuous substantial decline in the debt service burden and debt export ratio, even though the absolute size of the debt would remain constant. The convertible debt service burden would fall to 30 percent in 1990 and 21 percent in 1995. Similarly, the ratio of interest payments to GSP will decline to 2.4 percent in 1990 and to 1.2 percent in 1995. Although the decline in the debt service burden up to 1990 is close to that of Scenario A, it would be obtained through better growth performance and higher per capita income. After 1990, the debt service ratios in Scenario B fall much more rapidly than those under Scenario A.

Table 1

Yugoslavia: Average Annual Growth Rates in 1984 Prices
(percent)

	1986-90 Scenario A	1986-90 Scenario B	1991-95 Scenario A	1991-95 Scenario B
GSP	2.7	3.7	2.3	4.1
Agriculture	2.9	2.8	2.0	2.6
Industry	2.6	4.1	2.6	7.0
Energy	3.0	3.0	3.0	3.4
Construction	2.8	2.9	2.4	1.1
Services	2.6	3.8	2.2	3.4
Consumption	3.2	4.0	2.8	4.4
Investment	2.6	4.5	2.1	4.1
Exports (Goods & NFS)	2.4	4.6	2.0	5.8
Imports (Goods & NFS)	3.6	6.5	2.9	6.4

Current Account Balance
(convertible currencies)

Million US$

	1986	1987	1988	1989	1990	1995
(A)	838	798	798	753	753	350
(B)	838	798	350	300	300	10

MLT Debt Outstanding and Disbursed
(convertible currencies)

Billion US$

	1986	1987	1988	1989	1990	1995
(A)	17.4	17.0	16.6	16.2	15.8	15.8
(B)	17.8	17.8	17.8	17.8	17.8	19.5

Debt Service Ratio 1/
(convertible currencies)

Percent

	1986	1987	1988	1989	1990	1995
(A)	39.3	34.2	33.8	36.4	33.1	26.0
(B)	38.1	33.3	32.8	34.8	30.5	21.2

1/ Debt service ratios up to 1988 are after rescheduling.
Source: Annex Tables 2A, 2B and 3A, 3B.

42. Under Scenario B, to support the more rapid growth of the economy, particularly the growth of investment and exports, imports would grow at a rate of 6.5 percent a year between 1986-90 (Table 1). Investment would grow at an average annual rate of 4.5 percent in this period. However, because of an increased use of existing capital stock, the efficiency of investment would be higher than in Scenario A, with the ICOR ranging between 5-6. Implementation of reforms in the area of investment allocation (para 33) and greater reliance on market signals would encourage mobility of capital and allow investment to be directed into more efficient sectors. Investment would move toward the industrial sector, which would have a rate of return above the national average.1/ Employment would increase on average by 2.5 percent a year in this period.

43. Under Scenario B, the favorable developments in the economy in the late 1980s would allow a continuation of sustained growth in the 1990s. Between 1991-95, the policy measures adopted earlier would help increase the rate of growth to around 4.1 percent a year. Exports, mostly industrial, would grow by about 5.8 percent a year, supporting the growth of GSP. Investment would grow by 4.1 percent a year between 1991-95. Continuation of investment would allow employment to increase by 3 percent a year between 1991-95. As the economy moves toward more flexibility and maturity in the 1990s, the balance of payments and macro constraints would become less binding, and the economy could comfortably manage servicing the external debt. The flexibility of the economy would also allow it to respond better to future changes in the world economy.

44. While the option represented by Scenario A is feasible, it is basically undesirable. The economy would be able to achieve a low growth rate and gradually reduce its debt burden, but the slow pace of growth would generate little employment and would strain the country's political and social fabric. Capital equipment would remain technologically obsolete and underused. Moreover, under Scenario A, Yugoslavia would face difficulty attracting international financial support (para. 56) and would remain highly vulnerable to future external shocks.

45. In contrast, under Scenario B, the rate of growth would be substantially larger, investment would become more effective and the economy could achieve a higher level of income per capita. Yugoslavia would have a better access to international financial markets and could manage servicing the external debt with no major difficulty. However, experience in Yugoslavia indicates that implementation of an appropriate package of policy reforms would be very difficult, especially if actions have to be taken at a fast pace. The implementation of the proposed reforms and stabilization measures are not politically popular not only because of adjustment costs such as the closing of inefficient enterprises and related unemployment, but also because of interregional conflicts. Even if the reforms were not inhibited by economic constraints and factor market rigidities, they could face resistance from those who would be adversely affected (para. 51). The political and

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1/ The rate of return on capital investment on average would grow by about 9 percent between 1986-90.

economic risks to those advocating reform could be substantial. Nevertheless, these short-term costs should be weighed against the benefits of the long-term economic stability and better standard of living that could be achieved by adhering to the kind of policy package described under Scenario B.

III. POLICY PRIORITIES FOR SUSTAINED RECOVERY

46. In the next two years, the policy priorities should be on two fronts: bringing down inflation without jeopardizing the external balance, and firmly establishing a framework of incentives that will promote the efficient restructuring of the economy. These policies must be implemented with determination if the economy is to resume sustained growth. Such policies will generate adjustment costs and will face political and administrative obstacles. But there are also substantial costs to failing to reform the economy: standards of living and levels of employment will be lower and the economy will be more vulnerable to external shocks.

Macroeconomic Policies

47. While resuming growth, the authorities will need to control inflation. This is the most urgent task. Simultaneously, there is a need to encourage improvement in the efficiency of resource allocation in order to consolidate the external balance, maintain growth on a sound basis and begin tackling unemployment. To complement the stabilization measures and pave the way for resumed growth, the authorities need to implement and extend the major reforms (discussed in Section II). These reforms are essential to restructuring the economy for sustainable growth.

48. To stabilize the economy, macroeconomic policies during 1986-87 should concentrate on continuing fiscal and monetary restraint, with gradual relaxation thereafter. These restrained policies imply a need for greater enforcement of financial discipline on the part of social sector enterprises in order to control the liquidity in the economy effectively and decelerate the rate of inflation. While fiscal policy, as in the past, should aim at controlling the increases in public expenditures in real terms, a restrained credit policy requires unified, positive, floor real lending interest rates by 1987. Credit policy should also take into account the flow of credit among enterprises. In this respect, immediate attention should be focused on allowing only commercial banks to guarantee enterprise credit instruments, instead of the present practice of guarantees being issued by the enterprises themselves or their internal banks. Moreover, the commercial banks should provide incentives in the form of high yielding short-term monetary instruments that would attract enterprises' excess liquidity into the banking system.

49. To supplement the restrained monetary and fiscal policies, there should be an incomes policy to support efficient economic units. Enforcement of the regulation restricting income payments to workers in firms that make losses and the social compact that links wage increases to productivity gains would be positive steps. At the same time, in an environment where the cost elements are indexed to price increases and enterprises pass those cost

increases on to consumers, inflation cannot be tackled only through compression of demand. Therefore, greater competition from imports should be allowed, and competition among firms should be encouraged so that increases in productivity are reflected in lower prices, and not just in higher wages and profits.

Difficulties in Implementing the Policy Reforms

50. Economic recovery in Yugoslavia will require forceful implementation of the reform policies described earlier. However, the preoccupation of the Republics and Autonomous Provinces with economic autarchy has prevented the adoption of effective policies. It has prolonged the decision-making process and prevented the adoption of adequate and effective policy reforms.

51. The reform of the foreign trade and foreign exchange allocation systems, which is difficult and politically sensitive, needs to be completed rapidly. Implementation of this and other reforms will mean facing the issue of limited federal power and the strong regional divisions in Yugoslavia. Introduction and implementation of policy measures, particularly those related to interregional matters, have often been stalemated by the parliamentary veto power of each Republic. Those adversely affected by reforms will exert political pressure and slow the pace of implementation, as has been the case in the past and in other countries. Those parties include loss-making enterprises that depend on outside sources to cover losses; inefficient industries that are protected by the trade regime; regions that realize specific local advantages in various distortions of the incentive structure; and oligopolist enterprises that benefit from a lack of competition.

52. The strong regional differences, together with the decentralized decision-making process, make establishing a nationwide market and designing and carrying out policies within a unified framework difficult. Implementation of the Long Term Program of Economic Stabilization has already suffered from these competing regional interests and the constant struggle for power among the Federal Government and the Republics and Autonomous Provinces. Similarly, the important areas of reform under the first SAL (para. 65), particularly those relating to the foreign trade and foreign exchange regimes and investment planning, have faced long delays and have not met initial expectations. Much resistance and many delays have also been experienced in implementing other measures under the SAL, particularly in the areas of price and tariff adjustments. While Yugoslavia has been aiming at more uniform market signals, a more open economy and a greater integration of its decision-making, actual reform has been slow.

IV. FINANCING REQUIREMENTS

53. Under Scenario A, Yugoslavia would reduce its convertible MLT debt by $400 million a year up to 1990, and then maintain a constant debt. This is a much lower level of debt reduction than what is implied by the $1.2 billion annual current account surpluses projected in the 1986-90 five-year plan.

Average real interest rates paid by Yugoslavia would remain about 3 percent, reflecting the perception by the financial community that the economy remains vulnerable. Under Scenario B, it is assumed that real interest rates would decline to 2 percent.

54. Even after past reschedulings, under Scenario A, Yugoslavia would need to amortize annually about $2.2 billion in convertible MLT debt between 1986-88. With interest payments of about $1.8 billion, the debt service payments of about $4 billion a year would remain a heavy burden on the balance of payments. The convertible debt service payments would become even larger in 1989-90 ($4.8 billion a year), when the present multi-year rescheduling arrangements terminate.

55. Under Scenario A, the required gross convertible capital inflow would amount to $10.8 billion between 1986-90. The average inflow should increase from $1.8 billion a year between 1986-88 to $2.6 billion a year between 1989-90 (Table 2). The bulk of the inflow ($8.2 billion) would be on commercial terms, including loans from governments and their agencies. The inflow on commercial terms should increase from the average of $1.2 billion a year during 1986-88 to $2.2 billion a year during 1989-90. However, commercial banks have been cautious in making MLT loans to Yugoslavia since the early 1980s. Whether this caution will persist will depend upon whether Yugoslavia can regain their confidence by implementing the appropriate economic policies and succeeding in further expanding its foreign exchange earnings.

56. Under Scenario A, there are no major policy changes. Consequently creditors may not be willing to provide the additional financial support to Yugoslavia. In that case, Yugoslavia would find it more difficult to achieve even the low 2.7 percent yearly growth projected under this scenario. It is likely that Yugoslavia would even have to seek additional rescheduling starting in 1989 to manage the increase in debt service payments following the termination of the present rescheduling period.

57. Under Scenario B, convertible MLT debt would stay at the level of 1985 until the early 1990s. However, the debt service burden would not be larger than in Scenario A because of the better performance of exports (para. 43). Under this scenario, the gross convertible capital inflow would be over $13 billion between 1986-90. The average inflow would increase from $2.2 billion a year between 1986-88 to $3.2 billion a year between 1989-90 (Table 2). Of this amount, the gross inflow on commercial terms (from commercial banks and bilateral sources) would be $8.9 billion, or $1.4 billion a year during 1986-88 and $2.3 billion a year during 1989-90.

58. Under Scenario B, Yugoslavia would require about $2.3 billion more external borrowing than under Scenario A between 1986-90.1/ Provided appropriate reforms are introduced, the Bank would be prepared to increase its

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1/ The increased borrowing is reflected in the difference between total gross disbursements in the two scenarios. The difference in net borrowing would be $2 billion (Table 2 and Annex Tables 3-A and 3-B).

Table 2

Yugoslavia: Debt Outstanding and Disbursed
(million $)

	Scenario	1985	1990	Percent Share of Total 1985	Percent Share of Total 1990
Multilateral	A	4,641	2,735	26.1	17.3
	B	4,641	4,263	26.1	23.9
of which (World Bank)	A	2,160	2,064	12.1	13.1
	B	2,160	3,592	12.1	20.2
Bilateral and Private	A	13,160	13,067	73.9	82.7
	B	13,160	13,538	73.9	76.1
Total Convertible MLT Debt	A	17,801	15,802	100.0	100.0
	B	17,801	17,801	100.0	100.0
Total Debt	A	20,205	18,016		
	B	20,205	20,015		

Disbursement and Amortization During 1986-90

(million $)

		1986-88 [1] (average annl.)	1989-90 (average annl.)	1986-90 (Total)
Disbursements	A	1,825	2,649	10,773
	B	2,224	3,191	13,057
of which (commercial terms)	A	1,257	2,228	8,229
	B	1,401	2,358	8,919
Amortization	A	2,224	3,049	12,773
	B	2,224	3,192	13,057

[1] Rescheduling period.

Source: Annex Tables 3-A and 3-B.

direct lending to Yugoslavia and provide about \$1.6 billion of this additional amount. This level corresponds to total Bank commitments of \$3.1 billion (Annex Table 3-B).1/ The rest of the increased borrowing (\$700 million), would have to be shared by Governments, commercial banks and other multilateral organizations. The Bank would also enter into cofinancing agreements that would encourage commercial banks to resume MLT lending to Yugoslavia. Under Scenario B, the Bank's share in total debt outstanding and disbursed would increase from 10.7 percent in 1985 to 18 percent in 1990.2/ This level corresponds to an average Bank disbursement of about \$600 million annually. This level of exposure would increase the Bank's share in Yugoslavia's total debt service from 7.5 percent in 1985 to 12.7 percent by 1990.3/

59. Despite the increase in the Bank's exposure, the composition of debt would shift with a decline in the share of multilateral organizations. The share of multilateral organizations in total convertible MLT debt would decline from 26 percent in 1985 to 24 percent in 1990 (17 percent under Scenario A). This decline results from the amortization of the debt due to the IMF and the absence of new IMF disbursements beyond the current standby.

V. ACTION PROGRAM AND MONITORING

1986-87 Action Program

60. To improve the resource allocation system, which is the key underlying factor in reducing the rigidities and resuming of sound growth, Yugoslavia needs to implement major reform measures. In the past, initiation and implementation of reforms have faced long delays. To be most effective, Yugoslavia needs to undertake economic policies and reform measures at a much faster pace in the next two years in order to be able to resume growth and improve the incentive and resource allocation systems. During the next two years, the authorities should also concentrate on continuing fiscal and monetary restraint to control inflation (discussed in Section III).

61. The Government has developed a new price liberalization policy, which has been in effect since January 1985. The thrust of the new policy will need to be maintained; resort to administrative controls to combat inflation would be detrimental. The Government's commitment to continued adjustment of the presently administered prices, namely, petroleum and petroleum products, gas, electricity, coal and lignite, as well as railway tariffs and road user charges, would ensure that these prices increase to reach parity with opportunity costs. The Government should also unify the system of floor

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1/ Bank commitments to Yugoslavia would decline in the 1990s, reflecting the country's better access to the international capital markets and possible graduation from Bank borrowing.

2/ The Bank's share in convertible MLT debt increases from 12 percent in 1985 to 20 percent in 1990.

3/ In terms of convertible debt service, the Bank's share increases from 8.2 percent in 1985 to 14.2 percent in 1990.

lending rates by commercial banks and adjust them so they reach positive levels by 1987.

62. In the area of the <u>allocation of foreign exchange</u>, the Government should establish a market-based allocation system not later than 1987. During the same period, it should shift commodities out of the restricted import categories into the free import category in parallel with a managed float of the exchange rate. The reclassification of imports should lead to a decline in the share of the value of imports under quotas and licenses from more than 50 percent of total imports to 15 percent within two years.

63. In the area of <u>financial discipline</u>, the measures adopted since the end of 1984 should be enforced and extended. Until recently, loss-making enterprises in Yugoslavia could avoid or delay sanctions for bad decisions through default on payments due to banks and other firms and through reliance on financial assistance from the community through the use of the Joint Reserve Funds (JRFs). The law on Reserve Funds was amended in December 1984 to limit, and after 1987 prohibit, the use of JRFs for loss coverage under the guise of enterprise rehabilitation. The law on payments amended at the end of 1984 prevents enterprises that default on their obligations from increasing the personal income of workers at rates above the average increase in the economic sector of the region in which they operate. In addition, an amendment to the law on rehabilitation (January 1985) stipulates mandatory bankruptcy proceedings against loss-making enterprises. Another measure has been improvements in the accounting framework so as to provide a better indication of an enterprises' true financial situation. Similarly, a more effective supervision of the banks by the National Bank of Yugoslavia and the Social Accounting Service would improve the efficiency of the banking system's credit allocation among enterprises.

64. To improve the efficiency of <u>investment allocation</u> and avoid duplication of capacities, the Government should implement appropriate Joint Development Programs (JDPs) in the infrastructure sectors, in line with least-cost investment programs. To improve the process of investment selection, the Government should focus on implementation of the recently approved minimum uniform criteria for the selection of investment. An application of appropriate interest rates and prices should also improve the allocation of investment resources. A summary of the annual action program for 1986-90 is presented in a policy matrix in Annex II.

<u>World Bank Support</u>

65. To support Yugoslavia in initiating and implementing the policy reforms, the Bank has included Structural Adjustment Loans (SALs) in its lending program. The first SAL in 1983 supported Yugoslavia's effort to establish the foundation for a more efficient pattern of growth. It supported the recommendations of the Long Term Program of Economic Stabilization in four economy-wide areas: (i) price policies; (ii) foreign exchange allocation and external trade policies; (iii) enterprise decision-making and financial discipline; and (iv) investment planning.

66. Under Scenario B, the Bank would proceed in appraising a possible second SAL to Yugoslavia. The objective of this second SAL would be to consolidate and extend policy changes and reforms that will further promote the restructuring of production and demand patterns so as to allow the resumption of sustainable growth, the alleviation of the debt service burden and a slowdown in inflation. Within the context of an agreed medium-term macroeconomic framework and the more comprehensive program of reforms of the Government, the second SAL would support measures aimed at:

(i) Promoting greater reliance on market forces to determine prices and closing the gap between prices and opportunity costs wherever needed;

(ii) Establishing a market-based mechanism for the allocation of foreign exchange and reforming the foreign trade regime;

(iii) Ensuring a stricter enforcement of budget constraints, including the rehabilitation of ailing business and, where necessary, their closure; and

(iv) Strengthening the processes of investment allocation and selection so as to minimize inefficiencies.

67. If the implementation of reforms and adjustment measures continues, the Bank's future lending program would be heavily based on SALs and sector loans. Should the Government pursue adjustment policies firmly, we would support it through expanding our overall level of lending and increasing its policy based content. The possibilities for policy-based lending after SAL II could include subsequent SALs supporting the removal of the distortions in the financial market, improved factor mobility and elimination of the regional barriers to trade. Concurrent with SAL lending, the Bank would support financial and industrial sector restructuring, energy conservation and reform of investment planning through sectoral and subsectoral lending. Structural adjustment and sector-type lending, however, require a strong commitment on the part of the Government to accelerate the pace of economic reforms and to engage regularly with the Bank in substantive dialogue on macroeconomic and sectoral issues. Given the disappointing implementation of SAL I undertakings and the Government's unwillingness to date to make precise commitments for a SAL II, there is a distinct risk that this will not materialize.

68. Under enhanced monitoring arrangements requested by Yugoslavia and recently approved by the IMF Board, the IMF will monitor macroeconomic parameters and short-run developments closely, within the framework of a viable macroeconomic program. Through this monitoring, it should be possible to identify needed adjustments in policies and in the medium-term macro framework. In addition, under the proposed second SAL, the Bank would review with the Government economic developments at the macro and sectoral levels semi-annually in order to assess the suitability of the policy framework.

Annex Table 1

Yugoslavia: Summary of Key Macroeconomic Aggregates, 1978-85

	1978	1979	1980	1981	1982	1983	1984	1985 [1]
GSP Growth rate (% p.a.)	6.9	7.0	2.3	1.4	0.5	-1.3	2.0	0.5
Debt/Exports of G&S (%) [2]	99.2	104.4	105.8	115.8	131.2	139.4	131.5	130.0
Debt/GSP Ratio (%)	23.5	24.7	30.4	31.5	34.4	46.9	48.4	48.2
Interest Payments/Exports (%)	4.3	5.7	7.1	11.6	13.4	11.5	12.2	12.0
Interest Payments/GSP (%)	1.0	1.3	2.0	3.1	3.5	3.9	4.5	4.5
Debt Service Ratio (%)	17.7	17.8	18.5	23.4	26.3	30.8	33.7	34.3 [3]
Convertible Debt Service Ratio (%)	18.0	19.3	21.9	31.0	35.3	40.0	41.7	43.0 [3]
Total Investment/GSP (%) [4]	42.8	44.5	42.8	44.5	42.0	40.9	43.1	41.9
Fixed Investment/GSP (%)	39.6	36.4	35.1	31.0	29.2	25.3	23.6	21.9
Terms of Trade, 1982=100	100.9	97.3	96.6	94.9	100.0	98.0	90.3	86.7
Export Growth Rate (% p.a.)	1.4	1.6	10.9	-.4	-11.2	1.4	10.1	8.2
Import Growth Rate (% p.a.)	-1.3	18.0	-10.5	-12.3	-13.5	-5.5	-0.4	1.2
Current Account Balance ($mn)	-1,283	-3,661	-2,291	-946	-624	211	439	797
With Convertible Areas ($mn)	-1,272	-3,304	-2,203	-1,821	-1,602	246	800	370
Interest Payments ($mn)	495	821	1,281	1,987	2,049	1,688	1,854	1,997

[1] Preliminary estimates.

[2] Exports of goods and services include net remittances.

[3] Before rescheduling.

[4] There is considerable uncertainty to the estimates of stock accumulation. See footnote 2 on para. 13 of the text.

Annex Table 2-A

Yugoslavia - Projections of Key Variables,[1] 1986-95, Scenario A
(percentages and US dollars)

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
GSP Growth Rate	2.3	2.7	2.8	2.8	2.8	2.3	2.3	2.8	2.3	1.8
GSP/Capita Growth Rate	1.4	1.8	1.9	1.9	1.9	1.5	1.5	1.9	1.5	1.0
Consumption per Capita Growth Rate	1.5	3.0	2.2	2.5	2.3	2.3	2.2	2.4	1.9	1.1
Total Debt Outstanding and Disbursed (billions of dollars)	19.7	19.3	18.8	18.4	18.0	18.0	18.0	18.0	18.0	18.0
Debt/Exports (percent)	139	128	116	104	94	88	82	75	70	65
Debt/GSP (percent)	47.4	41.3	36.0	31.7	27.9	25.4	23.3	21.3	19.4	18.0
Debt Service (percent)	31.9	28.6	28.3	29.9	27.1	25.5	23.2	22.2	22.0	20.6
Convertible Debt Service (percent)	39.3	34.2	33.8	36.4	33.1	31.3	28.8	27.4	27.7	26.0
Interest/Exports	14.1	13.2	11.7	10.7	8.9	7.8	7.3	6.7	6.2	5.8
Interest Payments/GSP (percent)	4.9	4.3	3.8	3.3	2.6	2.3	2.1	1.9	1.7	1.6
Gross Investment/GSP	32.7	33.0	33.7	33.9	34.1	34.7	34.7	34.8	34.7	34.7
Fixed Investment/GSP	22.0	22.6	23.4	23.9	24.3	25.1	25.3	25.5	25.8	25.9
Domestic Saving/GSP	36.8	36.8	37.0	36.7	36.7	36.5	36.2	36.1	35.9	35.8
Marginal Savings Rate	37.0	37.3	36.0	36.5	34.8	32.9	35.0	34.2	34.7	35.8
National Saving/GSP	35.2	35.2	35.2	35.2	35.2	35.2	35.2	35.2	35.1	35.1
ICOR[2]	7.3	7.7	8.2	8.2	8.7	9.2				
Export Growth Rate	2.2	2.0	2.5	2.7	2.8	0.7	1.9	2.9	2.3	2.1
Exports/GSP	34.2	32.3	31.1	30.5	29.7	28.8	28.4	28.3	27.9	27.7
Import Growth Rate	.3	6.4	4.2	4.3	3.7	3.6	3.2	3.3	2.7	1.6
Imports/GSP	31.7	30.2	29.1	29.1	28.4	27.8	27.6	28.0	27.4	27.2
Convertible Current Account (US$)	838	798	798	753	753	350	350	350	350	350
Terms of Trade Index [3]	1.05	1.09	1.09	1.09	1.09	1.09	1.09	1.09	1.09	1.09

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[1] The exchange rate used for projections is based on the 1984 exchange rate of $1 = 152.8 Dinar, as shown in the IFS. The official data for 1984 are based on the "statistical exchange rate" of $1=124.8. This difference should be noted when projected figures are compared with the historical trade figures in current prices.
[2] Five-year averages, with the initial year the one of the column in which the figure appears.
[3] 1984 = 100.

Annex Table 2-B

Yugoslavia - Projections of Key Variables,[1] 1986-95, Scenario B
(percentages and US dollars)

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
GSP Growth Rate	2.3	2.7	4.9	4.1	4.7	4.4	3.6	4.4	3.9	4.2
GSP/Capita Growth Rate	1.4	1.8	4.0	3.2	3.8	3.5	2.8	3.6	3.1	3.4
Consumption per Capita Growth Rate	1.5	3.0	4.5	2.5	3.9	3.8	4.1	3.7	3.1	3.2
Total Debt Outstanding and Disbursed (Billions of Dollars)	20.1	20.1	20.0	20.0	20.0	20.0	20.8	21.2	21.8	21.8
Debt/Exports (percent)	141	133	120	105	93	84	80	73	66	58
Debt/GSP (percent)	48.0	43.0	36.8	33.3	29.7	25.5	22.7	19.6	18.0	16.1
Debt Service (percent)	30.8	27.8	26.9	28.4	24.7	21.3	20.0	18.7	18.0	16.7
Convertible Debt Service (percent)	38.1	33.3	32.8	34.8	30.5	26.8	24.8	21.8	22.8	21.2
Interest/Exports	14.0	12.6	11.4	9.8	7.6	6.0	5.8	5.2	4.8	4.3
Interest Payments/GSP (percent)	4.9	4.1	3.5	3.1	2.4	1.8	1.6	1.4	1.3	1.2
Gross Investment/GSP	32.7	33.0	34.6	34.9	35.0	35.3	35.2	34.4	33.9	33.5
Fixed Investment/GSP	22.0	22.6	24.6	25.3	26.0	26.6	27.0	26.8	26.8	26.8
Domestic Saving/GSP	36.8	36.8	36.9	36.8	36.6	36.4	35.2	34.7	34.4	34.2
Marginal Savings Rate	37.0	36.9	36.5	35.3	34.9	28.5	31.9	32.4	33.3	34.2
National Saving/GSP	35.2	35.2	35.2	35.4	35.5	35.2	34.4	34.0	33.5	33.5
ICOR [2]	5.1	4.9	5.5	5.6	5.9	6.1				
Export Growth Rate	2.2	2.0	5.3	7.1	6.6	5.7	2.8	7.0	6.7	7.0
Exports/GSP	34.2	32.3	30.7	31.7	32.0	30.2	28.1	27.0	27.2	27.5
Import Growth Rate	0.3	6.4	10.9	7.1	9.0	7.2	6.8	6.2	6.2	6.0
Imports/GSP	31.7	30.2	30.0	31.2	31.5	30.2	29.0	27.5	27.6	27.4
Convertible Current Account (US$)	838	798	350	300	300	-33	-720	-480	-558	10
Terms of Trade Index [3]	1.05	1.09	1.09	1.09	1.09	1.09	1.09	1.09	1.09	1.09

1/ The exchange rate used for projections is based on the 1984 exchange rate of \$1 = 152.8 Dinar as shown in the IFS. The official data for 1984 are based on the "statistical rate" of \$1=124.8. This difference should be noted when projected figures are compared with the historical trade figures in current prices.
2/ Five-year averages, with the initial year the one of the column in which the figure appears.
3/ 1984 = 100.

Annex Table 3-A

Yugoslavia: Financing Requirements and Sources
Scenario A
($ million)

Year	1985	1986	1987	1988	1989	1990	1995
World Bank							
Commitments	263	200	200	200	200	200	200
Disbursements	295	294	294	297	233	224	200
Amortizations	156	188	256	297	345	352	343
Net Flows	139	106	38	0	-112	-129	-143
DOD	2,160	2,266	2,303	2,303	2,191	2,064	1,341
IMF							
Commitments	417	0	0	0	0	0	0
Disbursements	275	142					
Amortizations	327	396	425	500	425	260	0
Net Flows	-52	-254	-425	-500	-425	-260	0
DOD	2,089	1,835	1,410	910	485	225	0
Other Multilateral							
Commitments	175	175	175	175	175	175	175
Disbursements	235	236	225	216	208	175	44
Amortizations	236	256	236	211	127	175	131
Net Flows	-1	-20	-11	5	81	0	
DOD	392	372	361	366	447	446	30
Bilateral [1/]							
Amortizations	459	613	531	434	619	754	199
Net Flows	-459	-613	-531	-434	-619	-754	-199
DOD	5,368	4,755	4,224	3,790	3,171	2,417	247
Commercial Banks [2/]							
Amortizations	258	878	573	702	954	754	459
Net Flows	-258	-878	-573	-702	954	-754	-459
DOD	7,152	6,274	5,701	4,999	4,045	3,291	742
New Credits on Commercial Terms [3/]							
Commitments	800	1,167	991	1,596	2,578	2,496	3,516
Disbursements	640	1,260	1,102	1,410	2,165	2,292	3,507
Amortizations				177	536	797	2,619
Net Flows	640	1,260	1,102	1,233	1,629	1,495	888
DOD	640	1,900	3,002	4,235	5,864	7,359	13,446
Total Convertible MLT							
Commitments	1,655	1,542	1,366	1,971	2,953	2,871	3,891
Disbursements	1,445	1,932	1,621	1,923	2,606	2,691	3,751
Amortizations	1,436	2,331	2,021	2,321	3,006	3,092	3,751
Net Flows	9	-399	-400	-398	-400	-402	-0
DOD	17,801	17,402	17,001	16,603	16,203	15,802	15,806

1/ Bilateral debt contracted prior to 12/2/82.
2/ Debt contracted prior to 1/17/83.
3/ Includes government and government guaranteed credits as well as credits from commercial banks.

Annex Table 3-B

Yugoslavia: Financing Requirements and Sources
Scenario B
($ million)

Year	1985	1986	1987	1988	1989	1990	1995
World Bank							
Commitments	263	300	800	800	800	400	200
Disbursements	295	297	627	728	782	502	295
Amortizations	156	188	256	297	353	411	539
Net Flows	139	109	371	431	429	91	-244
DOD	2,160	2,269	2,640	3,071	3,500	3,592	2,746
IMF							
Commitments	417	0	0	0	0	0	
Disbursements	275	142					
Amortizations	327	396	425	500	425	260	0
Net Flows	-52	-254	-425	-500	-425	-260	
DOD	2,089	1,835	1,410	910	485	225	0
Other Multilateral							
Commitments	175	175	175	175	175	175	100
Disbursements	235	236	225	216	208	175	44
Amortizations	236	256	236	211	127	175	131
Net Flows	-1	-20	-11	5	81	0	-87
DOD	392	372	361	366	447	446	51
Bilateral 1/							
Amortizations	459	613	531	434	619	754	199
Net Flows	-459	-613	-531	-434	-619	-754	-199
DOD	5,368	4,755	4,224	3,790	3,171	2,417	247
Commercial Banks 2/							
Amortizations	258	878	573	702	954	754	459
Net Flows	-258	-878	-573	-702	-954	-754	-459
DOD	7,152	6,274	5,701	4,999	4,045	3,291	742
New Credits on Commercial Terms 3/							
Commitments	800	1,870	994	1,474	2,317	2,631	3,850
Disbursements	640	1,656	1,169	1,378	2,148	2,568	3,940
Amortizations				177	660	893	2,958
Net Flows	640	1,656	1,169	1,201	1,488	1,675	982
DOD	640	2,296	3,465	4,666	6,154	7,830	15,767
Total Convertible MLT							
Commitments	1,655	2,345	1,969	2,449	3,292	3,206	4,050
Disbursements	1,445	2,331	2,021	2,322	3,138	3,245	4,279
Amortizations	1,436	2,331	2,021	2,321	3,138	3,247	4,286
Net Flows	9	0	0	1	0	-2	7
DOD	17,801	17,801	17,801	17,802	17,802	17,801	19,553

1/ Bilateral debt contracted prior to December 2, 1982
2/ Commercial banks' debt contracted prior to January 17, 1983.
3/ Includes government and government guaranteed credits, as well as credits from commercial banks.

Sectoral Issues

The purpose of this section is to identify major issues facing each sector and recommend specific policy measures which would address these issues and reduce factors that constrain sector growth.

INDUSTRY

ANALYSIS

The problems of industry are rooted in the static nature of policies and the structure of the economy and the sector. There are major macro-policy difficulties with prices, trade, foreign exchange rate and allocation, investment decision-making and financial discipline. Economic policy has been inward-looking; demand and external competition do not determine production costs and prices; a protectionist trade policy encourages import substitution and has caused a technological gap; the fixed exchange rate does not reflect increasing scarcity; and foreign exchange, because it is administratively allocated, offers no incentive to ration or substitute.

Investment decisions are negotiated among the Republics and Autonomous Provinces (RAPs), and market mechanisms do not play a role. The choice of import substitution industrialization, supported by protectionism, liberal financing, the absence of financial discipline and the lack of competition (domestic or international) have led to rigidity, high-cost output and a reliance on Government subventions.

Regional and federal priorities vary, but in the area of investment, neither is binding on enterprises; investment in priorities instead is induced by the allocation of credit. The allocation of foreign exchange has favored its earners and large-scale priority investments, while non-earners pay informal premia or do without. Banks, because they must guarantee credits for investment, could play a role in rationalizing investment, but they are owned by the enterprises. Underpriced foreign exchange has induced over-borrowing by firms, often sanctioned by the banking system, based on illusory prospects for exports. If repayment out of earnings is not possible, firms can resort the the solidarity funds, without having to undertake financial restructuring.

POLICY RECOMMENDATIONS

The economy needs to be realigned to reflect changes in domestic and external resources and product markets. At the same time, automatic economic and financial mechanisms that permit continuous adjustment, promote efficiency and reduce resource misallocation are needed. The partial adjustments undertaken in price policy, exchange rate policy, investment decision-making and financial discipline need to be carried further and to be accompanied by the liberalization of the foreign exchange market and trade policy. As competition and comparative advantage become more evident, these macro-policy changes will point to new directions for industry. In turn, these will require changes in the scale, location and scope of industry to rationalize the existing sector and promote efficient development.

The Bank should support the needed adjustment and future directions through sectoral and subsectoral lending, including support for an upgrading of the incentive framework, and through broad-based input services (technical, marketing and managerial advisory services). It should do so at a national level. Adjustment should take place in the context of macro-policy changes, although in priority areas such as lending for export industries, particularly for those with performance records, the Bank may undertake some identification work for project and sector improvement issues. Decisions on whether to carry out substantial work toward operations could be taken in the light of our macro dialogue with Yugoslavia.

Even without progress at the macro level, lending for energy conservation and technology development is possible. It may also be possible to consider loans for selected subsectors.

EXPECTED RESULTS

These policy changes, along with rationalization and redirection of industrial subsectors, will allow industry to improve its performance and enhance national economic growth. Specific benefits will be higher operating and financial efficiency, important cost reductions, increased competitiveness, and gains from increased specialization and trade.

ENERGY

ANALYSIS

The energy sector faces a number of problems:

- Rivalry and poor coordination among the Republics and Autonomous Provinces (RAPs) have led to a misallocation of investment, irrational siting of facilities, and an absence of national energy planning, programming and cooperation.

- Pricing distortions have encouraged the use of more costly gas and the underuse of cheaper domestic resources, inattention to conservation, and investment in otherwise financially unviable projects.

- The financial systems and controls of institutions in the energy sector need improvement, along with greater maintenance and operating efficiency, and the federal institutions need greater autonomy and effective leadership.

Despite these and other formidable problems, there has been some coordination: a national electric power transmission system, the beginnings of a national dispatch system, agreements to develop the hydroelectric resources of the Drina basin, an incipient joint power investment plan, and freer inter-RAP operations by oil companies.

POLICY RECOMMENDATIONS

Specific policy actions that need to be taken are:

- Immediate increases in the prices of electricity, domestic natural gas, and coal and lignite, as part of a longer term adjustment of energy prices to economic levels;

- Closer coordination of RAP power and coal investments through a Joint Development Plan and the interconnection of regional gas transmission networks, plus implementation of nationally important projects (the Drina basin hydroelectric and Kosovo lignite resources);

- A program to conserve energy and to encourage use of lower cost fuels;

- Strengthening of sector institutions, particularly through better management information systems, training, maintenance and operating efficiency and modern management techniques.

- Increasing energy prices to economic levels in order to rationalize consumption, along with complementary policies of consumer information and other incentives and greater financial discipline.

These adjustments are closely linked to the implementation of other reforms of the economic system, particularly relating to real interest rates and foreign exchange. Agreement on rational Joint Development Plans will depend on compensation of the RAPs and enterprises for the opportunity costs in terms of foreign exchange of energy traded within Yugoslavia. Without financial discipline, higher energy prices will restrain energy demand, investment and imports will be reduced, and energy enterprises will lack incentives for effective investment and operations.

EXPECTED RESULTS

The policy recommendations of the Bank will: benefit overall macroeconomic objectives, especially the efficiency of investment (incremental capital output ratio), reduce imports, promote regional economic integration, and improve resource allocation on the basis of pricing.

AGRICULTURE

ANALYSIS

The agriculture sectors faces structural problems and an adverse policy environment. The sector consists of both social and individual holdings. While the latter, a heterogeneous grouping, dominate, the priority in the allocation of fixed investment, inputs and credit is the social sector, followed by associated farmers and finally those with no production/marketing links to the social sector. The individual sector has been constrained by the resultant inadequate access to inputs, particularly research and extension services, as well as by a ceiling of 10 hectares for land ownership and virtual absence of a land rental market. For its part, the social sector consists of agro-industrial kombinat, which integrate primary production, processing and marketing. These enterprises are inefficient, lack adequate managerial and technical staff, have accumulated arrears with the banks, and are capitalized with only a limited equity base. Moreover, the vertical integration, designed to achieve regional self-sufficiency, combined with the regional segmentation of markets, has resulted in redundant processing capacity.

Another structural problem is the Yugoslav banks. They cannot act as independent financial institutions and often are unable to screen projects properly. Some are financially weak in light of the number of overdue loans in their portfolios and their low equity.

Resource misallocation has been the result in part of long-term pricing policies and negative real interest rates. The compensation payments to processors, as well as the premiums and export subsidies, all necessitated by the price distortions and positive protection, have been very costly.

Finally, agricultural exports have been unstable, in part because of export marketing strategies, high domestic prices and absence of export incentives.

POLICY RECOMMENDATIONS

Policy measures should include:

(a) Freeing up input supply arrangements,, particularly research and extension services to individual farmers;

(b) Instituting a land-rental market and a relaxation of the limits on the size of land holdings;

(c) Improving the efficiency in the social sector, particularly by strengthening managerial information systems and developing standards and performance guidelines;

(d) Training bank staff and improving managerial information systems including portfolio reviews, along with thorough review of the financial sector;

(e) Bringing domestic prices into line with border prices; and

(f) Developing long-term export marketing strategies and evaluating Yugoslavia's comparative advantage in the production of import substitutes.

(g) Improving the operational efficiency and financial performance of the forestry enterprises.

EXPECTED RESULTS

Implementation of these recommendations would correct some policy distortions and reduce structural rigidities. More specifically: (i) untapped potential would be better utilized; (ii) efficiency would be improved; (iii) regional specialization and an optimal crop/product mix would be encouraged; and (iv) the role of the sector in balance of payments support would be increased.

TRANSPORT

ANALYSIS

In addition to providing the backbone to the Yugoslav economy, the primary transport network provides an outlet for export commodities as well as serving a growing demand for international transit traffic. Continued investments are required in the transport sector to alleviate bottlenecks in the main road and rail networks, and rehabilitate existing infrastructure. However, at a time when there have been severe cuts in expenditures for modernization and rehabilitation of the road network, investment in the railway system has continued. While the railways have enjoyed regular real term increases in tariffs, there has been a lag in adjusting road user charges and a major reduction in the available funds for roads. Clearly, a more balanced development of both road and rail transport is required. Decentralization of operations in the transport sector hamper coordinated development, as well as the provision of rational and cost-effective transport services.

POLICY RECOMMENDATIONS

The specific policy objectives which are being pursued by the Bank include: (i) the planning and implementation of balanced investment programs; (ii) stronger inter-regional coordination, particularly through better technical integration in the railways; (iii) improved operational efficiency in the sector, including highway maintenance, as well as operations in railways and ports; and (iv) a sound pricing and fiscal policy, including cost-based railway tariffs and regular adjustments in road user charges.

A sector-lending approach would be the appropriate instrument for tackling sector issues. This type of lending is being pursued under recent operations in both highways and railways, where we have a broad base for continuing with a sector approach. This approach would also enable us to address the inter-regional issues.

EXPECTED RESULTS

Because of the political framework, the sector lending approach generally only provides partial coverage of the sector and there is a need for a more comprehensive overview of developments in transport at the national level. As such, a proposed review of the 1986-90 Transport Investment Program under SAL II would provide the necessary sectoral background, including the broad, general conditions on investment and the longer-term implications of pricing and fiscal policy. Such a strategy should enable the Yugoslav authorities to upgrade the efficiency of the transport system and ensure an appropriate balance of investment among transport modes to provide adequate support for renewed economic growth and the development of foreign trade.

WATER SUPPLY AND SEWERAGE

ANALYSIS

About 69 percent of the population of Yugoslavia has access to a piped water supply, and only 59 percent live in a dwelling unit connected to a waterborne sewage system. Where water service levels are high in the major urban areas, supplies are intermittent and low water pressures are common. Shortages in the major industrial areas such as Belgrade, have led to factory closings and slowing down new construction. Untreated discharges have caused pollution of domestic water supply sources.

The primary responsibility for the sector rests at the local level through locally established water supply and sewerage enterprises. Little is done to properly analyze new projects and establish priorities at the Republic level, and no planning takes place at the Federal level. Lack of adequate financing is a major constraint to improved service levels and pollution control. Communes wishing to improve their systems have no source from which they can obtain long term loans at reasonable interest rates.

POLICY RECOMMENDATIONS

It is recommended that the following actions be taken at the Republic and Federal levels:

(a) Assess sector needs regularly;

(b) Set realistic goals for the sector, taking into account the results of the needs survey and the availability of resources.

(c) Establish a mechanism by which communes can borrow funds for capital improvements for projects which conform to federal and republic goals;

(d) Establish a priority system for the allocation of funds to the sector; and

(e) Establish conditions for borrowing federal funds and institute a monitoring and enforcement mechanism.

EXPECTED RESULTS

In the long term, the following results could be expected from the above actions:

(a) improved water service in urban areas;

(b) increased productivity in areas where inadequate water supplies constitute a development constraint;

(c) lower health care costs;

(d) financial self-sufficiency of the sector.

Yugoslavia: Policy Matrix and Five Year Action Program

Area	Policy Objectives	Actions Taken by the Government	Further Measures Recommended	Proposed Timing 86	87	88	89	90
A. Macroeconomic Framework	Growth with sustainable macroeconomic balance.	Public Sector Budget in surplus and surplus in Current Account of the Balance of Payments.	Monitoring of macroeconomic performance agreement on medium-term plan. Enhanced IMF monitoring. Continuation of cautious macroeconomic policies allowing sustainable macro balances; implementation of reform measures to improve resource allocation.	X	X	X	X	X
B. Price Policy	More efficient resource allocation. Setting administered prices to reflect opportunity costs.	Most prices have been decontrolled since Jan. 1985. The administered prices have been periodically increased.	Closing the gap between administered prices and opportunity cost. Continued implementation of new price law limiting administrative interventions and price subsidies.	X	X	X	X	X
C. Foreign Exchange Allocation System	To establish a market-based mechanism for foreign exchange allocation and maintain international competitiveness.	Exchange rate was substantially devalued in real terms in 1982/84. Laws for improvement in the allocation system have been passed in Jan. 1986.	Establishment of a market based foreign exchange allocation system not later than 1987.	X	X			
D. Foreign Trade	To liberalize imports.		Reduction in the share of the value of imports under quota and licenses from 50 percent in 1985 to 15 percent in 1987.	X	X			
E. Investment Allocation	To improve investment selection and coordination.	Social Compact on investment criteria was adopted by all parties concerned in Sept. 85.	Implementation of social compact and preparing operational guidelines.	X				
			Adoption of joint development programs containing least cost development approaches in major infrastructure sectors.	X	X			
	To ensure economic use of investible resources.	Periodic increases in interest rates.	Increase interest rates to positive real levels and unification of lending rate structure by 1987.	X	X			
	To monitor trends in investment pattern and identify problems.	Poor reporting.	Improve reporting format for monitoring progress in investment and identifying problem areas.	X				

Area	Policy Objectives	Actions Taken by the Government	Further Measures Recommended	Proposed Timing 86	87	88	89	90
F. Financial Discipline	To reduce transfer of losses to other enterprises or communities.	Legislation has been adopted that restricts income of workers in firms that operate at a loss or default on payments and phases out the use of reserve funds to cover losses.	Implementation of the legislation and adoption of suitable monitoring system. Monitoring of arrears due to banks from enterprises and deferred foreign exchange losses strengthening the role of SDK in initiating bankrupcy proceedings.	X				
	To encourage prudent financial portfolio management by commercial banks.	Adoption of a new law on the basis of the Banking and Credit System.	To limit the share of single borrowers in the total loan portfolio of a bank and limit the share of any single member founder in the bank's equity.	X	X			
G. Financial Sector	To reduce distortions in the financial market and improve efficiency of financial intermediation.		Specific recommendations to be worked out after completion of the review of banks in connection with financial discipline.			X	X	X
H. Regional Development	To improve mobility of factors of production and eliminate the regional barriers to trade.		Specific measures to be worked out in connection with a study on regional development which is part of our economic and sector work program.				X	X

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YUGOSLAVIA: Baker Initiative Country Study

INTRODUCTION

To cope with the balance of payments deficit and rising external debt that emerged after the second oil price increase, Yugoslavia adopted stabilization policies, with the IMF's support, in the early 1980s. Those policies, combined with administrative allocation of foreign exchange, reduced the deficit and decelerated the increase in indebtedness. However, investment and growth have remained depressed, and inflation has become increasingly severe. Yugoslavia now needs to adopt policy measures at a much faster pace to resume growth and reduce inflation while continuing the orderly servicing of its external debt. This paper assesses the prospects for attaining these objectives and the amount and type of financial assistance Yugoslavia will need to do so.

Even without major policy reform, Yugoslavia would be able to achieve a low growth rate and gradually reduce its debt burden. It would have difficulty in attracting international financial support, however, and the slow pace of growth would put strains on the country's political and social fabric. With appropriate policy reforms, Yugoslavia could achieve significantly faster growth, have a better access to international financial markets, and manage its external debt with no major difficulty. Nevertheless, recent experience indicates that a rapid introduction and implementation of an appropriate package of policy reforms will be very difficult and depend heavily on the degree of political will within Yugoslavia to carry out such a program.

I. INITIAL CONDITIONS

1. The Yugoslav economy grew at an average annual rate of over 6 percent in the 1970s. However, this high growth rate was achieved at substantial cost. An overvalued exchange rate and a heavily protected domestic market together with distorted commodity and factor prices, created a structure of production with little flexibility and hindered the development of the sectors producing tradables.

2. These domestic rigidities, compounded by the oil price increases, disrupted the high growth of the Yugoslav economy in the late 1970s. While the rigidities distorted resource allocation, the second oil price increase precipitated a balance of payments crisis. Because of the inflexible production structure and inappropriate exchange rate policy, the economy was not able to counteract the external shock by stepping up exports. Moreover, instead of reducing domestic absorption to cushion the effects of the shock, Yugoslavia continued its investment drive: fixed capital formation remained roughly around 34 percent of GSP[1/] in the late 1970s. Finally, easy credit and monetary policy accelerated the rate of inflation to nearly 40 percent in 1980.

3. The second oil price increase contributed to a trade deficit of US $7.2 billion (11.7 percent of GSP) and a current account deficit of $3.7

[1/] Gross Social Product (GSP), is the basic Yugoslav concept for national income accounts. It is close to GDP, but excludes "non productive" activities such as administration, health, education, defense, banking, housing and culture. Our estimates indicate that GSP is about 10-12 percent smaller than GDP.

billion (6 percent of GSP) in 1979, financed through heavy external borrowing and a decline in foreign reserves of $1.3 billion. The external debt rose rapidly, doubling between 1978-81 to reach almost $20 billion. Consequently, the debt rose from 23.5 percent of GSP in 1978 to 31.5 percent in 1981. During the same period, the debt service ratio in convertible currencies increased from 18 percent to 31 percent.[1/] Similarly, the rates of debt to exports increased from 99 percent in 1978 to nearly 116 percent in 1981.

4. As the need for borrowing increased, greater reliance was put on commercial sources of funds, particularly short-term obligations. By 1980, close to 80 percent of new loans were being borrowed on commercial terms, and most of the loans had maturities of 2 to 3 years. The slowdown of the world economy, with its subsequent adverse effects on Yugoslav exports, and the increase in world interest rates, soon proved a heavy burden on the country's external finances.

5. The result of these various factors was that Yugoslavia became externally illiquid. By 1982, it could no longer service its debt on time, and by 1983 its convertible currency foreign exchange reserves could cover only one month of imports.

The Response

6. To deal with the crisis, the Yugoslav Government initiated stabilization and control measures in 1981 to restore domestic and external equilibrium. At the end of 1982, when these efforts proved insufficient to cope with the debt burden, Yugoslavia requested a debt relief arrangement from

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[1/] The total debt service ratio increased from 17.7 percent to 23.4 percent.

its creditors. Meanwhile, a major reform of the framework of incentives was begun.

7. The main stabilization measures, supported by the IMF, were restrictive fiscal and monetary policies and more active use of the exchange rate. The share of public sector expenditures[1] in GSP declined from 37 percent in 1980 to an estimated 32 percent in 1985. The budget of the consolidated public sector, which was running a deficit until 1980, yielded a surplus in subsequent years. The stringent fiscal policy was accompanied by a monetary policy that lowered ceilings on the net domestic assets of the banking system and raised interest rates. While nominal lending rates were adjusted, they remained highly negative, but the interest rates on term deposits moved closer to positive levels in real terms.[2] By far the most important response was the adjustment in the exchange rate. Between September 1982 and June 1984, the real effective exchange rate was depreciated by 35 percent.[3] Since July 1984, the nominal effective exchange rate has been adjusted regularly to keep the real effective exchange rate roughly constant.

8. In 1983, a major financial support package was put together to relieve Yugoslavia's debt burden under the umbrella of an IMF program. It consisted of $4.4 billion in medium- and long-term commitments and included refinancing by Governments and commercial banks. As part of this package, the World Bank provided a structural adjustment loan (SAL) of $275 million. Another financial package totalling $3.2 billion was put together for 1984 by the IMF, Governments and commercial banks. In 1985, Government creditors agreed to reschedule 90 percent of the original maturities for the year, and

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1/ Includes expenditures at all levels of government.

2/ The three-month time deposits are now 68 percent and will increase to more than 73 percent by April 1.

3/ The real effective exchange rate depreciated by 25 percent in 1983.

agreed to consider annual rescheduling of the debt after 1986, provided there exists a satisfactory arrangement between Yugoslavia and the IMF. Similarly, in 1985, Yugoslavia and the commercial banks reached an agreement for multi-year rescheduling arrangement to cover the original maturities falling due between 1985 and 1988. These maturities amounted to $5.7 billion ($3.6 billion of which is owed to commercial banks). The agreement is also dependent on enhanced monitoring by the IMF through 1991.

9. The Government also undertook other longer term policy reforms, in line with the objectives of the Long Term Program of Economic Stabilization adopted in July 1983 and supported by the Bank's first structural adjustment loan. Aimed at reforming the system of economic incentives, the reforms included adoption and revision of a number of laws and regulations governing the criteria for investment selection, price liberalization, financial discipline, planning, banking, joint ventures, fiscal policy, foreign credit, foreign trade, and the foreign exchange allocation system.

The Results

10. The current account deficit turned into a surplus in 1983. In 1985, that surplus was $0.8 billion (of which $370 million were in convertible currencies). However, export performance has been erratic (para 16). Moreover, because of the structure of the maturities, the burden of the external debt has remained large: debt service payments to convertible areas ran about 43 percent of convertible currency export earnings in 1985, a level that drops to about 27 percent when the rescheduled maturities are excluded.

11. The stabilization efforts have met with limited success in terms of economic performance. There are several reasons for this. The stabilization efforts have been unbalanced, focusing on the reduction of imports and fixed

investment. The actions have not constituted a timely, coordinated and mutually reinforcing package. The reduction of imports through administrative rationing of foreign exchange has circumvented the use of market incentives to channel resources toward the tradable sectors.

12. In the first half of the 1980s, the decline in domestic absorption was made possible by a substantial cut in fixed investment: gross fixed investment declined by about 8.5 percent in real terms between 1980 and 1985. The decline was faster, however, between 1983 and 1985. As a result, fixed investment, which was about 36 percent of GSP in 1979, dropped to about 23 percent of GSP in 1985. While most of the investments of the late 1970s were not based on efficiency considerations, available data suggest that the cutbacks have been across the board, instead of being directed at inefficient investments of the past.[1/]

13. The decline in fixed investment was associated with a substantial increase in inventory accumulation,[2/] the result in part of negative real interest rates and inflationary expectations caused by a succession of price freezes and liberalizations. It also reflects the ineffectiveness of the policies directed at reducing domestic absorption and the lack of tight budget constraints on enterprises.

1/ The sectoral composition of investment shows little change in the share of investment between 1979-83.

2/ Official estimates show inventory accumulation amounted to 20 percent of GSP in 1985 and has been a rising portion of GSP throughout the 1980s. There is considerable uncertainty attached to these estimates, and some evidence that they substantially overstate stockbuilding. If so, for the national accounts to remain consistent, either GSP was lower than estimated, or some other component of GSP, most likely consumption, was higher. The uncertainty here, on the order of 10-15 percent of GSP, calls for caution when providing recommendations for resource mobilization.

14. The slowdown in growth has been longer and more severe than expected. Since 1980, the annual rate of growth of GSP has averaged less than 1 percent a year in real terms (Annex Table 1). The inflationary pressure has persisted and even worsened, despite the reduction in domestic absorption. Inflation is estimated to have reached 80 percent in 1985. The restrictive monetary policy was not successful in controlling inflation, as it was not followed by timely implementation of hard budget constraints on loss-making enterprises. The tight credit policy was also overtaken by other forms of credit creation, particularly, inter-enterprise credit arrangements.

15. The significant increase in inflation and the slow growth in output have resulted in a substantial and extended decline in real wages--by June 1985, they were about one-third lower than in 1980. Over the same period, private consumption fell by about 1 percent annually.

16. Yugoslavia's export performance in the past five years has been erratic, despite the preferential access to credit and foreign exchange and the substantial depreciation of the real effective exchange rate vis-a-vis convertible currencies (para 7). On the whole, growth of exports to convertible areas in nominal terms has been about 3 percent since 1981. The reason for this poor performance has been an insufficient switch in the relative price of tradables and non-tradables. Some improvements in exports have taken place since 1984. This reflects in part the unofficial premium firms were able to realize on foreign exchange earnings under the previous foreign exchange allocation system that ended in 1985. This premium seems to have encouraged the expansion of exports, even those with low value added content. Nevertheless, Yugoslavia's share in the industrial country markets has not improved since the impact of the devaluation was felt in 1983.

17. As for the longer term policy reforms, they proceeded too slowly, except in the area of price liberalization. However, by January 1986, new regulations governing most of the areas of reform were partially in place, though in some cases the regulations appear inadequate or even counterproductive.

II. MEDIUM-TERM ECONOMIC PROSPECTS

18. Following the crisis of the early 1980s and the emergence of the adjustment problems in the economy, Yugoslavia is now planning for a period of recovery and sustained growth. This aspiration is reflected in the 1986-90 development plan, which aims at a growth rate in GSP of 4 percent a year. Resumption of growth is needed in order to avoid the grave social consequences of growing unemployment and the declining trend in real wages. However, the potential for sustained growth and substantial improvement in living standards will not be achieved in an environment marred by economic distortions and imbalances that cause inefficient resource use.

Constraints on Growth

19. Policies to address the economic distortions have been hampered by competing regional interests and a cumbersome decentralized decision making process in Yugoslavia. The effectiveness of policies in addressing the structural problems facing the economy has been impaired by a tendency to rely mainly on administrative measures instead of market forces to correct the imbalances. Economic policies and growth objectives have been over-ridden by strong regional interests and delays in action caused in reaching consensus. Moreover, the lack of coordination of investment activities among Republics

and Autonomous Provinces has prevented cost effective investments, limiting the scope for improved productivity and faster growth.

20. Resumption of growth is also constrained by the lack of external resources and a heavy debt service payment, which in turn exacerbate the depressed level of investment; slow export performance; and lack of mobility of capital and labor among regions. If these constraints are not reduced, recovery and a sustainable rate of growth of the economy will be difficult to achieve.

21. Even though Yugoslavia's foreign debt is not particularly large in comparison with many high debt countries,[1/] its high debt service burden has caused a deterioration in the standard of living and has eroded some of the gains of the development drive of the 1970s. Yugoslavia's debt service payments to the convertible currency countries in 1985 would have been about 43 percent of the export earnings from these areas in the absence of the rescheduling agreements. Total interest payments were about 5 percent of GSP. Interest payments to the convertible currencies were about 16 percent of the exports to those areas.

22. The maturity structure of the Yugoslav debt profile is especially unfavorable. Even after the recent rescheduling (para. 8), Yugoslavia will have to amortize 75 percent of its debt between 1986-90. Moreover, with the IMF financial program in Yugoslavia terminating this year, Yugoslavia will have to repay about 2.0 billion to the IMF by 1991.

1/ At the end of 1985, Yugoslavia's external debt was estimated to be about $20.2 billion, of which $18.8 billion was in convertible currencies. Of the total convertible currency debt, medium- or long-term (MLT) debt was about $17.8 billion, while short-term debt amounted to about $990 million.

23. The high level of debt service payments makes it necessary for Yugoslavia to maintain a large current account surplus. With so much of the country's foreign exchange earnings being pre-empted by the debt service payments, a shortage of foreign exchange has emerged which led to restriction of imports. The restriction of imports in turn has led to slowdown in investment and growth. It has also adversely affected exports which depend on imports and has further exacerbated the shortage of foreign exchange. Further curtailing of fixed investment to restrain domestic absorption will retard economic growth. It will also jeopardize the proper maintenance of existing capital stock and erode the competitiveness of industrial exports, as funds for restructuring and modernization of industry will not be available. However, to improve the efficiency, the increase in investment should be accompanied by improvements in the allocation of investment, as well as greater enforcement of financial discipline and use of market signals in determining prices.

24. Yugoslavia's export performance has been poor in recent years (para. 16). Resumption of growth must be led by exports. Promotion of exports requires an active exchange rate policy and a market-based allocation of foreign exchange. A new foreign exchange allocation system was introduced in January 1986, which has as its objective the eventual establishment of a foreign exchange market with a freely convertible Dinar. In its transitional phase, now being implemented, the system relies heavily on an administrative allocation of foreign exchange and import rights. While a common foreign exchange pool has been created through full surrender by exporters of the foreign exchange they earn, administrative interventions governing the use of the pool and import restrictions are continuing. As a result, it is not clear

how the transition toward the objective of a market with a convertible Dinar will be managed. However, the surrender requirement has eliminated the premium previously available to exporters and may, in the absence of appropriate exchange rate adjustments, reduce the incentive to export.

25. Productivity increases can not be achieved without increase in mobility of capital and labor. The uneven pace of development among regions has widened the disparities in income and the limited mobility of capital and labor has resulted in larger numbers of unemployed in the less developed areas. To resume a sustainable growth and reduce unemployment, the obstacles to the internal mobility of the factors of production among the regions should be removed. This objective could be approached by promoting joint ventures among the regions, broadening the scope of banking activity to include a wider allocation of financial resources through the banking system among regions, and encouraging labor mobility through wage and non-wage incentives.

Objectives of a Medium-Term Strategy

26. The objectives of a medium-term strategy are to (i) resume growth with sustainable macroeconomic balances; and (ii) reduce the debt service burden. Attaining these objectives requires both a system of economic incentives that ensures efficient resource allocation and prudent and well-coordinated macroeconomic policies which will reduce the rate of inflation.

27. More specifically, the medium-term strategy should aim at (i) increasing the rate of growth of exports, particularly to convertible currency areas, and improving the competitiveness of the economy through adopting an appropriate exchange rate policy; (ii) increasing per capita consumption in real terms; (iii) improving efficiency and maintaining a level of investment to support the growth objectives; (iv) liberalizing trade and maintaining a

prudent level of external reserves; and (v) improving the system of economic incentives, relying more on market signals to determine prices and allocate resources more efficiently.

28. The implication of this strategy is that Yugoslavia will need to implement major policy reforms in the system of resource allocation and use. These reforms will help the economy attain a cost-effective structure of production and pattern of demand that corresponds to its comparative advantage. Foremost among the reforms are: enforcement of financial discipline; liberalization of the trade and foreign exchange allocation systems; improvements in investment allocation; and greater reliance on market forces to determine prices. These reforms should be followed by further reforms in the areas of the financial sector, mobility of the factors of production and encouragement of small-scale private enterprise.

29. One of the most important reforms is to ensure greater financial discipline among social sector enterprises. Financial indiscipline has clear adverse effects on inflation, resource allocation and the balance of payments. A loose budget constraint enables social sector enterprises to pass losses on to others, a situation that discourages efficiency, fuels inflation and puts undue pressure on the balance of payments. Enterprises should be accountable for their losses. Enterprises that are not economically profitable should be restructured and, if need be, closed down. Financial assistance from other enterprises and the community to loss-making enterprises has been limited by recent legislation. This legislation needs to be implemented as planned so that all such assistance is eliminated by 1987 (except for enterprises that are being rehabilitated).

30. Financial indiscipline destabilizes the economy at the micro level, and there are few sanctions to combat it. Improved accounting procedures and

implementation of the regulations to restrict income payments to workers in firms that make losses should continue to receive high priority. Easy access of loss-making enterprises to overdraft facilities and bank credits should be replaced by a mechanism which applies financial and economic criteria. At the macro level, rescuing firms with chronic losses will only reduce the resources available to more efficient firms and/or transfer the losses to the banking system.

31. The past and present Yugoslav foreign exchange allocation systems are essentially based on quantity rationing. The previous system did not operate efficiently and prevented the emergence of a foreign exchange market. The objective of the new system, a market with a freely convertible Dinar, needs to be established as rapidly as possible on a predetermined schedule. Import restrictions need to be reduced on a parallel schedule. Quantitative restrictions could initially be replaced by tariff-like surcharges to avoid a destabilizing surge of imports. Gradually, these should also be reduced.

32. The allocation of investment and efficiency in use of investment resources are prime determinants of economic growth. The most important need of investment policy in Yugoslavia is to coordinate regional investment decisions in highly capital-intensive sectors and to ensure selection of projects that reflect economic and financial profitability. In this respect, adoption of Joint Development Plans for the infrastructure sectors based on least-cost criteria is an essential element in the coordination of large investment activities. The new Plan calls for JDPs in power, telecommunication and railways. To date none has been completed. At the same time, to encourage efficient allocation of investment and financial resources, it is essential to implement the recently approved uniform investment

criteria, establish a more appropriate cost for capital, and ensure that prices reflect opportunity cost. Interest rates, on both deposits and loans, must be raised to positive real levels to avoid severe macro instability as well as gross misallocation of resources.

33. Price controls distort resource allocation by influencing the relative profitability of production. Most prices in Yugoslavia have been liberalized. To increase the efficiency of resource allocation, the Government needs to continue to allow market forces to determine prices and should make adjustments to close the gap between administered prices and opportunity costs. This is especially the case for energy products and electricity.

Alternative Scenarios

34. The policy reforms and economic environment under which the objectives of stabilizing the economy, resuming growth and reducing the external debt burden can be achieved are examined here as two scenarios. In Scenario A, it is assumed that the Government undertakes no major policy changes. The transitional phase of the present foreign exchange regime (para. 24) remains. Domestic inflation would stay above world inflation and domestic prices for energy would lag behind their economic cost. In Scenario B, an auction-type system of foreign exchange allocation is assumed in 1988-91. The economy has free access to foreign borrowing at a managed exchange rate. The domestic and international inflation rate would converge around 1989 and energy prices are adjusted to reflect the opportunity cost. Under Scenario B, economic reforms would allow improved resource allocation, and the benefits of greater flexibility in responding to price signals. The model used for projections incorporates the above-mentioned features of the reform in the system of resource allocation in Yugoslavia.

Table 1

Yugoslavia: Average Annual Growth Rates in 1984 Prices

	1986-90 Scenario A	1986-90 Scenario B	1991-95 Scenario A	1991-95 Scenario B
GSP	2.7	3.7	2.3	4.1
Agriculture	2.9	2.8	2.0	2.6
Industry	2.6	4.1	2.6	7.0
Energy	3.0	3.0	3.0	3.4
Construction	2.8	2.9	2.4	1.1
Services	2.6	3.8	2.2	3.4
Consumption	3.2	4.0	2.8	4.4
Fixed Investment	3.3	4.2	4.2	4.1
Exports GNFS	2.4	4.6	2.0	5.8
Imports GNFS	3.6	6.5	2.9	6.4

Current Account Balance
(convertible currencies)

Million US$

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
(A)	838	798	798	753	753	350	350	350	350	350
(B)	838	798	350	300	300	33	-720	-480	-558	10

Debt Outstanding and Disbursed
(convertible currencies)

Billion US$

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
(A)	17.4	17.0	16.6	16.2	15.8	15.8	15.8	15.8	15.8	15.8
(B)	17.8	17.8	17.8	17.8	17.8	17.8	17.8	17.8	17.8	17.8

Debt Service Ratio[1/]
(convertible currencies)

Percent

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
(A)	39.2	34.1	35.1	38.9	35.2	32.7	29.7	29.1	29.3	26.9
(B)	39.2	34.1	34.1	37.4	34.0	29.8	27.1	25.8	24.9	21.7

1/ Debt service ratios up to 1988 are after rescheduling.

Source: Annex Tables 2A and 2B

35. The results under Scenario A indicate that the rate of growth of GSP would remain around 2.7 percent between 1986-90 and would then slow to 2.3 percent between 1991-95 (Table 1 and Annex Tables 2-A). The rate of employment growth would remain around 2 percent. The debt service ratio in convertible currencies would be 35 percent in 1990 before declining to 27 percent in 1995. Export growth would remain sluggish in both the 1986-90 and the 1991-95 periods, averaging about 2.4 percent and 2 percent, respectively.

36. The favorable terms of trade effect of the decline in oil prices would allow the economy to gain additional resources, which would be reflected in the rate of growth of fixed investment. Fixed investment would rise 3.3 percent on average during 1986-90 and 4.2 percent during 1991-95. However, the efficiency of investment as measured by the incremental capital output ratio (ICOR) would decline. ICOR would increase from 7.3 during 1986-90 to 9.2 during 1991-95.

37. Under Scenario B, simultaneous implementation of policies aimed at both stabilization and recovery leads to accelerated growth. Up to the end of 1987, the Government would continue to emphasize stabilization objectives in order to reduce inflation (para. 44). At the same time, it would implement and extend the reforms relating to the foreign exchange and foreign trade regimes, financial discipline and investment allocation. These steps would reorient the economy toward growth and reduced inflation and unemployment. The prospects for resumed growth are, therefore, tied to both the effectiveness of the stabilization measures and the speed of structural reforms.

38. The key underlying assumption in Scenario B is the political will to implement an effective reform program in 1986-87. Between 1988-90, under this

scenario, the result of improvements and reforms in the incentive and resource allocation system would allow the growth rate to accelerate by 4.4 percent a year (Annex Table 2-B) and would allow the economy to become more responsive to price signals. The improvements in international competitiveness leads to a larger role of exports in growth: the economy would benefit from a floating exchange rate and exports would increase by an average of 6.3 percent a year between 1988-90, conditions that would allow a continuous substantial decline in the debt service burden and debt export ratios even though the absolute size of the debt remains constant. The convertible debt service burden would fall to 34 percent in 1990 and 22 percent in 1995. Similarly, the ratio of interest payments to GSP will decline to 2.8 percent in 1990 and to 1.2 percent in 1995. Although decline in the debt service burden up to 1990 is close to that of Scenario A, it would be obtained through better growth performance and higher per capita income. After 1990, the debt service ratios in Scenario B fall much more rapidly than under Scenario A.

39. Under Scenario B, to support the more rapid growth of the economy, particularly the growth of investment and exports, imports would grow at a rate of 6.5 percent a year between 1986-90 (Table 1). Fixed investment would grow at an average annual rate of 4.2 percent in this period. Moreover, because of an increased use of existing capital stock, the efficiency of investment would be higher than in Scenario A, with the ICOR ranging between 5-6. Increased mobility of capital and implementation of reforms in the area of investment allocation (para 32) would allow investment to be directed into more efficient sectors.Investment would move toward the industrial sector, which would have a rate of return above the national average.[1/] Employment would increase on average by 2.5 percent a year in this period.

[1/] The rate of return on capital investment on average would grow by about 9 percent between 1986-90.

40. Under Scenario B, the favorable developments in the economy in the late 1980s would allow a continuation of sustained growth in the 1990s. Between 1991-95, the policy measures adopted earlier would increase the rate of growth to around 4.1 percent a year. Exports, mostly industrial, would grow by about 5.8 percent a year, supporting the growth of GSP. As the economy moves toward more flexibility and maturity in the 1990s, the balance of payments and macro constraints would become less binding; and the economy could comfortably manage servicing the external debt. The flexibility of the economy would allow it to better respond to future changes in the world economy. Fixed investment would grow by 4.1 percent a year between 1991-95. Continuation of investment would allow employment to increase by 3 percent a year between 1991-95.

41. On the whole, the option represented by Scenario A is undesirable. The economy would be able to achieve a low growth rate and gradually reduce its debt burden, but the slow pace of growth would not generate much employment and would put strains on the country's social fabric. Moreover, under Scenario A, Yugoslavia would face difficulty attracting international financial support (para. 53) and would remain highly vulnerable to future external shocks. In contrast, under Scenario B, the rate of growth would be substantially larger. Investment becomes more efficient and the economy could achieve a higher level of income per capita. Yugoslavia would have a better access to international financial markets and could comfortably manage servicing the external debt with no major difficulty. However, our experience in Yugoslavia indicates that implementation of an appropriate package of policy reforms would be very difficult, especially if it has to be implemented at a fast pace.

III. POLICY PRIORITIES FOR SUSTAINED RECOVERY

42. In the next two years, the policy priorities will be on two fronts: bringing down inflation without jeopardizing the external balance, and firmly establishing a framework of incentives that will promote the efficient restructuring of the economy. These policies must be implemented with determination if the economy is to resume sustained growth. Such policies will generate adjustment costs and will face political and administrative obstacles. But there are also substantial costs of failing to reform the economy: standards of living and levels of employment will be lower and the economy will be more vulnerable to external shocks.

Macroeconomic Policies

43. While resuming growth, the authorities will need to control inflation. This is the most urgent task. Simultaneously, there is a need to encourage improvement in the efficiency of resource allocation in order to consolidate the external balance, maintain growth on a sound basis and begin tackling unemployment. To complement the stabilization measures and pave the way for resumed growth, the authorities need to implement and extend the major reforms (discussed in Section II). These reforms are essential to restructuring the economy for sustainable growth.

44. To stabilize the economy, macroeconomic policies during 1986-87 should concentrate on continuing fiscal and monetary restraint, with gradual relaxation thereafter. These restrained policies imply a need for greater enforcement of financial discipline on the part of social sector enterprises in order to control the liquidity in the economy effectively and decelerate the rate of inflation. While fiscal policy, as in the past, should aim at

controlling the increases in public expenditures in real terms, a restrained credit policy requires unified, positive floor real lending interest rates by 1987. Credit policy should also take into account the flow of credit among enterprises. In this respect, immediate attention should be focussed on allowing only commercial banks to guarantee enterprise credit instruments, instead of the present practice of guarantees being issued by the enterprises themselves or their internal banks. Moreover, the commercial banks should provide incentives in the form of high yielding short-term monetary instruments that would attract enterprises' excess liquidity into the banking system.

45. To supplement the restrained monetary and fiscal policies, there should be an incomes policy to support efficient economic units. Enforcement of the regulation restricting income payments to workers in firms that make losses is a positive step. At the same time, in an environment where the cost elements are indexed to price increases and enterprises pass those cost increases on to consumers, inflation cannot be tackled only through compression of demand. Therefore, greater competition from imports should be allowed, and competition among firms should be encouraged so that increases in productivity are reflected in lower prices, and not just in higher wages and profits.

Difficulties in Implementing Policy Reforms

46. Economic recovery in Yugoslavia will require forceful implementation of the reform policies described earlier. However, the preoccupation of the Republics and Autonomous Provinces with developing a stronger political and economic base has prevented the adoption of effective policies. It has prolonged the decision making process and prevented the adoption of adequate and effective reforms.

47. The reform of the foreign trade and foreign exchange allocation systems, which is difficult and politically sensitive, needs to be completed rapidly. Implementation of this and other reforms will mean facing the issue of the strong regional divisions in Yugoslavia and limited federal power. Those adversely affected by reforms will exert political pressure and slow the pace of implementation, as has been the case in the past and in other countries. Those parties include loss-making enterprises that depend on outside sources to cover losses; inefficient industries that are protected by the trade regime; regions that realize specific local advantages in various distortions of the incentive structure; and oligopolist enterprises that benefit from a lack of competition.

48. The strong regional differences, together with the decentralized decision-making process, make establishing a nationwide market and designing and carrying out policies within a unified framework difficult. Implementation of the Long-Term Program of Economic Stabilization has already suffered from these competing regional interests and the constant struggle for power among the Federal Government and the Republics and Autonomous Provinces. Similarly, the important areas of reform under the first SAL (para. 62), particularly those relating to the foreign trade and foreign exchange regimes and investment planning, have faced long delays and have not met initial expectations. Much resistance and many delays have also been experienced in implementing other measures under the SAL, particularly in the areas of price and tariff adjustments. While Yugoslavia has been aiming at more uniform market signals, a more open economy and a greater integration of its decision making, actual reform has been slow.

IV. Financing Requirements

49. The composition of total convertible MLT debt would shift under the two scenarios, with a rise in the share of debt on commercial terms. This includes the joint share of commercial banks and governments, which would rise from 75.6 percent of convertible MLT debt in 1985 to about 80 percent by 1990 (83 percent under Scenario A). The increase in the share of commercial banks and governments reflects the additional money that Yugoslavia needs from those sources during the next five years. The share of international financial institutions would decline from 24.4 percent to 20 percent (17 percent under Scenario A). The latter decline mainly results from the amortization of the debt due to the IMF and the absence of new IMF disbursements beyond the current standby.

50. Under Scenario A, Yugoslavia would reduce its convertible MLT debt by $400 million a year up to 1990, and then keep a constant debt (Annex Table 2-A). Such a debt reduction falls short of that implicitly anticipated in the 1986-90 five-year plan, which projects current account surpluses as large as $1.2 billion a year. Average real interest rates paid by Yugoslavia would remain about 3 percent. Under Scenario B, it is assumed that real interest rates would decline to 2 percent, while no reduction in convertible MLT debt would take place.

51. Even after past reschedulings, under Scenario A, Yugoslavia would need to amortize annually about $2.2 billion in convertible MLT debt between 1986-88. With interest payments of about $1.8 billion, total debt service payments of about $4 billion a year would remain a heavy burden on the balance of payments. The convertible debt service payments will become larger in

1989-90 ($5 billion a year), when the present multi-year rescheduling arrangements terminate.

52. Under Scenario A, the gross convertible capital inflow would amount to $11.2 billion between 1986-90. The average inflow should increase from $1.8 billion a year between 1986-88 to $2.9 billion a year between 1989-90 (Table 2). Under this scenario, Yugoslavia will have difficulty in attracting international financial support of this magnitude. The bulk of the inflow ($8.6 billion) would be on commercial terms, including loans from governments and their agencies. The inflow on commercial terms should double from the average of $1.2 billion a year during 1986-88 to $2.4 billion a year during 1989-90. However, commercial banks have been cautious in making MLT loans to Yugoslavia since the early 1980s. Whether this caution will persist will depend upon whether Yugoslavia can regain their confidence by implementing the appropriate economic policies and succeeding in further expanding its foreign exchange earnings.

53. In the absence of major policy changes under Scenario A, the creditors may not be willing to provide the additional financial support to Yugoslavia. In that case, the external resources would be less forthcoming and Yugoslavia would then find it more difficult to achieve even the low 2.7 percent yearly growth projected under this scenario. It is likely that Yugoslavia would even have to seek additional rescheduling starting in 1989 to manage the increase in debt service payments following the termination of the present rescheduling period.

54. Under Scenario B, covertible MLT debt would stay at the level of 1985 ($17.8 billion) throughout the period. However, the debt service burden would not be larger than in Scenario A because of the better performance of

Table 2

Yugoslavia: Debt Outstanding and Disbursed

	Scenario	1985	1990	Percent Share of Total 1985	Percent Share of Total 1990
Multilateral	A	4,350	2,709	24.4	17.1
	B	4,350	3,600	24.4	20.2
of which	A	2,058	2,018	11.6	12.8
(World Bank)	B	2,058	2,909	11.6	16.3
Bilateral and Private	A	13,451	13,092	75.6	82.9
	B	13,451	14,201	75.6	79.8
Total Convertible	A	17,801	15,801	100.0	100.0
MLT Debt	B	17,801	17,801	100.0	100.0
Total Debt	A	20,205	18,051		
	B	20,205	20,015		

Disbursement and Amortization During 1986-90

(million $)

		1986-88 1/ (average annl.)	1989-90 (average annl.)	1986-90 (Total)
Disbursements	A	1,823	2,880	11,233
	B	2,223	3,453	13,577
of which	A	1,239	2,447	8,610
(commercial terms)	B	1,473	2,800	10,018
Amortization	A	2,223	3,281	13,233
	B	2,223	3,452	13,577

1/ Rescheduling period.

Source: Annex Tables 3-A and 3-B.

exports (para. 38). Under this scenario, the gross convertible capital inflow would be over \$13.5 billion between 1986-90. The average inflow would increase from \$2.2 billion a year between 1986-88 to \$3.4 billion a year between 1989-90 (Table 2). Of this amount, the gross inflow on commercial terms (from commercial banks and bilaterals) would be \$10 billion, or \$1.5 billion a year during 1986-88 and \$2.8 billion a year during 1989-90.

55. Under Scenario B, Yugoslavia would require about \$2.3 billion more borrowing than under Scenario A between 1986-90[1/]. Provided appropriate reforms are introduced, the Bank would be prepared to increase its direct lending to Yugoslavia and provide about \$930 million of this amount between 1986-90. This level corresponds to total Bank commitments of \$2.1 billion, disbursements of \$2.4 billion and amortization of \$1.5 billion (Annex Table 3-B).[2/] The rest, \$1.4 billion, would have to be shared by governments, commercial banks and other multilateral organizations. The Bank would also enter into cofinancing agreements that would encourage commercial banks to resume MLT lending to Yugoslavia. Under Scenario B, the Bank's share in convertible MLT debt outstanding and disbursed would increase to 16.3 percent. This level corresponds to an average Bank disbursement of about \$470 million annually. This level of exposure would increase the Bank's share in Yugoslavia's total debt service from 6.5 percent in 1985 to 10.9 percent by 1990.

1/ The net would be \$2 billion, of which net flow on commercial terms would be \$1.1 billion.

2/ Bank commitments to Yugoslavia would decline in the 1990s, reflecting a better access of Yugoslavia to the international capital markets and possible graduation from the Bank borrowing.

56. To repay its external debt in an orderly way and to ensure successful implementation of the macro-stabilization policies, Yugoslavia willneed external financial assistance. This assistance, however, will not be forthcoming unless it is linked to a genuine structural reform. If the adjustment does not take place and the policy changes are not implemented, the Bank lending to Yugoslavia would be adversely affected, and a lower lending level would become unavoidable (Annex Table 3-A).

V. Action Program and Monitoring

1986-88 Action Program

57. To improve the resource allocation system, which is the key underlying factor behind the resumption of sound growth, Yugoslavia needs to implement major reform measures. In the past, initiation and implementation of reforms have faced long delays. To be most effective, Yugoslavia needs to implement economic policies and reform measures at a much faster pace in the next two years in order to be able to resume growth and improve the incentive and resource allocation systems.

58. The Government has developed a new price liberalization policy, which has been in effect since January 1985. The thrust of the new policy will need to be maintained; resort to administrative controls to combat inflation would be detrimental. The Government's commitment to continued adjustment of the presently administered prices, namely, petroleum and petroleum products, gas, electricity, coal and lignite, as well as railway tariffs and road user charges, would ensure that increases in these prices reach parity with opportunity costs. The Government should also unify the system of floor lending rates and adjust them so they reach positive levels by 1987.

59. In the area of the allocation of foreign exchange, the Government should establish a market-based allocation system not later than 1987. During the same period, it should shift commodities out of the restricted import categories into the free import category in parallel with a managed float of the exchange rate. The reclassification of imports should lead to a decline in the share of the value of imports under quotas and licenses from more than 50 percent of total imports to 15 percent within two years.

60. In the area of financial discipline, the measures adopted since the end of 1984 should be consolidated and extended. Until recently, loss-making enterprises in Yugoslavia could avoid or delay sanctions for bad decisions through default on payments due to banks and other firms and through reliance on financial assistance from the community through the use of the Joint Reserve Funds (JRFs). The law on Reserve Funds was amended in December 1984 to limit, and after 1987 prohibit, the use of JRFs for loss coverage under the guise of enterprise rehabilitation. The law on payments amended at the end of 1984 prevents enterprises defaulting on their obligations from increasing the personal income of workers at rates above the average increase in the economic sector of the region in which they operate. In addition, an amendment to the law on rehabilitation (January 1985) stipulates mandatory bankrupcy proceedings against loss-making enterprises. Another measure has been improvements in the accounting framework that should provide a better indication of an enterprises' true financial situation. Similarly, the more effective supervision of the banks by the National Bank of Yugoslavia and the Social Accounting Service would improve the efficiency of the banking system credit allocation among enterprises.

61. To improve the efficiency of investment allocation and avoid duplication of capacities, the Government should implement appropriate Joint Development Programs (JDP) in the infrastructure sectors, in line with least-cost investment programs. To improve the process of investment selection, the Government should focus on implementation of the recently approved minimum uniform criteria for the selection of investment. The application of appropriate interest rates and prices should also improve the allocation of investment resources. A summary of the annual action program for 1986-90 is presented in the attached policy matrix.

World Bank Support

62. To support Yugoslavia in initiating and implementing the policy reforms, the Bank has included Structural Adjustment Loans (SALs) in its lending program. The first SAL in 1983 supported Yugoslavia's effort to establish the foundation for a more efficient pattern of growth. It supported the recommendations of the Long Term Program of Economic Stabilization in four economy-wide areas: (i) price policies; (ii) foreign exchange allocation and external trade policies; (iii) enterprise decision-making and financial discipline; and (iv) investment planning.

63. Under Scenario B the Bank would proceed in appraising a possible second SAL to Yugoslavia. The objective of this second SAL would be to consolidate and extend policy changes and reforms that will further promote the restructuring of production and demand patterns so as to allow the resumption of sustainable growth, the alleviation of the debt service burden and a slowdown in inflation. Within the context of an agreed medium-term macroeconomic framework and the more comprehensive program of reforms of the Government, the second SAL would support measures aimed at:

(i) Promoting greater reliance on market forces to determine prices and closing the gap between prices and opportunity costs wherever needed;

(ii) Establishing a market-based mechanism for the allocation of foreign exchange and reforming the foreign trade regime;

(iii) Ensuring a stricter enforcement of budget constraints including the rehabilitation of ailing business and, where necessary, closing them down; and

(iv) Strengthening the processes of investment allocation and selection so as to minimize inefficiencies.

64. If the implementation of reforms and adjustment measures continues, the Bank's future lending program would be heavily based on SALs and sector loans. The proposed program is currently under review in the context of the Country Assistance Strategy Brief. Should the Government pursue adjustment policies firmly, we would support it through expanding our policy-based lending. The possibilities include support for the removal of the distortions in the financial market and improvements in fiscal incentives (SAL III), and support for improved mobility of the factors of production and elimination of the regional barriers to trade (SAL IV). Concurrent with the SAL lending, the Bank would support financial and industrial sector restructuring, energy conservation, and reform of investment planning through sectoral and subsectoral lending. SAL and sector-type lending, however, require a strong commitment on the part of the Government to engage regularly with the Bank in substantive dialogue on macroeconomic and sectoral issues and to continue a program of reforming the economy. At the present time, this commitment does not exist. While we will continue to work with the Government in establishing such a commitment, there is a risk that it will not materialize.

65. Under enhanced monitoring arrangements requested by Yugoslavia and recently approved by the IMF Board, IMF will monitor macroeconomic parameters and short-run developments closely, within the framework of a viable macroeconomic program. Through this monitoring, it should be possible to identify needed adjustments in policies and in the medium-term macro framework. In addition, under the proposed second SAL, the Bank would review with the Government economic developments at the macro and sectoral levels semi-annually in order to assess the suitability of the policy framework.

Annex Table 1

Yugoslavia: Summary of Key Macroeconomic Aggregates, 1978-85

	1978	1979	1980	1981	1982	1983	1984	1985 [1]
GSP Growth rate (% p.a.)	6.9	7.0	2.3	1.4	0.5	-1.3	2.0	0.5
Debt to Exports of G&S Ratio (%) [2]	99.2	104.4	105.8	115.8	131.2	139.4	131.5	130.0
Debt to GSP Ratio (%)	23.5	24.7	30.4	31.5	34.4	46.9	48.4	48.2
Interest Payments to Exports Ratio (%)	4.3	5.7	7.1	11.6	13.4	11.5	12.2	12.0
Interest Payments to GSP Ratio (%)	1.0	1.3	2.0	3.1	3.5	3.9	4.5	4.5
Debt Service Ratio	17.7	17.8	18.5	23.4	26.3	30.8	33.7	34.3 [3]
Convertible Debt Service Ratio (%)	18.0	19.3	21.9	31.0	35.3	40.0	41.7	43.0 [3]
Terms of Trade, 1982=100	100.9	97.3	96.6	94.9	100.0	98.0	90.3	86.7
Export Growth Rate (% p.a.)	1.4	1.6	10.9	-.4	-11.2	1.4	10.1	8.2
Import Growth Rate (% p.a.)	-1.3	18.0	-10.5	-12.3	-13.5	-5.5	-0.4	1.2
Current Account Balance ($mn) [4]	(1,283)	(3,661)	(2,291)	(946)	(624)	211	439	797
With Convertible Areas ($mn) [4]	(1,272)	(3,304)	(2,203)	(1,821)	(1,602)	246	800	370
Interest Payments ($mn)	495	821	1,281	1,987	2,049	1,688	1,854	1,896

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[1] Preliminary estimates.

[2] Exports of goods and services include net remittances.

[3] Before rescheduling.

[4] Figures in brackets are deficits.

Annex Table 2-A [1]

Yugoslavia - Projections of Key Variables, 1986-95, Scenario A

(percentages and US dollars)

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
GSP Growth Rate	2.3	2.7	2.8	2.8	2.8	2.3	2.3	2.8	2.3	1.8
GSP/Capita Growth Rate	1.4	1.8	1.9	1.9	1.9	1.5	1.5	1.9	1.5	1.0
Consumption per Capita Growth Rate	1.5	3.0	2.2	2.5	2.3	2.3	2.2	2.4	1.9	1.1
Total Debt Outstanding and Disbursed (billions of dollars)	19.7	19.3	18.8	18.4	18.0	18.0	18.0	18.0	18.0	18.0
Debt/Exports (percent)	139	128	116	104	94	88	82	75	70	65
Debt/GSP (percent)	47.6	40.1	35.4	31.4	27.8	25.0	23.0	21.1	19.4	18.0
Debt Service (percent)	31.7	28.5	29.0	31.4	28.4	25.9	23.7	23.1	23.1	21.2
Convertible Debt/Service (percent)	39.2	34.1	35.1	38.9	35.2	32.7	29.7	29.1	29.3	26.9
Interest/Exports	11.5	10.8	9.6	8.7	7.2	6.4	5.9	5.5	5.0	4.7
Interest Payment/GSP (percent)	5.0	4.2	3.7	3.3	2.6	2.3	2.1	1.9	1.7	1.6
Gross Investment/GSP	32.7	33.0	33.7	33.9	34.1	34.7	34.7	34.8	34.7	34.7
Domestic Saving/GSP	36.8	36.8	37.0	36.7	36.7	36.5	36.2	36.1	35.9	35.8
Marginal Savings Rate	37.0	37.3	36.0	36.5	34.8	32.9	35.0	34.2	34.7	35.8
National Saving/GSP	35.2	35.2	35.2	35.2	35.2	35.2	35.2	35.2	35.1	35.1
[illegible] [2]	7.3	7.7	8.2	8.2	8.7	9.2				
Export Growth Rate	2.2	2.0	2.5	2.7	2.8	0.7	1.9	2.9	2.3	2.1
Exports/GSP	34.4	31.4	30.6	30.3	29.7	28.4	28.1	28.3	27.9	27.6
Import Growth Rate	.3	6.4	4.2	4.3	3.7	3.6	3.2	3.3	2.7	1.6
Imports/GSP	32.0	29.3	29.1	29.1	28.4	27.8	27.6	28.0	27.4	27.2
Current Account (US$)	838	798	798	753	753	350	350	350	350	350
Terms of Trade Index										

1/ The exchange rate used for projections is based on the 1984 exchange rate of $1 = 152.8.

2/ Five year averages.

Annex Table 2-B [1]

Yugoslavia - Projections of Key Variables, 1986-95, Scenario B
(percentages and US dollars)

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
GSP Growth Rate	2.3	2.7	4.9	4.1	4.7	4.4	3.6	4.4	3.9	4.2
GSP/Capita Growth Rate	1.4	1.8	4.0	3.2	3.8	3.5	2.8	3.6	3.1	3.4
Consumption per Capita Growth Rate	1.5	3.0	4.5	2.5	3.9	3.8	4.1	3.7	3.1	3.2
Total Debt Outstanding and Disbursed (Billions of Dollars)	20.1	20.1	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0
Debt/Exports (percent)	141	132	120	105	93	84	77	68	61	54
Debt/GSP (percent)	48.0	41.8	36.8	33.3	29.7	25.1	21.8	18.5	16.5	14.7
Debt Service (percent)	31.7	28.5	27.5	29.6	26.9	23.3	21.5	20.3	19.5	17.0
Convertible Debt/Service (percent)	39.2	34.1	34.1	37.4	34.0	29.8	27.1	25.8	24.9	21.7
Interest/Exports12.1	12.1	10.8	9.3	8.2	6.8	5.5	5.1	4.8	4.2	3.7
Interest Payment/GSP (percent)	5.0	4.2	3.5	3.1	2.8	2.1	1.8	1.5	1.4	1.2
Gross Investment/GSP	32.7	33.0	34.6	34.9	35.0	35.3	35.2	34.4	33.9	33.5
Domestic Saving/GSP	36.8	36.8	36.9	36.8	36.6	36.4	35.2	34.7	34.4	34.2
Marginal Savings Rate	37.0	36.9	36.5	35.3	34.9	28.5	31.9	32.4	33.3	34.2
National Saving/GSP	35.2	35.2	35.2	35.4	35.5	35.2	34.4	34.0	33.5	33.5
ICOR [2]	5.1	4.9	5.5	5.6	5.9	6.1				
Export Growth Rate	2.2	2.0	5.3	7.1	6.6	5.7	2.8	7.0	6.7	7.0
Exports/GSP	34.0	31.4	30.8	31.8	32.1	29.8	28.1	27.0	27.2	27.4
Import Growth Rate	0.3	6.4	10.9	7.1	9.0	7.2	6.8	6.2	6.2	6.0
Imports/GSP	31.6	29.3	30.0	31.2	31.5	29.8	29.0	27.5	27.6	27.4
Current Account (US$)	838	798	350	300	300	33	-720	-480	-558	10
Terms of Trade Index	1.05	1.09	1.09	1.09	1.09	1.09	1.09	1.09	1.09	1.09

[1] The exchange rate used for projections is based on the 1984 exchange rate of $1 = 152.8.
[2] Five year averages.

Annex Table 3-A

Yugoslavia: Financing Requirements and Sources
Scenario A

Year	1986	1987	1988	1989	1990	1995
World Bank						
Commitments	200	200	200	200	200	200
Disbursements	306	313	318	250	234	122
Amortizations	188	256	304	352	360	350
Net Flows	118	57	14	-102	-126	-228
DOD	2,176	2,233	2,246	2,144	2,018	1,147
IMF						
Commitments	0	0	0	0	0	0
Disbursements	142					
Amortizations	363	368	354	452	260	0
Net Flows	-221	-368	-354	-452	-260	0
DOD	1,679	1,311	957	505	245	
Other Multilateral						
Commitments	175	175	175	175	175	100
Disbursements	236	225	216	208	175	44
Amortizations	256	236	211	127	175	131
Net Flows	-20	-11	5	81	0	-87
DOD	372	361	366	447	446	51
Bilateral 1/						
Commitments	574	456	390			
Disbursements	574	456	390			
Amortizations	1,187	987	824	619	754	199
Net Flows	-613	-531	-434	-619	-754	-199
DOD	4,755	4,224	3,790	3,171	2,417	247
Commercial Banks 2/						
Commitments	864	780	466			
Disbursements	864	780	466			
Amortizations	1,742	1,353	1,168	954	754	459
Net Flows	-878	-573	-702	-954	-754	-459
DOD	6,078	5,505	4,803	3,849	3,095	546
New Credits on Commercial Terms 3/						
Commitments	1,167	991	1,596	2,578	2,496	3,516
Disbursements	1,215	1,026	1,475	2,382	2,512	3,726
Amortizations			403	736	1,019	2,753
Net Flows	1,215	1,026	,1072	1,646	1,493	973
DOD	2,342	3,368	4,440	6,086	7,580	13,809
Total Convertible MLT						
Commitments	2,980	2,602	2,827	2,953	2,871	3,816
Disbursements Rescheduling	1,899	1,564	2,009			
Disbursements Refinancing	3,337	2,800	2,865	2,840	2,921	3,892
Amortizations Rescheduling	2,298	1,964	2,408			
Amortizations Refinancing	3,736	3,200	3,264	3,240	3,322	3,892
Net Flows	-399	-400	-399	-400	-401	
DOD	17,401	17,001	16,601	16,201	15,801	15,800

1/ Bilateral debt contracted prior to 12/2/82.
2/ Debt contracted prior to 1/17/83.
3/ From commercial banks and bilateral sources.

Annex Table 3-B

Yugoslavia: Financing Requirements and Sources
Scenario B

Year	1986	1987	1988	1989	1990	1995
World Bank						
Commitments	300	550	450	450	375	200
Disbursements	309	572	553	473	450	280
Amortizations	188	256	304	360	397	472
Net Flows	121	316	249	113	53	-192
DOD	2,179	2,495	2,743	2,856	2,909	2,152
IMF						
Commitments	0	0	0	0	0	0
Disbursements	142					
Amortizations	363	368	354	452	260	0
Net Flows	-221	-368	-354	-452	-260	0
DOD	1,679	1,311	957	505	245	0
Other Multilateral						
Commitments	175	175	175	175	175	100
Disbursements	236	225	216	208	175	44
Amortizations	256	236	211	127	175	131
Net Flows	-20	-11	5	81	0	-87
DOD	372	361	366	447	446	51
Bilateral 1/						
Commitments	574	456	390			
Disbursements	574	456	390			
Amortizations	1,187	987	824	619	754	199
Net Flows	-613	-531	-434	-619	-754	-199
DOD	4,755	4,224	3,790	3,171	2,417	247
Commercial Banks 2/						
Commitments	864	780	466			
Disbursements	864	780	466			
Amortizations	1,742	1,353	1,168	954	754	459
Net Flows	-878	-573	-702	-954	-754	-459
DOD	6,078	5,505	4,803	3,849	3,095	546
New Credits on Commercial Terms 3/						
Commitments	1,663	1,044	1,788	2,940	2,834	3,801
Disbursements	1,611	1,168	1,639	2,710	2,890	3,959
Amortizations			403	877	1,176	3,022
Net Flows	1,611	1,168	1,236	1,833	1,714	937
DOD	2,739	3,906	5,143	6,975	8,689	14,805
Total Convertible MLT						
Commitments	3,576	3,005	3,269	3,565	3,384	4,101
Disbursements Rescheduling	2,298	1,965	2,408			
Disbursements Refinancing	3,736	3,201	3,264	3,391	3,515	4,283
Amortizations Rescheduling	2,298	1,968	2,403			
Amortizations Refinancing	3,376	3,200	3,264	3,389	3,516	4,283
Net Flows	0	1	0	2	-1	
DOD	17,801	17,801	17,801	17,801	17,801	17,801

1/ Bilateral debt contracted prior to 12/2/82.
2/ Debt contracted prior to 1/17/83.
3/ From commercial banks and bilateral sources.

Sectoral Issues

INDUSTRY

ANALYSIS

The problems of industry are rooted in the static nature of policies and the structure of the economy and the sector. There are major macro-policy difficulties with prices, trade, foreign exchange rate and allocation, investment decision-making and financial discipline. Economic policy has been inward-looking; demand and external competition do not determine production costs and prices; a protectionist trade policy encourages import sustitution and has caused a technological gap; the fixed exchange rate does not reflect increasing scarcity; and foreign exchange, because it is administratively allocated, offers no incentive to ration or substitute.

Investment decisions are negotiated among the Republics and Autonomous Provinces (RAPs), and market mechanisms do not play a role. The choice of import substitution industrialization, supported by protectionism, liberal financing, the absence of financial discipline and the lack of competition (domestic or international) have led to rigidity, high-cost output and a reliance on Government subventions.

Regional and federal priorities vary, but in the area of investment, neither is binding on enterprises; investment in priorities instead is induced by the allocation of credit. The allocation of foreign exchange has favored its earners and large-scale priority investments, while non-earners pay informal premia or do without. Banks, because they must guarantee credits for investment, could play a role in rationalizing investment, but they are owned by the enterprises. Underpriced foreign exchange has induced over-borrowing by firms, often sanctioned by the banking system, based on illusory prospects for exports. If repayment out of earnings is not possible, firms can resort the the solidarity funds, without having to undertake financial restructuring.

POLICY RECOMMENDATIONS

The economy needs to be realigned to reflect changes in domestic and external resources and product markets. At the same time, automatic economic and financial mechanisms that permit continuous adjustment, promote efficiency and reduce resource misallocation are needed. The partial adjustments undertaken in price policy, exchange rate policy, investment decision-making and financial discipline need to be carried further and to be accompanied by the liberalization of the foreign exchange market and trade policy. As competition and comparative advantage become more evident, these macro-policy changes will point to new directions for industry. In turn, these will require changes in the scale, location and scope of industry to rationalize the existing sector and promote efficient development.

The Bank should support the needed adjustment and future directions through sectoral and subsectoral lending, including support for an upgrading of the incentive framework, and through broad-based input services (technical, marketing and managerial advisory services). It should do so at a national level. Adjustment should take place in the context of macro-policy changes, although in priority areas such as lending for export industries, particularly for those with performance records, the Bank may undertake some identification work for project and sector improvement issues. Decisions on whether to carry out substantial work toward operations could be taken in the light of our macro dialogue with Yugoslavia.

Even without progress at the macro level, lending for energy conservation and technology development is possible. It may also be possible to consider loans for selected subsectors.

EXPECTED RESULTS

These policy changes, along with rationalization and redirection of industrial subsectors, will allow industry to improve its performance and enhance national economic growth. Specific benefits will be higher operating and financial efficiency, important cost reductions, increased competitiveness, and gains from increased specialization and trade.

ENERGY

ANALYSIS

The energy sector faces a number of problems:

- Rivalry and poor coordination among the Republics and Autonomous Provinces (RAPs) have led to a misallocation of investment, irrational siting of facilities, and an absence of national energy planning, programming and cooperation.

- Pricing distortions have encouraged the use of more costly gas and the underuse of cheaper domestic resources, inattention to conservation, and investment in otherwise financially unviable projects.

- The financial systems and controls of institutions in the energy sector need improvement, along with greater maintenance and operating efficiency, and the federal institutions need greater autonomy and effective leadership.

Despite these and other formidable problems, there has been some coordination: a national electric power transmission system, the beginnings of a national dispatch system, agreements to develop the hydroelectric resources of the Drina basin, an incipient joint power investment plan, and freer inter-RAP operations by oil companies.

POLICY RECOMMENDATIONS

Specific policy actions that need to be taken are:

- Immediate increases in the prices of electricity, domestic natural gas, and coal and lignite, as part of a longer term adjustment of energy prices to economic levels;

- Closer coordination of RAP power and coal investments through a Joint Development Plan and the interconnection of regional gas transmission networks, plus implementation of nationally important projects (the Drina basin hydroelectric and Kosovo lignite resources);

- A program to conserve energy and to encourage use of lower cost fuels;

- Strengthening of sector institutions, particularly through better management information systems, training, maintenance and operating efficiency and modern management techniques.

- Increasing energy prices to economic levels in order to rationalize consumption, along with complementary policies of consumer information and other incentives and greater financial discipline.

These adjustments are closely linked to the implementation of other reforms of the economic system, particularly relating to real interest rates and foreign exchange. Agreement on rational Joint Development Plans will depend on compensation of the RAPs and enterprises for the opportunity costs in terms of foreign exchange of energy traded within Yugoslavia. Without financial discipline, higher energy prices will restrain energy demand, investment and imports will be reduced, and energy enterprises will lack incentives for effective investment and operations.

EXPECTED RESULTS

The policy recommendations of the Bank will: benefit overall macroeconomic objectives, especially the efficiency of investment (incremental capital output ratio), reduce imports, promote regional economic integration, and improve resource allocation on the basis of pricing.

AGRICULTURE

ANALYSIS

The agriculture sectors faces structural problems and an adverse policy environment. The sector consists of both social and individual holdings. While the latter, a heterogeneous grouping, dominate, the priority in the allocation of fixed investment, inputs and credit is the social sector, followed by associated farmers and finally those with no production/marketing links to the social sector. The individual sector has been constrained by the resultant inadequate access to inputs, particularly research and extension services, as well as by a ceiling of 10 hectares for land ownership and virtual absence of a land rental market. For its part, the social sector consists of agro-industrial kombinat, which integrate primary production, processing and marketing. These enterprises are inefficient, lack adequate managerial and technical staff, have accumulated arrears with the banks, and are capitalized with only a limited equity base. Moreover, the vertical integration, designed to achieve regional self-sufficiency, combined with the regional segmentation of markets, hs resulted in redundant processing capacity.

Another structural problem is the Yugoslav banks. They cannot act as independent financial institutions and often are unable to screen projects properly. Some are financially weak in light of the number of overdue loans in their portfolios and their low equity.

Resource misallocation has been the result in part of long-term pricing policies and negative real interest rates. The compensation payments to processors, as well as the premiums and export subsidies, all necessitated by the price distortions and positive protection, have been very costly.

Finally, agricultural exports have been unstable, in part because of export marketing strategies, high domestic prices and absence of export incentives.

POLICY RECOMMENDATIONS

Policy measures should include:

(a) Freeing up input supply arrangements,, particularly research and extension services to individual farmers;

(b) Instituting a land-rental market and a relaxation of the limits on the size of land holdings;

(c) Improving the efficiency in the social sector, particularly by strengthening managerial information systems and developing standards and performance guidelines;

(d) Traning bank staff and improving managerial information systems including portfolio reviews, along with thorough review of the financial sector;

(e) Bringing domestic prices into line with border prices; and

(f) Developing long-term export marketing strategies and evaluating Yugoslavia's comparative advantage in the production of import substitutes.

EXPECTED RESULTS

Implementation of these recommendations would correct some policy distortions and reduce structural rigidities. More specifically: (i) untapped potential would be better utilized; (ii) efficiency would be improved; (iii) regional specialization and an optimal crop/product mix would be encouraged; and (iv) the role of the sector in balance of payments support would be increased.

TRANSPORT

ANALYSIS

In addition to providing the backbone to the Yugoslav economy, the primary transport network provides an outlet for export commodities as well as serving a growing demand for international transit traffic. Continued investments are required in the transport sector to alleviate bottlenecks in the main road and rail networks, and rehabilitate existing infrastructure. However, at a time when there have been severe cuts in expenditures for modernization and rehabilitation of the road network, investment in the railway system has continued. While the railways have enjoyed regular real term increases in tariffs, there has been a lag in adjusting road user charges and a major reduction in the available funds for roads. Clearly, a more balanced development of both road and rail transport is required. Decentralization of operations in the transport sector hamper coordinated development, as well as the provision of rational and cost-effective transport services.

POLICY RECOMMENDATIONS

The specific policy objectives which are being pursued by the Bank include: (i) the planning and implementation of balanced investment programs; (ii) stronger inter-regional coordination, particularly through better technical integration in the railways; (iii) improved operational efficiency in the sector, including highway maintenance, as well as operations in railways and ports; and (iv) a sound pricing and fiscal policy, including cost-based railway tariffs and regular adjustments in road user charges.

A sector-lending approach would be the appropriate instrument for tackling sector issues This type of lending is being pursued under recent operations in both highways and railways, where we have a broad base for continuing with a sector approach. This approach would also enable us to address the inter-regional issues.

EXPECTED RESULTS

Because of the political framework, the sector lending approach generally only provides partial coverage of the sector and there is a need for a more comprehensive overview of developments in transport at the national level. As such, a proposed review of the 1986-90 Transport Investment Program under SAL II would provide the necessary sectoral background, including the broad, general conditions on investment and the longer-term implications of pricing and fiscal policy. Such a strategy should enable the Yugoslav authorities to upgrade the efficiency of the transport system and ensure an appropriate balance of investment among transport modes to provide adequate support for renewed economic growth and the development of foreign trade.

WATER SUPPLY AND SEWERAGE

ANALYSIS

About 69 percent of the population of Yugoslavia has access to a piped water supply, and only 59 percent live in a dwelling unit connected to a waterborne sewage system. Where water service levels are high in the major urban areas, supplies are intermittent and low water pressures are common. Shortages in the major industrial areas such as Belgrade, have led to factory closings and slowing down new construction. Untreated discharges have caused pollution of domestic water supply sources.

The primary responsibility for the sector rests at the local level through locally established water supply and sewerage enterprises. Little is done to properly analyze new projects and establish priorities at the Republic level, and no planning takes place at the Federal level. Lack of adequate financing is a major constraint to improved service levels and pollution control. Communes wishing to improve their systems have no source from which they can obtain long term loans at reasonable interest rates.

POLICY RECOMMENDATIONS

It is recommended that the following actions be taken at the Republic and Federal levels:

(a) Assess sector needs regularly;

(b) Set realistic goals for the sector, taking into account the results of the needs survey and the availability of resources.

(c) Establish a mechanism by which communes can borrow funds for capital improvements for projects which conform to federal and republic goals;

(d) Establish a priority system for the allocation of funds to the sector; and

(e) Establish conditions for borrowing federal funds and institute a monitoring and enforcement mechanism.

EXPECTED RESULTS

In the long term, the following results could be expected from the above actions:

(a) improved water service in urban areas;

(b) increased productivity in areas where inadequate water supplies constitute a development constraint;

(c) lower health care costs;

(d) financial self-sufficiency of the sector.

Yugoslavia: Policy Matrix and Five Year Action Program

Area	Policy Objectives	Actions Taken by the Government	Further Measures Recommended	Proposed Timing 86	87	88	89	90
A. Macroeconomic Framework	Growth with sustainable macroeconomic balance.	Public Sector Budget in surplus and surplus in Current Account of the Balance of Payments.	Monitoring of macroeconomic performance agreement on medium-term plan. Enhanced IMF monitoring. Continuation of cautious macroeconomic policies allowing sustainable macro balances; implementation of reform measures to improve resource allocation.	X	X	X	X	X
B. Price Policy	More efficient resource allocation. Setting administered prices to reflect opportunity costs.	Most prices have been decontrolled since Jan. 1985. The administered prices have been periodically increased.	Closing the gap between administered prices and opportunity cost. Continued implementation of new price law limiting administrative interventions and price subsidies.	X	X	X	X	X
C. Foreign Exchange Allocation System	To establish a market-based mechanism for foreign exchange allocation and maintain international competitiveness.	Exchange rate was substantially devalued in real terms in 1982/84. Laws for improvement in the allocation system have been passed in Jan. 1986.	Introduction of a satisfactory market for foreign exchange which will lead to a free market for FX.	X	X	X	X	X
D. Foreign Trade	To liberalize imports.		Gradual reduction of quantitative restrictions in parallel with supporting exchange rate and tariff measures.	x	x	x		
E. Investment Allocation	To improve investment selection and coordination.	Social Compact on investment criteria was adopted by all parties concerned in Sept. 85.	Implementation of social compact and preparing operational guidelines.	X				
			Adoption of joint development programs containing least cost development approaches in major infrastructure sectors.	X	X			
	To ensure economic use of investible resources.	Periodic increases in interest rates.	Increase interest rates to positive real levels and unification of lending rate structure by 1987.	X	X			
	To monitor trends in investment pattern and identify problems.	Poor reporting.	Improve reporting format for monitoring progress in investment and identifying. problem areas.	X				

Area	Policy Objectives	Actions Taken by the Government	Further Measures Recommended	Proposed Timing 86	87	88	89	90
F. Financial Discipline	To reduce transfer of losses to other enterprises or communities.	Legislation has been adopted that restricts income of workers in firms that operate at a loss or default on payments and phases out the use of reserve funds to cover losses.	Implementation of the legislation and adoption of suitable monitoring system. Monitoring of arrears due to banks from enterprises and deferred foreign exchange losses strengthening the role of SDK in initiating bankrupcy proceedings.	X				
	To encourage prudent financial portfolio management by commercial banks.	Adoption of a new law on the basis of the Banking and Credit System.	To limit the share of single borrowers in the total loan portfolio of a bank and limit the share of any single member founder in the bank's equity.	X	X			
G. Financial Sector	To reduce distortions in the financial market and improve efficiency of financial intermediation.		Specific recommendations to be worked out after completion of the review of banks in connection with financial discipline.			X	X	X
H. Regional Development	To improve mobility of factors of production and eliminate the regional barriers to trade.		Specific measures to be worked out in connection with a study on regional development which is part of our FY88 economic and sector work program.				X	X

YUGOSLAVIA

SELECTED ANALYTICAL VARIABLES FOR ECONOMISTS AND MANAGERS

ATLAS PER CAPITA GNP (CUR) (1983) =2,570
POPULATION IN MILLIONS (1983) =22.800
LT DEBT OUTSTANDING AND DISBURSED IN MILLIONS (CUR)(1983) =17,010.15
BALANCE ON CURRENT ACCOUNT IN MILLIONS (1983) =275

	HISTORIC DATA		REFERENCE YEAR	RECENT DATA		EST. DATA		PROJ.DATA	
	1960-1973	1973-1980	1980	1981	1982	1983	1984	1985	1986
GROWTH OF GDP AGGREGATES (CONST)						GROWTH RATES			
1.GDP	5.96	6.33	68,055	1.40	0.50	-1.30	2.10	2.60	3.00
2. AGRICULTURE	3.29	1.79	7,423	2.78	7.41	-1.09	1.90	2.00	2.50
3. INDUSTRY	6.87	7.23	27,249	2.21	-1.50	-2.26	2.60	2.80	3.50
4.GDP OUTPUT DEFLATOR	12.69	18.08	100	41.31	28.45	36.87	58.00	62.21	35.56
5.IMPORTS GNFS (NAT. ACCTS.)	10.11	3.26	16,984	-10.80	-15.30	-5.60	4.80	1.30	3.10
6.EXPORTS GNFS (NAT. ACCTS.)	9.70	3.15	14,208	0.50	-11.50	-0.70	10.00	5.30	4.40
7.MERCHANDISE EXPORTS (1)	8.04	2.21	8,977	..	..	..	..	..	..
8.DOMESTIC ABSORPTION	5.87	6.25	70,831	-1.15	-0.08	-2.14	-1.91	1.11	2.79
9.INVESTMENT	4.74	7.93	23,787	-0.50	-1.30	-5.90	-4.70	2.60	4.20
10.PER CAP TOTAL CONSUMPTION	5.38	4.51	2,109	-2.22	-0.23	-0.93	-1.26	-0.25	1.45
11.POPULATION (MIL)	1.00	0.91	22	0.75	0.78	0.68	0.68	0.68	0.68
TRADE PRICE INDICATORS (1980=100)						INDICES			
12.TERMS OF TRADE OF AGR/IND	98.54	96.31	100.00	106.46	109.05	114.92	109.18	101.76	101.79
13.TERMS OF TRADE	102.14	100.20	100.00	96.88	97.44	97.30	94.41	83.55	81.15
14.TERMS OF TRADE (UNCTAD)	104.25	101.19	100.57	100.51	..	..	..	..	..
15.NOMINAL EFFECTIVE EXCHANGE RATE(2)	..	112.99	100.00	83.40	65.60	40.16	27.31	19.01	..
16.REAL EFFECTIVE EXCHANGE RATE(2)	..	105.04	100.00	104.88	99.58	77.09	75.93	74.44	..
INVESTMENT AND SAVINGS						RATIOS			
17.INVESTMENT/GDP (CURRENT)	30.5	34.6	35.0	35.8	33.3	31.1	29.2	32.5	33.2
18.INVESTMENT/GDP (CONSTANT)	34.4	34.4	35.0	34.3	33.7	32.1	30.0	30.0	30.3
19.DOMESTIC SAVINGS/GDP (CURRENT)	27.5	29.1	30.9	33.7	32.4	31.3	30.0	31.2	31.6
20.DOMESTIC SAVINGS/GDY (CONSTANT)	29.7	28.4	30.9	32.4	32.5	31.8	33.2	33.1	33.2
21.GROSS NAT. SAVINGS/GDP (CURRENT)	31.4	34.7	36.0	38.0	37.2	36.6	..	..	..
22.RESOURCE BALANCE/GDP (CONSTANT)	-3.9	-6.5	-4.1	-1.3	-0.3	0.6	1.6	2.3	2.6
23.MARG PROPENSITY TO SAVE (CONSTANT)	29.4	35.1	80.7	237.6	45.9	86.8	127.3	-1.5	40.9
24.TERMS OF TRADE ADJ./GDP (CONSTANT)	0.4	0.1	0.0	-0.6	-0.5	-0.5	-1.1	-3.3	-3.9
25.ICOR (CONSTANT)	5.8	5.4	15.4	23.2	57.9	-20.8	..	..	..

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	HISTORIC DATA		REFERENCE YEAR	RECENT DATA		EST. DATA		PROJ.DATA	
	1960-1973	1973-1980	1980	1981	1982	1983	1984	1985	1986
TRADE AND BALANCE OF PAYMENTS						RATIOS			
26.SHARE OF MANUF IN EXPORTS (CUR)(1)	59.2	70.4	73.2	82.9	82.0	80.8	81.4	81.4	82.2
27.IMPORT GDP ELASTICITY	1.7	0.5	-3.7	-7.7	-30.6	4.3	2.3	0.5	1.0
28.CUR ACCT BALANCE/GDP (CURRENT)(3)	-0.1	-2.7	-3.4	-1.4	-0.8	0.6	1.5	1.8	2.2
29.RESERVES IN MONTHS OF IMPORTS OF GOODS AND SERVICES(3)	1.6	2.0	1.5	1.3	1.0	1.2	1.2	1.8	1.9
DEBT INDICATORS (4)									
30.LT DEBT SERVICE TO EXPORTS RATIO	23.5	24.8	29.2	24.5	25.4	20.2	20.7	21.5	25.4
31.LT INT. SERVICE TO EXPORTS RATIO	4.3	7.1	12.0	12.2	12.2	11.5	11.8	13.3	12.5
32.LT DEBT SERVICE TO GNP RATIO	4.7	4.5	6.0	5.7	6.5	6.1	7.1	5.9	6.7
33.DOD. LT PUB DEBT AT VIR/ DOD. TOTAL LT PUB DEBT	5.4	10.6	24.1	35.4	37.2	59.4	..	..	..
34.NET TRANSFERS/TOTAL DISB	37.6	27.6	0.4	-41.4	-92.3	-8.7	-133.7	-299.6	-147.9
35.WORLD BANK DEBT/TOTAL LT DEBT	..	..	8.3	9.2	10.3	10.7	11.2	12.3	14.4
MONETARY INDICATORS (CURRENT)									
36.CHG IN CLMS GOV/GOV BUDGET BAL	..	..	..	..	160.9	..	..	..	..
37.CLMS GOV/CLMS PRIV SECT	7.4	7.8	5.9	5.1	4.3	3.1	2.1	..	..
38.MONEY SUPPLY/GDP	59.0	70.9	73.5	67.4	69.4	71.3	64.5	..	..
GOVERNMENT ACCT (CURRENT)									
39.DIRECT TAXES/GDP(5)	10.8	10.9	..	..	..	..	..	..	..
40.TOTAL REVENUE/GDP(5)	20.1	12.4	8.2	6.9	6.4	6.3	5.8	5.4	..
41.GOV. BUDGET BALANCE/GDP(5)	0.0	-1.0	-1.2	-0.1	0.1	0.0	0.0	0.0	..
42.PUBLIC/TOTAL CONSUMPTION	23.7	24.3	24.2	23.5	23.3	22.5	22.8	24.1	24.3

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NOTE: ALL REFERENCE YEAR VALUE DATA IN US$ 1980 MILLIONS, EXCEPT PER CAP TOTAL CONSUMPTION WHICH IS IN US$.

LEGEND: .. INDICATES NOT AVAILABLE
M INDICATES DATA IN MILLIONS

FOOTNOTES:
(1) SERIES STARTS IN 1962.
(2) US$/LOCAL CURRENCY. SERIES STARTS IN 1979. INCREASES INDICATE APPRECIATION; DECREASES INDICATE DEPRECIATION.
(3) SERIES STARTS IN 1965.
(4) SERIES STARTS IN 1970; DATA ARE BASED ON INFORMATION FROM THE NATIONAL BANK OF YUGOSLAVIA; FLOWS ARE NET OF RESCHEDULING TRANSACTIONS.
(5) SERIES STARTS IN 1970.

MANAGEMENT SUPPLEMENT
SAVEM TABLES
SELECTED DEBT INDICATORS
1975-1985

VUGOSLAVIA

	1975	1980	1981	1982	1983 /a	1984 /a	1985 /a
I. VALUES (in current US$, billions) /b							
1. Long-Term debt (LT)	5.82	16.34	16.12	16.27	17.01	17.00	16.70
2. Short-Term debt (ST)	..	2.05	2.31	1.81	1.14	1.04	1.04
3. Total Debt (DOD)	5.82	18.39	18.44	18.08	18.15	18.04	17.74
4. Interest (INT)	0.29	1.90	2.28	2.11	1.67	1.74	1.86
5. Amortization	1.15	2.38	1.93	2.03	1.41	1.24	1.10
6. XGS, (nominal)	6.17	13.81	15.75	15.36	13.22	13.88	13.33
II. RATIOS (percent)							
7. DOD/XGS	94.3	133.2	117.0	117.7	137.3	130.0	133.1
8. TDS/XGS	23.4	31.0	26.7	26.9	23.3	21.5	22.2
9. INT/XGS	4.7	13.7	14.4	13.7	12.6	12.5	14.0
III. GROWTH RATES (nominal)							
10. DOD (% change)	18.2	18.4	0.2	-1.9	0.4	-0.6	-1.7
IV. VULNERABILITY COEFFICIENTS							
11. VIR/DOD (%)	63.2	81.1	81.7	80.4	79.7	77.1	77.5
12. Concessional/DOD (%)	12.8	6.9	6.6	6.8	6.3	6.7	6.8
13. Preferred Creditors/DOD (%)	9.7	7.7	8.3	9.6	10.2	12.7	12.6
14. Average Cost of Funds (%)	5.4	11.2	12.4	11.5	9.2	9.6	10.4
15. ST/DOD (%)	..	11.1	12.5	10.0	6.3	5.8	5.9
16. Average Maturity (yrs)	15.1	8.0	10.3	8.7	10.2	10.3	11.3
Memorandum Item:							
Use of IMF Credit (in US$, millions)	181.7	760.3	1251.8	1754.3	2067.9	1946.6	..
Service Charges:			347.9	185.6	365.9	498.9	521.0
(Repurchases)			266.1	43.3	180.8	276.1	315.8
(Charges)			81.8	142.3	185.1	222.8	205.2

a. Net of rescheduling transactions.
b. All debt data preliminary based on information from the National Bank of Yugoslavia.

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

Files
3/31

DATE March 31, 1986

TO Files

FROM Martin Schrenk, CPD

EXTENSION 61521

SUBJECT Yugoslavia: Baker Paper

Attached are notes on issues which I found worth addressing in the present draft. I conveyed them to the Region.

Attachment.

cc: V. Dubey
B. Kavalsky
Y. Huang
S. El Serafy

P 1866

COMMENTS

General: Paper obviously written in an attempt to adhere to a rigorous size constraint which makes it very difficult to draft effectively. But paper makes inefficient use of size constraint by sometimes wordy and often redundant normative statements (which are pretty the same as for any other country, and of which the audience does not need to be persuaded) This uses up lots of space which would better have been used for analysis.

1. Political Will: Paper makes a very perceptive case for the political problems arising from excessive federalism, e.g particularly in paras 46-48, discussing the difficulties for Policy Reform. Much of this is constitutional. Yet, Introduction makes a general case of lack of political will, and refers to "carry out" rather than introduce reform measures. Unfortunately those bold generalizations are only in part factually correct, and the "lack of political will" argument may remain more in the minds of the audience than the carefully worded details which give a different message.

I suggest a more differentiated generalization. For example that some desirable measures requiring legal actions or parliamentary approval are stalemated in the constitutional framework which gives each single republic veto power. In these cases outside pressure is not only inappropriate, it is also likely to be counter-productive if they affect political feasibility of systemic changes. But there are other policy areas in which legislation is clear, but for which the political will is missing to implement. Examples of the former category are anythiing related to inter-regional policy issues, examples of the latter most measures aiming at financial discipline, and the integrated investment programs for priorities are cases in point.

2. Structural Weakness and their causes: In para (1) the strutural weaknesses are summarized as "structure of production with little flexibility", and the same is repeated elsewhere. This does not tell anything me of substance. As Causes of this weakness are identified in the same para ER, protection, and price distortions. This seems to be another case of generalization which is much more sweeping than the more detailled anaysis tells us. For example in paras 29-30 a vivid account is given of the effects of financial indiscipline, and there this problem is called "the most important reform".

3. Inflation: I Very much agreee of argument of para (2) and elsewhere that inflation carries severe economic costs in Yugoslavia. But doubt whether the "easy credit and monetary policy" is helpful as an explanation. Again, this is a misleading generalization. Report"s description of problems of financial indiscipline gives some much more persuasive clues, for example that this subverts much of the effects of a C&M policy. Another important factor is the lag of a wage and cost drag, which leads to an almost immediate pass-through of increasing interest cost and ecchange rate devaluation into wages and domestic costs, as described in para (45)

4. Inventory accumulation: I find the figure of 20% of GSṖ in 85 hard to believe. That means much higher IA than fixed investment.

The assertion that this is result of "negative real interest rates and inflationary expectations" is not very helpful here and probably unsupported. IRs in 85 were much less negative than in early 80s (I heard in enterprise interviews that input stocks have now to be carefully planned because of steeply rising carrying costs), and it is far from certain that inflationary expectations any greater than before. What about slack demand as an explanation? A closer look at stocks - i.e. whether inputs of outputs, and by branch - will probably permit more solid argument.

5. Poor X-performance: Para (16) refers to "insufficient switch in the relative price of tradables and non-tradeables" as THE reason. If this is so, needs explanation. And than there is an oblique reference to an "inofficial export premium", meaning apparently the Retention Quotas. These DID have a positive impact on X, as paper acknowledges. But while an effective incentive, it is not an efficient one. This needed to be discussed as a major (if not THE reason for a better policy of FE allocation. Para (24) expresses some concern of the effect of abolishing RQs. It mentions that one can do without if ER were appropriately adjusted. But elsewhere we get the impression that the Dinar depreciation under the stewardship of the IMF during the last 3 years was OK.

6. Factor Mobility: Para (25) talks about mobility of Cap and Lab to counteract "widening regional disparities". This makes a fetish out of factor market forces. Mobility of labor OK on economic grounds, but there are powerful impediments through ethnic barriers. And Capital: if the productivity advantages of MDRs exceeds their wage advantages -- and there is plenty of evidence that this is exactly the case -- the unit labor cost in LDRs are higher, and the effect of capital mobility will be to suck out capital from poorer regions. We face a more general problem: while between countries a flexible ER can neutralize such differences, this does not happen within a country, in effect emasculating the "comparative advantage" argument. This causes serious policy problems in every country facing such a problem. And a remedy takes much more elaborate structural policies to cope with the problems than unrestrained factor movements driven by market forces. And political feasibility becomes a major problem here, which cannot be swept aside with technocratic arguments and reference to lacking "political will".

7. Investment Allocation: I have little to add except two points: (a) Yugoslavia is a case were we cannot ignore the contribution of IRs to inflation, given the colossal amount of existing debt; (b) it is nc clear what the strong condition of "positive real ER" implies under such circumstances. Maybe a positive rate would not clear the market.

8. Bank's Action Program: In para (64) reference to SAL III-IV:(I: financial markets and fiscal incentives; IV factor mobility and elimination of regional barriers.) Note: fiscal incentives and regiona

regional trade barriers do NOT have to wait that long, because no constitutional or systemic problems are involved. But other topics, such as inter-regional factor mobility and certain capital and labor marker features are probably unsuitable for SALs because of the extraordinary political and constitutional implications. And many solutions may simply not be politically feasible; efforts to try anyway are likely to be counter-productive. On the other hand, there is a clear case of a more aggressive dialogue on matters of regional development policy, focussing on more efficient and more inventive use of the large subsidies involved, and developing conditionalities from what in the dialogue arises as politically feasible action.

9. Modelling: I have -- as in most of these papers and many CPPs -- great difficulties to see how the policy assumptions of the two scenarios translate into specific assumptions going into the model. Perhaps one could draw up another kind of matrix, showing in the first colum the policy changes which make a difference in the model, in the second column identify the parameters affected, in the third line the parameter values of A, and in the fourth colum those of B. Obviously only those parameters which change would have to be presented.

N-623

March 24, 1986

Mr. Armeane Choksi, Division Chief, CPDTA

Roberto Fernandes, Division Chief, EM1DB

3-2440

Baker Initiative Country Study

Please find attached a draft copy of the Baker Initiative Country Study on Yugoslavia. We understand you will be arranging a working level review meeting to discuss this paper. We would be happy to attend that meeting.

cc: Messrs. Wapenhans; Lari, EM1DR; Hasan, EMNVP; Dubey, CPDDR; Picciotto, Dewey, Liebenthal, EMP; Harrison, EM1DR

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March 24, 1986
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YUGOSLAVIA: Baker Initiative Country Study

INTRODUCTION

To cope with the balance of payments deficit and rising external debt that emerged after the second oil price increase, Yugoslavia adopted stabilization policies, with the IMF's support, in the early 1980s. Those policies, combined with administrative allocation of foreign exchange, reduced the deficit and decelerated the increase in indebtedness. However, investment and growth have remained depressed, and inflation has become increasingly severe. Yugoslavia now needs to adopt policy measures at a much faster pace to resume growth and reduce inflation while continuing the orderly servicing of its external debt. This paper assesses the prospects for attaining these objectives and the amount and type of financial assistance Yugoslavia will need to do so.

Even without major policy reform, Yugoslavia would be able to achieve a low growth rate and gradually reduce its debt burden. It would have difficulty in attracting international financial support, however, and the slow pace of growth would put strains on the country's political and social fabric. With appropriate policy reforms, Yugoslavia could achieve significantly faster growth, have a better access to international financial markets, and manage its external debt with no major difficulty. Nevertheless, recent experience indicates that a rapid introduction and implementation of an appropriate package of policy reforms will be very difficult and depend heavily on the degree of political will within Yugoslavia to carry out such a program.

I. INITIAL CONDITIONS

1. The Yugoslav economy grew at an average annual rate of over 6 percent in the 1970s. However, this high growth rate was achieved at substantial cost. An overvalued exchange rate and a heavily protected domestic market together with distorted commodity and factor prices, created a structure of production with little flexibility and hindered the development of the sectors producing tradables.

2. These domestic rigidities, compounded by the oil price increases, disrupted the high growth of the Yugoslav economy in the late 1970s. While the rigidities distorted resource allocation, the second oil price increase precipitated a balance of payments crisis. Because of the inflexible production structure and inappropriate exchange rate policy, the economy was not able to counteract the external shock by stepping up exports. Moreover, instead of reducing domestic absorption to cushion the effects of the shock, Yugoslavia continued its investment drive: fixed capital formation remained roughly around 34 percent of GSP[1/] in the late 1970s. Finally, easy credit and monetary policy accelerated the rate of inflation to nearly 40 percent in 1980.

3. The second oil price increase contributed to a trade deficit of US $7.2 billion (11.7 percent of GSP) and a current account deficit of $3.7

[1/] Gross Social Product (GSP), is the basic Yugoslav concept for national income accounts. It is close to GDP, but excludes "non productive" activities such as administration, health, education, defense, banking, housing and culture. Our estimates indicate that GSP is about 10-12 percent smaller than GDP.

billion (6 percent of GSP) in 1979, financed through heavy external borrowing and a decline in foreign reserves of $1.3 billion. The external debt rose rapidly, doubling between 1978-81 to reach almost $20 billion. Consequently, the debt rose from 23.5 percent of GSP in 1978 to 31.5 percent in 1981. During the same period, the debt service ratio in convertible currencies increased from 18 percent to 31 percent.[1/] Similarly, the rates of debt to exports increased from 99 percent in 1978 to nearly 116 percent in 1981.

4. As the need for borrowing increased, greater reliance was put on commercial sources of funds, particularly short-term obligations. By 1980, close to 80 percent of new loans were being borrowed on commercial terms, and most of the loans had maturities of 2 to 3 years. The slowdown of the world economy, with its subsequent adverse effects on Yugoslav exports, and the increase in world interest rates, soon proved a heavy burden on the country's external finances.

5. The result of these various factors was that Yugoslavia became externally illiquid. By 1982, it could no longer service its debt on time, and by 1983 its convertible currency foreign exchange reserves could cover only one month of imports.

The Response

6. To deal with the crisis, the Yugoslav Government initiated stabilization and control measures in 1981 to restore domestic and external equilibrium. At the end of 1982, when these efforts proved insufficient to cope with the debt burden, Yugoslavia requested a debt relief arrangement from

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1/ The total debt service ratio increased from 17.7 percent to 23.4 percent.

its creditors. Meanwhile, a major reform of the framework of incentives was begun.

7. The main stabilization measures, supported by the IMF, were restrictive fiscal and monetary policies and more active use of the exchange rate. The share of public sector expenditures[1/] in GSP declined from 37 percent in 1980 to an estimated 32 percent in 1985. The budget of the consolidated public sector, which was running a deficit until 1980, yielded a surplus in subsequent years. The stringent fiscal policy was accompanied by a monetary policy that lowered ceilings on the net domestic assets of the banking system and raised interest rates. While nominal lending rates were adjusted, they remained highly negative, but the interest rates on term deposits moved closer to positive levels in real terms.[2/] By far the most important response was the adjustment in the exchange rate. Between September 1982 and June 1984, the real effective exchange rate was depreciated by 35 percent.[3/] Since July 1984, the nominal effective exchange rate has been adjusted regularly to keep the real effective exchange rate roughly constant.

8. In 1983, a major financial support package was put together to relieve Yugoslavia's debt burden under the umbrella of an IMF program. It consisted of $4.4 billion in medium- and long-term commitments and included refinancing by Governments and commercial banks. As part of this package, the World Bank provided a structural adjustment loan (SAL) of $275 million. Another financial package totalling $3.2 billion was put together for 1984 by the IMF, Governments and commercial banks. In 1985, Government creditors agreed to reschedule 90 percent of the original maturities for the year, and

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1/ Includes expenditures at all levels of government.

2/ The three-month time deposits are now 68 percent and will increase to more than 73 percent by April 1.

3/ The real effective exchange rate depreciated by 25 percent in 1983.

agreed to consider annual rescheduling of the debt after 1986, provided there exists a satisfactory arrangement between Yugoslavia and the IMF. Similarly, in 1985, Yugoslavia and the commercial banks reached an agreement for multi-year rescheduling arrangement to cover the original maturities falling due between 1985 and 1988. These maturities amounted to $5.7 billion ($3.6 billion of which is owed to commercial banks). The agreement is also dependent on enhanced monitoring by the IMF through 1991.

9. The Government also undertook other longer term policy reforms, in line with the objectives of the Long Term Program of Economic Stabilization adopted in July 1983 and supported by the Bank's first structural adjustment loan. Aimed at reforming the system of economic incentives, the reforms included adoption and revision of a number of laws and regulations governing the criteria for investment selection, price liberalization, financial discipline, planning, banking, joint ventures, fiscal policy, foreign credit, foreign trade, and the foreign exchange allocation system.

The Results

10. The current account deficit turned into a surplus in 1983. In 1985, that surplus was $0.8 billion (of which $370 million were in convertible currencies). However, export performance has been erratic (para 16). Moreover, because of the structure of the maturities, the burden of the external debt has remained large: debt service payments to convertible areas ran about 43 percent of convertible currency export earnings in 1985, a level that drops to about 27 percent when the rescheduled maturities are excluded.

11. The stabilization efforts have met with limited success in terms of economic performance. There are several reasons for this. The stabilization efforts have been unbalanced, focusing on the reduction of imports and fixed

investment. The actions have not constituted a timely, coordinated and mutually reinforcing package. The reduction of imports through administrative rationing of foreign exchange has circumvented the use of market incentives to channel resources toward the tradable sectors.

12. In the first half of the 1980s, the decline in domestic absorption was made possible by a substantial cut in fixed investment: gross fixed investment declined by about 8.5 percent in real terms between 1980 and 1985. The decline was faster, however, between 1983 and 1985. As a result, fixed investment, which was about 36 percent of GSP in 1979, dropped to about 23 percent of GSP in 1985. While most of the investments of the late 1970s were not based on efficiency considerations, available data suggest that the cutbacks have been across the board, instead of being directed at inefficient investments of the past.[1/]

13. The decline in fixed investment was associated with a substantial increase in inventory accumulation,[2/] the result in part of negative real interest rates and inflationary expectations caused by a succession of price freezes and liberalizations. It also reflects the ineffectiveness of the policies directed at reducing domestic absorption and the lack of tight budget constraints on enterprises.

1/ The sectoral composition of investment shows little change in the share of investment between 1979-83.

2/ Official estimates show inventory accumulation amounted to 20 percent of GSP in 1985 and has been a rising portion of GSP throughout the 1980s. There is considerable uncertainty attached to these estimates, and some evidence that they substantially overstate stockbuilding. If so, for the national accounts to remain consistent, either GSP was lower than estimated, or some other component of GSP, most likely consumption, was higher. The uncertainty here, on the order of 10-15 percent of GSP, calls for caution when providing recommendations for resource mobilization.

14. The slowdown in growth has been longer and more severe than expected. Since 1980, the annual rate of growth of GSP has averaged less than 1 percent a year in real terms (Annex Table 1). The inflationary pressure has persisted and even worsened, despite the reduction in domestic absorption. Inflation is estimated to have reached 80 percent in 1985. The restrictive monetary policy was not successful in controlling inflation, as it was not followed by timely implementation of hard budget constraints on loss-making enterprises. The tight credit policy was also overtaken by other forms of credit creation, particularly, inter-enterprise credit arrangements.

15. The significant increase in inflation and the slow growth in output have resulted in a substantial and extended decline in real wages--by June 1985, they were about one-third lower than in 1980. Over the same period, private consumption fell by about 1 percent annually.

16. Yugoslavia's export performance in the past five years has been erratic, despite the preferential access to credit and foreign exchange and the substantial depreciation of the real effective exchange rate vis-a-vis convertible currencies (para 7). On the whole, growth of exports to convertible areas in nominal terms has been about 3 percent since 1981. The reason for this poor performance has been an insufficient switch in the relative price of tradables and non-tradables. Some improvements in exports have taken place since 1984. This reflects in part the unofficial premium firms were able to realize on foreign exchange earnings under the previous foreign exchange allocation system that ended in 1985. This premium seems to have encouraged the expansion of exports, even those with low value added content. Nevertheless, Yugoslavia's share in the industrial country markets has not improved since the impact of the devaluation was felt in 1983.

17. As for the longer term policy reforms, they proceeded too slowly, except in the area of price liberalization. However, by January 1986, new regulations governing most of the areas of reform were partially in place, though in some cases the regulations appear inadequate or even counterproductive.

II. MEDIUM-TERM ECONOMIC PROSPECTS

18. Following the crisis of the early 1980s and the emergence of the adjustment problems in the economy, Yugoslavia is now planning for a period of recovery and sustained growth. This aspiration is reflected in the 1986-90 development plan, which aims at a growth rate in GSP of 4 percent a year. Resumption of growth is needed in order to avoid the grave social consequences of growing unemployment and the declining trend in real wages. However, the potential for sustained growth and substantial improvement in living standards will not be achieved in an environment marred by economic distortions and imbalances that cause inefficient resource use.

Constraints on Growth

19. Policies to address the economic distortions have been hampered by competing regional interests and a cumbersome decentralized decision making process in Yugoslavia. The effectiveness of policies in addressing the structural problems facing the economy has been impaired by a tendency to rely mainly on administrative measures instead of market forces to correct the imbalances. Economic policies and growth objectives have been over-ridden by strong regional interests and delays in action caused in reaching consensus. Moreover, the lack of coordination of investment activities among Republics

and Autonomous Provinces has prevented cost effective investments, limiting the scope for improved productivity and faster growth.

20. Resumption of growth is also constrained by the lack of external resources and a heavy debt service payment, which in turn exacerbate the depressed level of investment; slow export performance; and lack of mobility of capital and labor among regions. If these constraints are not reduced, recovery and a sustainable rate of growth of the economy will be difficult to achieve.

21. Even though Yugoslavia's foreign debt is not particularly large in comparison with many high debt countries,[1/] its high debt service burden has caused a deterioration in the standard of living and has eroded some of the gains of the development drive of the 1970s. Yugoslavia's debt service payments to the convertible currency countries in 1985 would have been about 43 percent of the export earnings from these areas in the absence of the rescheduling agreements. Total interest payments were about 5 percent of GSP. Interest payments to the convertible currencies were about 16 percent of the exports to those areas.

22. The maturity structure of the Yugoslav debt profile is especially unfavorable. Even after the recent rescheduling (para. 8), Yugoslavia will have to amortize 75 percent of its debt between 1986-90. Moreover, with the IMF financial program in Yugoslavia terminating this year, Yugoslavia will have to repay about 2.0 billion to the IMF by 1991.

1/ At the end of 1985, Yugoslavia's external debt was estimated to be about $20.2 billion, of which $18.8 billion was in convertible currencies. Of the total convertible currency debt, medium- or long-term (MLT) debt was about $17.8 billion, while short-term debt amounted to about $990 million.

23. The high level of debt service payments makes it necessary for Yugoslavia to maintain a large current account surplus. With so much of the country's foreign exchange earnings being pre-empted by the debt service payments, a shortage of foreign exchange has emerged which led to restriction of imports. The restriction of imports in turn has led to slowdown in investment and growth. It has also adversely affected exports which depend on imports and has further exacerbated the shortage of foreign exchange. Further curtailing of fixed investment to restrain domestic absorption will retard economic growth. It will also jeopardize the proper maintenance of existing capital stock and erode the competitiveness of industrial exports, as funds for restructuring and modernization of industry will not be available. However, to improve the efficiency, the increase in investment should be accompanied by improvements in the allocation of investment, as well as greater enforcement of financial discipline and use of market signals in determining prices.

24. Yugoslavia's export performance has been poor in recent years (para. 16). Resumption of growth must be led by exports. Promotion of exports requires an active exchange rate policy and a market-based allocation of foreign exchange. A new foreign exchange allocation system was introduced in January 1986, which has as its objective the eventual establishment of a foreign exchange market with a freely convertible Dinar. In its transitional phase, now being implemented, the system relies heavily on an administrative allocation of foreign exchange and import rights. While a common foreign exchange pool has been created through full surrender by exporters of the foreign exchange they earn, administrative interventions governing the use of the pool and import restrictions are continuing. As a result, it is not clear

how the transition toward the objective of a market with a convertible Dinar will be managed. However, the surrender requirement has eliminated the premium previously available to exporters and may, in the absence of appropriate exchange rate adjustments, reduce the incentive to export.

25. Productivity increases can not be achieved without increase in mobility of capital and labor. The uneven pace of development among regions has widened the disparities in income and the limited mobility of capital and labor has resulted in larger numbers of unemployed in the less developed areas. To resume a sustainable growth and reduce unemployment, the obstacles to the internal mobility of the factors of production among the regions should be removed. This objective could be approached by promoting joint ventures among the regions, broadening the scope of banking activity to include a wider allocation of financial resources through the banking system among regions, and encouraging labor mobility through wage and non-wage incentives.

Objectives of a Medium-Term Strategy

26. The objectives of a medium-term strategy are to (i) resume growth with sustainable macroeconomic balances; and (ii) reduce the debt service burden. Attaining these objectives requires both a system of economic incentives that ensures efficient resource allocation and prudent and well-coordinated macroeconomic policies which will reduce the rate of inflation.

27. More specifically, the medium-term strategy should aim at (i) increasing the rate of growth of exports, particularly to convertible currency areas, and improving the competitiveness of the economy through adopting an appropriate exchange rate policy; (ii) increasing per capita consumption in real terms; (iii) improving efficiency and maintaining a level of investment to support the growth objectives; (iv) liberalizing trade and maintaining a

prudent level of external reserves; and (v) improving the system of economic incentives, relying more on market signals to determine prices and allocate resources more efficiently.

28. The implication of this strategy is that Yugoslavia will need to implement major policy reforms in the system of resource allocation and use. These reforms will help the economy attain a cost-effective structure of production and pattern of demand that corresponds to its comparative advantage. Foremost among the reforms are: enforcement of financial discipline; liberalization of the trade and foreign exchange allocation systems; improvements in investment allocation; and greater reliance on market forces to determine prices. These reforms should be followed by further reforms in the areas of the financial sector, mobility of the factors of production and encouragement of small-scale private enterprise.

29. One of the most important reforms is to ensure greater financial discipline among social sector enterprises. Financial indiscipline has clear adverse effects on inflation, resource allocation and the balance of payments. A loose budget constraint enables social sector enterprises to pass losses on to others, a situation that discourages efficiency, fuels inflation and puts undue pressure on the balance of payments. Enterprises should be accountable for their losses. Enterprises that are not economically profitable should be restructured and, if need be, closed down. Financial assistance from other enterprises and the community to loss-making enterprises has been limited by recent legislation. This legislation needs to be implemented as planned so that all such assistance is eliminated by 1987 (except for enterprises that are being rehabilitated).

30. Financial indiscipline destabilizes the economy at the micro level, and there are few sanctions to combat it. Improved accounting procedures and

implementation of the regulations to restrict income payments to workers in firms that make losses should continue to receive high priority. Easy access of loss-making enterprises to overdraft facilities and bank credits should be replaced by a mechanism which applies financial and economic criteria. At the macro level, rescuing firms with chronic losses will only reduce the resources available to more efficient firms and/or transfer the losses to the banking system.

31. The past and present Yugoslav foreign exchange allocation systems are essentially based on quantity rationing. The previous system did not operate efficiently and prevented the emergence of a foreign exchange market. The objective of the new system, a market with a freely convertible Dinar, needs to be established as rapidly as possible on a predetermined schedule. Import restrictions need to be reduced on a parallel schedule. Quantitative restrictions could initially be replaced by tariff-like surcharges to avoid a destabilizing surge of imports. Gradually, these should also be reduced.

32. The allocation of investment and efficiency in use of investment resources are prime determinants of economic growth. The most important need of investment policy in Yugoslavia is to coordinate regional investment decisions in highly capital-intensive sectors and to ensure selection of projects that reflect economic and financial profitability. In this respect, adoption of Joint Development Plans for the infrastructure sectors based on least-cost criteria is an essential element in the coordination of large investment activities. The new Plan calls for JDPs in power, telecommunication and railways. To date none has been completed. At the same time, to encourage efficient allocation of investment and financial resources, it is essential to implement the recently approved uniform investment

criteria, establish a more appropriate cost for capital, and ensure that prices reflect opportunity cost. Interest rates, on both deposits and loans, must be raised to positive real levels to avoid severe macro instability as well as gross misallocation of resources.

33. Price controls distort resource allocation by influencing the relative profitability of production. Most prices in Yugoslavia have been liberalized. To increase the efficiency of resource allocation, the Government needs to continue to allow market forces to determine prices and should make adjustments to close the gap between administered prices and opportunity costs. This is especially the case for energy products and electricity.

Alternative Scenarios

34. The policy reforms and economic environment under which the objectives of stabilizing the economy, resuming growth and reducing the external debt burden can be achieved are examined here as two scenarios. In Scenario A, it is assumed that the Government undertakes no major policy changes. The transitional phase of the present foreign exchange regime (para. 24) remains. Domestic inflation would stay above world inflation and domestic prices for energy would lag behind their economic cost. In Scenario B, an auction-type system of foreign exchange allocation is assumed in 1988-91. The economy has free access to foreign borrowing at a managed exchange rate. The domestic and international inflation rate would converge around 1989 and energy prices are adjusted to reflect the opportunity cost. Under Scenario B, economic reforms would allow improved resource allocation, and the benefits of greater flexibility in responding to price signals. The model used for projections incorporates the above-mentioned features of the reform in the system of resource allocation in Yugoslavia.

Table 1

Yugoslavia: Average Annual Growth Rates in 1984 Prices

	1986-90 Scenario		1991-95 Scenario	
	A	B	A	B
GSP	2.7	3.7	2.3	4.1
Agriculture	2.9	2.8	2.0	2.6
Industry	2.6	4.1	2.6	7.0
Energy	3.0	3.0	3.0	3.4
Construction	2.8	2.9	2.4	1.1
Services	2.6	3.8	2.2	3.4
Consumption	3.2	4.0	2.8	4.4
Fixed Investment	3.3	4.2	4.2	4.1
Exports GNFS	2.4	4.6	2.0	5.8
Imports GNFS	3.6	6.5	2.9	6.4

Current Account Balance
(convertible currencies)

Million US$

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
(A)	838	798	798	753	753	350	350	350	350	350
(B)	838	798	350	300	300	33	-720	-480	-558	10

Debt Outstanding and Disbursed
(convertible currencies)

Billion US$

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
(A)	17.4	17.0	16.6	16.2	15.8	15.8	15.8	15.8	15.8	15.8
(B)	17.8	17.8	17.8	17.8	17.8	17.8	17.8	17.8	17.8	17.8

Debt Service Ratio[1/]
(convertible currencies)

Percent

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
(A)	39.2	34.1	35.1	38.9	35.2	32.7	29.7	29.1	29.3	26.9
(B)	39.2	34.1	34.1	37.4	34.0	29.8	27.1	25.8	24.9	21.7

1/ Debt service ratios up to 1988 are after rescheduling.

Source: Annex Tables 2A and 2B

35. The results under Scenario A indicate that the rate of growth of GSP would remain around 2.7 percent between 1986-90 and would then slow to 2.3 percent between 1991-95 (Table 1 and Annex Tables 2-A). The rate of employment growth would remain around 2 percent. The debt service ratio in convertible currencies would be 35 percent in 1990 before declining to 27 percent in 1995. Export growth would remain sluggish in both the 1986-90 and the 1991-95 periods, averaging about 2.4 percent and 2 percent, respectively.

36. The favorable terms of trade effect of the decline in oil prices would allow the economy to gain additional resources, which would be reflected in the rate of growth of fixed investment. Fixed investment would rise 3.3 percent on average during 1986-90 and 4.2 percent during 1991-95. However, the efficiency of investment as measured by the incremental capital output ratio (ICOR) would decline. ICOR would increase from 7.3 during 1986-90 to 9.2 during 1991-95.

37. Under Scenario B, simultaneous implementation of policies aimed at both stabilization and recovery leads to accelerated growth. Up to the end of 1987, the Government would continue to emphasize stabilization objectives in order to reduce inflation (para. 44). At the same time, it would implement and extend the reforms relating to the foreign exchange and foreign trade regimes, financial discipline and investment allocation. These steps would reorient the economy toward growth and reduced inflation and unemployment. The prospects for resumed growth are, therefore, tied to both the effectiveness of the stabilization measures and the speed of structural reforms.

38. The key underlying assumption in Scenario B is the political will to implement an effective reform program in 1986-87. Between 1988-90, under this

scenario, the result of improvements and reforms in the incentive and resource allocation system would allow the growth rate to accelerate by 4.4 percent a year (Annex Table 2-B) and would allow the economy to become more responsive to price signals. The improvements in international competitiveness leads to a larger role of exports in growth: the economy would benefit from a floating exchange rate and exports would increase by an average of 6.3 percent a year between 1988-90, conditions that would allow a continuous substantial decline in the debt service burden and debt export ratios even though the absolute size of the debt remains constant. The convertible debt service burden would fall to 34 percent in 1990 and 22 percent in 1995. Similarly, the ratio of interest payments to GSP will decline to 2.8 percent in 1990 and to 1.2 percent in 1995. Although decline in the debt service burden up to 1990 is close to that of Scenario A, it would be obtained through better growth performance and higher per capita income. After 1990, the debt service ratios in Scenario B fall much more rapidly than under Scenario A.

39. Under Scenario B, to support the more rapid growth of the economy, particularly the growth of investment and exports, imports would grow at a rate of 6.5 percent a year between 1986-90 (Table 1). Fixed investment would grow at an average annual rate of 4.2 percent in this period. Moreover, because of an increased use of existing capital stock, the efficiency of investment would be higher than in Scenario A, with the ICOR ranging between 5-6. Increased mobility of capital and implementation of reforms in the area of investment allocation (para 32) would allow investment to be directed into more efficient sectors.Investment would move toward the industrial sector, which would have a rate of return above the national average.1/ Employment would increase on average by 2.5 percent a year in this period.

1/ The rate of return on capital investment on average would grow by about 9 percent between 1986-90.

40. Under Scenario B, the favorable developments in the economy in the late 1980s would allow a continuation of sustained growth in the 1990s. Between 1991-95, the policy measures adopted earlier would increase the rate of growth to around 4.1 percent a year. Exports, mostly industrial, would grow by about 5.8 percent a year, supporting the growth of GSP. As the economy moves toward more flexibility and maturity in the 1990s, the balance of payments and macro constraints would become less binding; and the economy could comfortably manage servicing the external debt. The flexibility of the economy would allow it to better respond to future changes in the world economy. Fixed investment would grow by 4.1 percent a year between 1991-95. Continuation of investment would allow employment to increase by 3 percent a year between 1991-95.

41. On the whole, the option represented by Scenario A is undesirable. The economy would be able to achieve a low growth rate and gradually reduce its debt burden, but the slow pace of growth would not generate much employment and would put strains on the country's social fabric. Moreover, under Scenario A, Yugoslavia would face difficulty attracting international financial support (para. 53) and would remain highly vulnerable to future external shocks. In contrast, under Scenario B, the rate of growth would be substantially larger. Investment becomes more efficient and the economy could achieve a higher level of income per capita. Yugoslavia would have a better access to international financial markets and could comfortably manage servicing the external debt with no major difficulty. However, our experience in Yugoslavia indicates that implementation of an appropriate package of policy reforms would be very difficult, especially if it has to be implemented at a fast pace.

III. POLICY PRIORITIES FOR SUSTAINED RECOVERY

42. In the next two years, the policy priorities will be on two fronts: bringing down inflation without jeopardizing the external balance, and firmly establishing a framework of incentives that will promote the efficient restructuring of the economy. These policies must be implemented with determination if the economy is to resume sustained growth. Such policies will generate adjustment costs and will face political and administrative obstacles. But there are also substantial costs of failing to reform the economy: standards of living and levels of employment will be lower and the economy will be more vulnerable to external shocks.

Macroeconomic Policies

43. While resuming growth, the authorities will need to control inflation. This is the most urgent task. Simultaneously, there is a need to encourage improvement in the efficiency of resource allocation in order to consolidate the external balance, maintain growth on a sound basis and begin tackling unemployment. To complement the stabilization measures and pave the way for resumed growth, the authorities need to implement and extend the major reforms (discussed in Section II). These reforms are essential to restructuring the economy for sustainable growth.

44. To stabilize the economy, macroeconomic policies during 1986-87 should concentrate on continuing fiscal and monetary restraint, with gradual relaxation thereafter. These restrained policies imply a need for greater enforcement of financial discipline on the part of social sector enterprises in order to control the liquidity in the economy effectively and decelerate the rate of inflation. While fiscal policy, as in the past, should aim at

controlling the increases in public expenditures in real terms, a restrained credit policy requires unified, positive floor real lending interest rates by 1987. Credit policy should also take into account the flow of credit among enterprises. In this respect, immediate attention should be focussed on allowing only commercial banks to guarantee enterprise credit instruments, instead of the present practice of guarantees being issued by the enterprises themselves or their internal banks. Moreover, the commercial banks should provide incentives in the form of high yielding short-term monetary instruments that would attract enterprises' excess liquidity into the banking system.

45. To supplement the restrained monetary and fiscal policies, there should be an incomes policy to support efficient economic units. Enforcement of the regulation restricting income payments to workers in firms that make losses is a positive step. At the same time, in an environment where the cost elements are indexed to price increases and enterprises pass those cost increases on to consumers, inflation cannot be tackled only through compression of demand. Therefore, greater competition from imports should be allowed, and competition among firms should be encouraged so that increases in productivity are reflected in lower prices, and not just in higher wages and profits.

Difficulties in Implementing Policy Reforms

46. Economic recovery in Yugoslavia will require forceful implementation of the reform policies described earlier. However, the preoccupation of the Republics and Autonomous Provinces with developing a stronger political and economic base has prevented the adoption of effective policies. It has prolonged the decision making process and prevented the adoption of adequate and effective reforms.

47. The reform of the foreign trade and foreign exchange allocation systems, which is difficult and politically sensitive, needs to be completed rapidly. Implementation of this and other reforms will mean facing the issue of the strong regional divisions in Yugoslavia and limited federal power. Those adversely affected by reforms will exert political pressure and slow the pace of implementation, as has been the case in the past and in other countries. Those parties include loss-making enterprises that depend on outside sources to cover losses; inefficient industries that are protected by the trade regime; regions that realize specific local advantages in various distortions of the incentive structure; and oligopolist enterprises that benefit from a lack of competition.

48. The strong regional differences, together with the decentralized decision-making process, make establishing a nationwide market and designing and carrying out policies within a unified framework difficult. Implementation of the Long-Term Program of Economic Stabilization has already suffered from these competing regional interests and the constant struggle for power among the Federal Government and the Republics and Autonomous Provinces. Similarly, the important areas of reform under the first SAL (para. 62), particularly those relating to the foreign trade and foreign exchange regimes and investment planning, have faced long delays and have not met initial expectations. Much resistance and many delays have also been experienced in implementing other measures under the SAL, particularly in the areas of price and tariff adjustments. While Yugoslavia has been aiming at more uniform market signals, a more open economy and a greater integration of its decision making, actual reform has been slow.

IV. Financing Requirements

49. The composition of total convertible MLT debt would shift under the two scenarios, with a rise in the share of debt on commercial terms. This includes the joint share of commercial banks and governments, which would rise from 75.6 percent of convertible MLT debt in 1985 to about 80 percent by 1990 (83 percent under Scenario A). The increase in the share of commercial banks and governments reflects the additional money that Yugoslavia needs from those sources during the next five years. The share of international financial institutions would decline from 24.4 percent to 20 percent (17 percent under Scenario A). The latter decline mainly results from the amortization of the debt due to the IMF and the absence of new IMF disbursements beyond the current standby.

50. Under Scenario A, Yugoslavia would reduce its convertible MLT debt by $400 million a year up to 1990, and then keep a constant debt (Annex Table 2-A). Such a debt reduction falls short of that implicitly anticipated in the 1986-90 five-year plan, which projects current account surpluses as large as $1.2 billion a year. Average real interest rates paid by Yugoslavia would remain about 3 percent. Under Scenario B, it is assumed that real interest rates would decline to 2 percent, while no reduction in convertible MLT debt would take place.

51. Even after past reschedulings, under Scenario A, Yugoslavia would need to amortize annually about $2.2 billion in convertible MLT debt between 1986-88. With interest payments of about $1.8 billion, total debt service payments of about $4 billion a year would remain a heavy burden on the balance of payments. The convertible debt service payments will become larger in

1989-90 ($5 billion a year), when the present multi-year rescheduling arrangements terminate.

52. Under Scenario A, the gross convertible capital inflow would amount to $11.2 billion between 1986-90. The average inflow should increase from $1.8 billion a year between 1986-88 to $2.9 billion a year between 1989-90 (Table 2). Under this scenario, Yugoslavia will have difficulty in attracting international financial support of this magnitude. The bulk of the inflow ($8.6 billion) would be on commercial terms, including loans from governments and their agencies. The inflow on commercial terms should double from the average of $1.2 billion a year during 1986-88 to $2.4 billion a year during 1989-90. However, commercial banks have been cautious in making MLT loans to Yugoslavia since the early 1980s. Whether this caution will persist will depend upon whether Yugoslavia can regain their confidence by implementing the appropriate economic policies and succeeding in further expanding its foreign exchange earnings.

53. In the absence of major policy changes under Scenario A, the creditors may not be willing to provide the additional financial support to Yugoslavia. In that case, the external resources would be less forthcoming and Yugoslavia would then find it more difficult to achieve even the low 2.7 percent yearly growth projected under this scenario. It is likely that Yugoslavia would even have to seek additional rescheduling starting in 1989 to manage the increase in debt service payments following the termination of the present rescheduling period.

54. Under Scenario B, covertible MLT debt would stay at the level of 1985 ($17.8 billion) throughout the period. However, the debt service burden would not be larger than in Scenario A because of the better performance of

Table 2

Yugoslavia: Debt Outstanding and Disbursed

	Scenario	1985	1990	Percent Share of Total 1985	Percent Share of Total 1990
Multilateral	A	4,350	2,709	24.4	17.1
	B	4,350	3,600	24.4	20.2
of which	A	2,058	2,018	11.6	12.8
(World Bank)	B	2,058	2,909	11.6	16.3
Bilateral and Private	A	13,451	13,092	75.6	82.9
	B	13,451	14,201	75.6	79.8
Total Convertible	A	17,801	15,801	100.0	100.0
MLT Debt	B	17,801	17,801	100.0	100.0
Total Debt	A	20,205	18,051		
	B	20,205	20,015		

Disbursement and Amortization During 1986-90

(million $)

		1986-88 [1] (average annl.)	1989-90 (average annl.)	1986-90 (Total)
Disbursements	A	1,823	2,880	11,233
	B	2,223	3,453	13,577
of which	A	1,239	2,447	8,610
(commercial terms)	B	1,473	2,800	10,018
Amortization	A	2,223	3,281	13,233
	B	2,223	3,452	13,577

[1] Rescheduling period.

Source: Annex Tables 3-A and 3-B.

exports (para. 38). Under this scenario, the gross convertible capital inflow would be over $13.5 billion between 1986-90. The average inflow would increase from $2.2 billion a year between 1986-88 to $3.4 billion a year between 1989-90 (Table 2). Of this amount, the gross inflow on commercial terms (from commercial banks and bilaterals) would be $10 billion, or $1.5 billion a year during 1986-88 and $2.8 billion a year during 1989-90.

55. Under Scenario B, Yugoslavia would require about $2.3 billion more borrowing than under Scenario A between 1986-90[1/]. Provided appropriate reforms are introduced, the Bank would be prepared to increase its direct lending to Yugoslavia and provide about $930 million of this amount between 1986-90. This level corresponds to total Bank commitments of $2.1 billion, disbursements of $2.4 billion and amortization of $1.5 billion (Annex Table 3-B).[2/] The rest, $1.4 billion, would have to be shared by governments, commercial banks and other multilateral organizations. The Bank would also enter into cofinancing agreements that would encourage commercial banks to resume MLT lending to Yugoslavia. Under Scenario B, the Bank's share in convertible MLT debt outstanding and disbursed would increase to 16.3 percent. This level corresponds to an average Bank disbursement of about $470 million annually. This level of exposure would increase the Bank's share in Yugoslavia's total debt service from 6.5 percent in 1985 to 10.9 percent by 1990.

1/ The net would be $2 billion, of which net flow on commercial terms would be $1.1 billion.

2/ Bank commitments to Yugoslavia would decline in the 1990s, reflecting a better access of Yugoslavia to the international capital markets and possible graduation from the Bank borrowing.

56. To repay its external debt in an orderly way and to ensure successful implementation of the macro-stabilization policies, Yugoslavia willneed external financial assistance. This assistance, however, will not be forthcoming unless it is linked to a genuine structural reform. If the adjustment does not take place and the policy changes are not implemented, the Bank lending to Yugoslavia would be adversely affected, and a lower lending level would become unavoidable (Annex Table 3-A).

V. Action Program and Monitoring

1986-88 Action Program

57. To improve the resource allocation system, which is the key underlying factor behind the resumption of sound growth, Yugoslavia needs to implement major reform measures. In the past, initiation and implementation of reforms have faced long delays. To be most effective, Yugoslavia needs to implement economic policies and reform measures at a much faster pace in the next two years in order to be able to resume growth and improve the incentive and resource allocation systems.

58. The Government has developed a new price liberalization policy, which has been in effect since January 1985. The thrust of the new policy will need to be maintained; resort to administrative controls to combat inflation would be detrimental. The Government's commitment to continued adjustment of the presently administered prices, namely, petroleum and petroleum products, gas, electricity, coal and lignite, as well as railway tariffs and road user charges, would ensure that increases in these prices reach parity with opportunity costs. The Government should also unify the system of floor lending rates and adjust them so they reach positive levels by 1987.

59. In the area of the allocation of foreign exchange, the Government should establish a market-based allocation system not later than 1987. During the same period, it should shift commodities out of the restricted import categories into the free import category in parallel with a managed float of the exchange rate. The reclassification of imports should lead to a decline in the share of the value of imports under quotas and licenses from more than 50 percent of total imports to 15 percent within two years.

60. In the area of financial discipline, the measures adopted since the end of 1984 should be consolidated and extended. Until recently, loss-making enterprises in Yugoslavia could avoid or delay sanctions for bad decisions through default on payments due to banks and other firms and through reliance on financial assistance from the community through the use of the Joint Reserve Funds (JRFs). The law on Reserve Funds was amended in December 1984 to limit, and after 1987 prohibit, the use of JRFs for loss coverage under the guise of enterprise rehabilitation. The law on payments amended at the end of 1984 prevents enterprises defaulting on their obligations from increasing the personal income of workers at rates above the average increase in the economic sector of the region in which they operate. In addition, an amendment to the law on rehabilitation (January 1985) stipulates mandatory bankrupcy proceedings against loss-making enterprises. Another measure has been improvements in the accounting framework that should provide a better indication of an enterprises' true financial situation. Similarly, the more effective supervision of the banks by the National Bank of Yugoslavia and the Social Accounting Service would improve the efficiency of the banking system credit allocation among enterprises.

61. To improve the efficiency of investment allocation and avoid duplication of capacities, the Government should implement appropriate Joint Development Programs (JDP) in the infrastructure sectors, in line with least-cost investment programs. To improve the process of investment selection, the Government should focus on implementation of the recently approved minimum uniform criteria for the selection of investment. The application of appropriate interest rates and prices should also improve the allocation of investment resources. A summary of the annual action program for 1986-90 is presented in the attached policy matrix.

World Bank Support

62. To support Yugoslavia in initiating and implementing the policy reforms, the Bank has included Structural Adjustment Loans (SALs) in its lending program. The first SAL in 1983 supported Yugoslavia's effort to establish the foundation for a more efficient pattern of growth. It supported the recommendations of the Long Term Program of Economic Stabilization in four economy-wide areas: (i) price policies; (ii) foreign exchange allocation and external trade policies; (iii) enterprise decision-making and financial discipline; and (iv) investment planning.

63. Under Scenario B the Bank would proceed in appraising a possible second SAL to Yugoslavia. The objective of this second SAL would be to consolidate and extend policy changes and reforms that will further promote the restructuring of production and demand patterns so as to allow the resumption of sustainable growth, the alleviation of the debt service burden and a slowdown in inflation. Within the context of an agreed medium-term macroeconomic framework and the more comprehensive program of reforms of the Government, the second SAL would support measures aimed at:

(i) Promoting greater reliance on market forces to determine prices and closing the gap between prices and opportunity costs wherever needed;

(ii) Establishing a market-based mechanism for the allocation of foreign exchange and reforming the foreign trade regime;

(iii) Ensuring a stricter enforcement of budget constraints including the rehabilitation of ailing business and, where necessary, closing them down; and

(iv) Strengthening the processes of investment allocation and selection so as to minimize inefficiencies.

64. If the implementation of reforms and adjustment measures continues, the Bank's future lending program would be heavily based on SALs and sector loans. The proposed program is currently under review in the context of the Country Assistance Strategy Brief. Should the Government pursue adjustment policies firmly, we would support it through expanding our policy-based lending. The possibilities include support for the removal of the distortions in the financial market and improvements in fiscal incentives (SAL III), and support for improved mobility of the factors of production and elimination of the regional barriers to trade (SAL IV). Concurrent with the SAL lending, the Bank would support financial and industrial sector restructuring, energy conservation, and reform of investment planning through sectoral and subsectoral lending. SAL and sector-type lending, however, require a strong commitment on the part of the Government to engage regularly with the Bank in substantive dialogue on macroeconomic and sectoral issues and to continue a program of reforming the economy. At the present time, this commitment does not exist. While we will continue to work with the Government in establishing such a commitment, there is a risk that it will not materialize.

65. Under enhanced monitoring arrangements requested by Yugoslavia and recently approved by the IMF Board, IMF will monitor macroeconomic parameters and short-run developments closely, within the framework of a viable macroeconomic program. Through this monitoring, it should be possible to identify needed adjustments in policies and in the medium-term macro framework. In addition, under the proposed second SAL, the Bank would review with the Government economic developments at the macro and sectoral levels semi-annually in order to assess the suitability of the policy framework.

Annex Table 1

Yugoslavia: Summary of Key Macroeconomic Aggregates, 1978-85

	1978	1979	1980	1981	1982	1983	1984	1985 [1]
GSP Growth rate (% p.a.)	6.9	7.0	2.3	1.4	0.5	-1.3	2.0	0.5
Debt to Exports of G&S Ratio (%) [2]	99.2	104.4	105.8	115.8	131.2	139.4	131.5	130.0
Debt to GSP Ratio (%)	23.5	24.7	30.4	31.5	34.4	46.9	48.4	48.2
Interest Payments to Exports Ratio (%)	4.3	5.7	7.1	11.6	13.4	11.5	12.2	12.0
Interest Payments to GSP Ratio (%)	1.0	1.3	2.0	3.1	3.5	3.9	4.5	4.5
Debt Service Ratio	17.7	17.8	18.5	23.4	26.3	30.8	33.7	34.3 [3]
Convertible Debt Service Ratio (%)	18.0	19.3	21.9	31.0	35.3	40.0	41.7	43.0 [3]
Terms of Trade, 1982=100	100.9	97.3	96.6	94.9	100.0	98.0	90.3	86.7
Export Growth Rate (% p.a.)	1.4	1.6	10.9	-.4	-11.2	1.4	10.1	8.2
Import Growth Rate (% p.a.)	-1.3	18.0	-10.5	-12.3	-13.5	-5.5	-0.4	1.2
Current Account Balance ($mn) [4]	(1,283)	(3,661)	(2,291)	(946)	(624)	211	439	797
With Convertible Areas ($mn) [4]	(1,272)	(3,304)	(2,203)	(1,821)	(1,602)	246	800	370
Interest Payments ($mn)	495	821	1,281	1,987	2,049	1,688	1,854	1,896

[1] Preliminary estimates.

[2] Exports of goods and services include net remittances.

[3] Before rescheduling.

[4] Figures in brackets are deficits.

Annex Table 2-A [1]

Yugoslavia - Projections of Key Variables, 1986-95, Scenario A

(percentages and US dollars)

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
GSP Growth Rate	2.3	2.7	2.8	2.8	2.8	2.3	2.3	2.8	2.3	1.8
GSP/Capita Growth Rate	1.4	1.8	1.9	1.9	1.9	1.5	1.5	1.9	1.5	1.0
Consumption per Capita Growth Rate	1.5	3.0	2.2	2.5	2.3	2.3	2.2	2.4	1.9	1.1
Total Debt Outstanding and Disbursed (billions of dollars)	19.7	19.3	18.8	18.4	18.0	18.0	18.0	18.0	18.0	18.0
Debt/Exports (percent)	139	128	116	104	94	88	82	75	70	65
Debt/GSP (percent)	47.6	40.1	35.4	31.4	27.8	25.0	23.0	21.1	19.4	18.0
Debt Service (percent)	31.7	28.5	29.0	31.4	28.4	25.9	23.7	23.1	23.1	21.2
Convertible Debt/Service (percent)	39.2	34.1	35.1	38.9	35.2	32.7	29.7	29.1	29.3	26.9
Interest/Exports	11.5	10.8	9.6	8.7	7.2	6.4	5.9	5.5	5.0	4.7
Interest Payment/GSP (percent)	5.0	4.2	3.7	3.3	2.6	2.3	2.1	1.9	1.7	1.6
Gross Investment/GSP	32.7	33.0	33.7	33.9	34.1	34.7	34.7	34.8	34.7	34.7
Domestic Saving/GSP	36.8	36.8	37.0	36.7	36.7	36.5	36.2	36.1	35.9	35.8
Marginal Savings Rate	37.0	37.3	36.0	36.5	34.8	32.9	35.0	34.2	34.7	35.8
National Saving/GSP	35.2	35.2	35.2	35.2	35.2	35.2	35.2	35.2	35.1	35.1
ICOR [2]	7.3	7.7	8.2	8.2	8.7	9.2				
Export Growth Rate	2.2	2.0	2.5	2.7	2.8	0.7	1.9	2.9	2.3	2.1
Exports/GSP	34.4	31.4	30.6	30.3	29.7	28.4	28.1	28.3	27.9	27.6
Import Growth Rate	.3	6.4	4.2	4.3	3.7	3.6	3.2	3.3	2.7	1.6
Imports/GSP	32.0	29.3	29.1	29.1	28.4	27.8	27.6	28.0	27.4	27.2
Current Account (US$)	838	798	798	753	753	350	350	350	350	350
Terms of Trade Index										

1/ The exchange rate used for projections is based on the 1984 exchange rate of $1 = 152.8.

2/ Five year averages.

Annex Table 2-B [1]

Yugoslavia - Projections of Key Variables, 1986-95, Scenario B
(percentages and US dollars)

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
GSP Growth Rate	2.3	2.7	4.9	4.1	4.7	4.4	3.6	4.4	3.9	4.2
GSP/Capita Growth Rate	1.4	1.8	4.0	3.2	3.8	3.5	2.8	3.6	3.1	3.4
Consumption per Capita Growth Rate	1.5	3.0	4.5	2.5	3.9	3.8	4.1	3.7	3.1	3.2
Total Debt Outstanding and Disbursed (Billions of Dollars)	20.1	20.1	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0
Debt/Exports (percent)	141	132	120	105	93	84	77	68	61	54
Debt/GSP (percent)	48.0	41.8	36.8	33.3	29.7	25.1	21.8	18.5	16.5	14.7
Debt Service (percent)	31.7	28.5	27.5	29.6	26.9	23.3	21.5	20.3	19.5	17.0
Convertible Debt/Service (percent)	39.2	34.1	34.1	37.4	34.0	29.8	27.1	25.8	24.9	21.7
Interest/Exports12.1	12.1	10.8	9.3	8.2	6.8	5.5	5.1	4.8	4.2	3.7
Interest Payment/GSP (percent)	5.0	4.2	3.5	3.1	2.8	2.1	1.8	1.5	1.4	1.2
Gross Investment/GSP	32.7	33.0	34.6	34.9	35.0	35.3	35.2	34.4	33.9	33.5
Domestic Saving/GSP	36.8	36.8	36.9	36.8	36.6	36.4	35.2	34.7	34.4	34.2
Marginal Savings Rate	37.0	36.9	36.5	35.3	34.9	28.5	31.9	32.4	33.3	34.2
National Saving/GSP	35.2	35.2	35.2	35.4	35.5	35.2	34.4	34.0	33.5	33.5
ICOR [2]	5.1	4.9	5.5	5.6	5.9	6.1				
Export Growth Rate	2.2	2.0	5.3	7.1	6.6	5.7	2.8	7.0	6.7	7.0
Exports/GSP	34.0	31.4	30.8	31.8	32.1	29.8	28.1	27.0	27.2	27.4
Import Growth Rate	0.3	6.4	10.9	7.1	9.0	7.2	6.8	6.2	6.2	6.0
Imports/GSP	31.6	29.3	30.0	31.2	31.5	29.8	29.0	27.5	27.6	27.4
Current Account (US$)	838	798	350	300	300	33	-720	-480	-558	10
Terms of Trade Index	1.05	1.09	1.09	1.09	1.09	1.09	1.09	1.09	1.09	1.09

[1] The exchange rate used for projections is based on the 1984 exchange rate of $1 = 152.8.
[2] Five year averages.

Annex Table 3-A

Yugoslavia: Financing Requirements and Sources
Scenario A

Year	1986	1987	1988	1989	1990	1995
World Bank						
Commitments	200	200	200	200	200	200
Disbursements	306	313	318	250	234	122
Amortizations	188	256	304	352	360	350
Net Flows	118	57	14	-102	-126	-228
DOD	2,176	2,233	2,246	2,144	2,018	1,147
IMF						
Commitments	0	0	0	0	0	0
Disbursements	142					
Amortizations	363	368	354	452	260	0
Net Flows	-221	-368	-354	-452	-260	0
DOD	1,679	1,311	957	505	245	
Other Multilateral						
Commitments	175	175	175	175	175	100
Disbursements	236	225	216	208	175	44
Amortizations	256	236	211	127	175	131
Net Flows	-20	-11	5	81	0	-87
DOD	372	361	366	447	446	51
Bilateral[1/]						
Commitments	574	456	390			
Disbursements	574	456	390			
Amortizations	1,187	987	824	619	754	199
Net Flows	-613	-531	-434	-619	-754	-199
DOD	4,755	4,224	3,790	3,171	2,417	247
Commercial Banks[2/]						
Commitments	864	780	466			
Disbursements	864	780	466			
Amortizations	1,742	1,353	1,168	954	754	459
Net Flows	-878	-573	-702	-954	-754	-459
DOD	6,078	5,505	4,803	3,849	3,095	546
New Credits on Commercial Terms [3/]						
Commitments	1,167	991	1,596	2,578	2,496	3,516
Disbursements	1,215	1,026	1,475	2,382	2,512	3,726
Amortizations			403	736	1,019	2,753
Net Flows	1,215	1,026	,1072	1,646	1,493	973
DOD	2,342	3,368	4,440	6,086	7,580	13,809
Total Convertible MLT						
Commitments	2,980	2,602	2,827	2,953	2,871	3,816
Disbursements Rescheduling	1,899	1,564	2,009			
Disbursements Refinancing	3,337	2,800	2,865	2,840	2,921	3,892
Amortizations Rescheduling	2,298	1,964	2,408			
Amortizations Refinancing	3,736	3,200	3,264	3,240	3,322	3,892
Net Flows	-399	-400	-399	-400	-401	
DOD	17,401	17,001	16,601	16,201	15,801	15,800

1/ Bilateral debt contracted prior to 12/2/82.
2/ Debt contracted prior to 1/17/83.
3/ From commercial banks and bilateral sources.

Annex Table 3-B

Yugoslavia: Financing Requirements and Sources
Scenario B

Year	1986	1987	1988	1989	1990	1995
World Bank						
Commitments	300	550	450	450	375	200
Disbursements	309	572	553	473	450	280
Amortizations	188	256	304	360	397	472
Net Flows	121	316	249	113	53	-192
DOD	2,179	2,495	2,743	2,856	2,909	2,152
IMF						
Commitments	0	0	0	0	0	0
Disbursements	142					
Amortizations	363	368	354	452	260	0
Net Flows	-221	-368	-354	-452	-260	0
DOD	1,679	1,311	957	505	245	0
Other Multilateral						
Commitments	175	175	175	175	175	100
Disbursements	236	225	216	208	175	44
Amortizations	256	236	211	127	175	131
Net Flows	-20	-11	5	81	0	-87
DOD	372	361	366	447	446	51
Bilateral 1/						
Commitments	574	456	390			
Disbursements	574	456	390			
Amortizations	1,187	987	824	619	754	199
Net Flows	-613	-531	-434	-619	-754	-199
DOD	4,755	4,224	3,790	3,171	2,417	247
Commercial Banks 2/						
Commitments	864	780	466			
Disbursements	864	780	466			
Amortizations	1,742	1,353	1,168	954	754	459
Net Flows	-878	-573	-702	-954	-754	-459
DOD	6,078	5,505	4,803	3,849	3,095	546
New Credits on Commercial Terms 3/						
Commitments	1,663	1,044	1,788	2,940	2,834	3,801
Disbursements	1,611	1,168	1,639	2,710	2,890	3,959
Amortizations			403	877	1,176	3,022
Net Flows	1,611	1,168	1,236	1,833	1,714	937
DOD	2,739	3,906	5,143	6,975	8,689	14,805
Total Convertible MLT						
Commitments	3,576	3,005	3,269	3,565	3,384	4,101
Disbursements Rescheduling	2,298	1,965	2,408			
Disbursements Refinancing	3,736	3,201	3,264	3,391	3,515	4,283
Amortizations Rescheduling	2,298	1,968	2,403			
Amortizations Refinancing	3,376	3,200	3,264	3,389	3,516	4,283
Net Flows	0	1	0	2	-1	
DOD	17,801	17,801	17,801	17,801	17,801	17,801

1/ Bilateral debt contracted prior to 12/2/82.
2/ Debt contracted prior to 1/17/83.
3/ From commercial banks and bilateral sources.

Sectoral Issues

INDUSTRY

ANALYSIS

The problems of industry are rooted in the static nature of policies and the structure of the economy and the sector. There are major macro-policy difficulties with prices, trade, foreign exchange rate and allocation, investment decision-making and financial discipline. Economic policy has been inward-looking; demand and external competition do not determine production costs and prices; a protectionist trade policy encourages import sustitution and has caused a technological gap; the fixed exchange rate does not reflect increasing scarcity; and foreign exchange, because it is administratively allocated, offers no incentive to ration or substitute.

Investment decisions are negotiated among the Republics and Autonomous Provinces (RAPs), and market mechanisms do not play a role. The choice of import substitution industrialization, supported by protectionism, liberal financing, the absence of financial discipline and the lack of competition (domestic or international) have led to rigidity, high-cost output and a reliance on Government subventions.

Regional and federal priorities vary, but in the area of investment, neither is binding on enterprises; investment in priorities instead is induced by the allocation of credit. The allocation of foreign exchange has favored its earners and large-scale priority investments, while non-earners pay informal premia or do without. Banks, because they must guarantee credits for investment, could play a role in rationalizing investment, but they are owned by the enterprises. Underpriced foreign exchange has induced over-borrowing by firms, often sanctioned by the banking system, based on illusory prospects for exports. If repayment out of earnings is not possible, firms can resort the the solidarity funds, without having to undertake financial restructuring.

POLICY RECOMMENDATIONS

The economy needs to be realigned to reflect changes in domestic and external resources and product markets. At the same time, automatic economic and financial mechanisms that permit continuous adjustment, promote efficiency and reduce resource misallocation are needed. The partial adjustments undertaken in price policy, exchange rate policy, investment decision-making and financial discipline need to be carried further and to be accompanied by the liberalization of the foreign exchange market and trade policy. As competition and comparative advantage become more evident, these macro-policy changes will point to new directions for industry. In turn, these will require changes in the scale, location and scope of industry to rationalize the existing sector and promote efficient development.

The Bank should support the needed adjustment and future directions through sectoral and subsectoral lending, including support for an upgrading of the incentive framework, and through broad-based input services (technical, marketing and managerial advisory services). It should do so at a national level. Adjustment should take place in the context of macro-policy changes, although in priority areas such as lending for export industries, particularly for those with performance records, the Bank may undertake some identification work for project and sector improvement issues. Decisions on whether to carry out substantial work toward operations could be taken in the light of our macro dialogue with Yugoslavia.

Even without progress at the macro level, lending for energy conservation and technology development is possible. It may also be possible to consider loans for selected subsectors.

EXPECTED RESULTS

These policy changes, along with rationalization and redirection of industrial subsectors, will allow industry to improve its performance and enhance national economic growth. Specific benefits will be higher operating and financial efficiency, important cost reductions, increased competitiveness, and gains from increased specialization and trade.

ENERGY

ANALYSIS

The energy sector faces a number of problems:

- Rivalry and poor coordination among the Republics and Autonomous Provinces (RAPs) have led to a misallocation of investment, irrational siting of facilities, and an absence of national energy planning, programming and cooperation.

- Pricing distortions have encouraged the use of more costly gas and the underuse of cheaper domestic resources, inattention to conservation, and investment in otherwise financially unviable projects.

- The financial systems and controls of institutions in the energy sector need improvement, along with greater maintenance and operating efficiency, and the federal institutions need greater autonomy and effective leadership.

Despite these and other formidable problems, there has been some coordination: a national electric power transmission system, the beginnings of a national dispatch system, agreements to develop the hydroelectric resources of the Drina basin, an incipient joint power investment plan, and freer inter-RAP operations by oil companies.

POLICY RECOMMENDATIONS

Specific policy actions that need to be taken are:

- Immediate increases in the prices of electricity, domestic natural gas, and coal and lignite, as part of a longer term adjustment of energy prices to economic levels;

- Closer coordination of RAP power and coal investments through a Joint Development Plan and the interconnection of regional gas transmission networks, plus implementation of nationally important projects (the Drina basin hydroelectric and Kosovo lignite resources);

- A program to conserve energy and to encourage use of lower cost fuels;

- Strengthening of sector institutions, particularly through better management information systems, training, maintenance and operating efficiency and modern management techniques.

- Increasing energy prices to economic levels in order to rationalize consumption, along with complementary policies of consumer information and other incentives and greater financial discipline.

These adjustments are closely linked to the implementation of other reforms of the economic system, particularly relating to real interest rates and foreign exchange. Agreement on rational Joint Development Plans will depend on compensation of the RAPs and enterprises for the opportunity costs in terms of foreign exchange of energy traded within Yugoslavia. Without financial discipline, higher energy prices will restrain energy demand, investment and imports will be reduced, and energy enterprises will lack incentives for effective investment and operations.

EXPECTED RESULTS

The policy recommendations of the Bank will: benefit overall macroeconomic objectives, especially the efficiency of investment (incremental capital output ratio), reduce imports, promote regional economic integration, and improve resource allocation on the basis of pricing.

AGRICULTURE

ANALYSIS

The agriculture sectors faces structural problems and an adverse policy environment. The sector consists of both social and individual holdings. While the latter, a heterogeneous grouping, dominate, the priority in the allocation of fixed investment, inputs and credit is the social sector, followed by associated farmers and finally those with no production/marketing links to the social sector. The individual sector has been constrained by the resultant inadequate access to inputs, particularly research and extension services, as well as by a ceiling of 10 hectares for land ownership and virtual absence of a land rental market. For its part, the social sector consists of agro-industrial kombinat, which integrate primary production, processing and marketing. These enterprises are inefficient, lack adequate managerial and technical staff, have accumulated arrears with the banks, and are capitalized with only a limited equity base. Moreover, the vertical integration, designed to achieve regional self-sufficiency, combined with the regional segmentation of markets, hs resulted in redundant processing capacity.

Another structural problem is the Yugoslav banks. They cannot act as independent financial institutions and often are unable to screen projects properly. Some are financially weak in light of the number of overdue loans in their portfolios and their low equity.

Resource misallocation has been the result in part of long-term pricing policies and negative real interest rates. The compensation payments to processors, as well as the premiums and export subsidies, all necessitated by the price distortions and positive protection, have been very costly.

Finally, agricultural exports have been unstable, in part because of export marketing strategies, high domestic prices and absence of export incentives.

POLICY RECOMMENDATIONS

Policy measures should include:

(a) Freeing up input supply arrangements,, particularly research and extension services to individual farmers;

(b) Instituting a land-rental market and a relaxation of the limits on the size of land holdings;

(c) Improving the efficiency in the social sector, particularly by strengthening managerial information systems and developing standards and performance guidelines;

(d) Traning bank staff and improving managerial information systems including portfolio reviews, along with thorough review of the financial sector;

(e) Bringing domestic prices into line with border prices; and

(f) Developing long-term export marketing strategies and evaluating Yugoslavia's comparative advantage in the production of import substitutes.

EXPECTED RESULTS

Implementation of these recommendations would correct some policy distortions and reduce structural rigidities. More specifically: (i) untapped potential would be better utilized; (ii) efficiency would be improved; (iii) regional specialization and an optimal crop/product mix would be encouraged; and (iv) the role of the sector in balance of payments support would be increased.

TRANSPORT

ANALYSIS

In addition to providing the backbone to the Yugoslav economy, the primary transport network provides an outlet for export commodities as well as serving a growing demand for international transit traffic. Continued investments are required in the transport sector to alleviate bottlenecks in the main road and rail networks, and rehabilitate existing infrastructure. However, at a time when there have been severe cuts in expenditures for modernization and rehabilitation of the road network, investment in the railway system has continued. While the railways have enjoyed regular real term increases in tariffs, there has been a lag in adjusting road user charges and a major reduction in the available funds for roads. Clearly, a more balanced development of both road and rail transport is required. Decentralization of operations in the transport sector hamper coordinated development, as well as the provision of rational and cost-effective transport services.

POLICY RECOMMENDATIONS

The specific policy objectives which are being pursued by the Bank include: (i) the planning and implementation of balanced investment programs; (ii) stronger inter-regional coordination, particularly through better technical integration in the railways; (iii) improved operational efficiency in the sector, including highway maintenance, as well as operations in railways and ports; and (iv) a sound pricing and fiscal policy, including cost-based railway tariffs and regular adjustments in road user charges.

A sector-lending approach would be the appropriate instrument for tackling sector issues This type of lending is being pursued under recent operations in both highways and railways, where we have a broad base for continuing with a sector approach. This approach would also enable us to address the inter-regional issues.

EXPECTED RESULTS

Because of the political framework, the sector lending approach generally only provides partial coverage of the sector and there is a need for a more comprehensive overview of developments in transport at the national level. As such, a proposed review of the 1986-90 Transport Investment Program under SAL II would provide the necessary sectoral background, including the broad, general conditions on investment and the longer-term implications of pricing and fiscal policy. Such a strategy should enable the Yugoslav authorities to upgrade the efficiency of the transport system and ensure an appropriate balance of investment among transport modes to provide adequate support for renewed economic growth and the development of foreign trade.

WATER SUPPLY AND SEWERAGE

ANALYSIS

About 69 percent of the population of Yugoslavia has access to a piped water supply, and only 59 percent live in a dwelling unit connected to a waterborne sewage system. Where water service levels are high in the major urban areas, supplies are intermittent and low water pressures are common. Shortages in the major industrial areas such as Belgrade, have led to factory closings and slowing down new construction. Untreated discharges have caused pollution of domestic water supply sources.

The primary responsibility for the sector rests at the local level through locally established water supply and sewerage enterprises. Little is done to properly analyze new projects and establish priorities at the Republic level, and no planning takes place at the Federal level. Lack of adequate financing is a major constraint to improved service levels and pollution control. Communes wishing to improve their systems have no source from which they can obtain long term loans at reasonable interest rates.

POLICY RECOMMENDATIONS

It is recommended that the following actions be taken at the Republic and Federal levels:

(a) Assess sector needs regularly;

(b) Set realistic goals for the sector, taking into account the results of the needs survey and the availability of resources.

(c) Establish a mechanism by which communes can borrow funds for capital improvements for projects which conform to federal and republic goals;

(d) Establish a priority system for the allocation of funds to the sector; and

(e) Establish conditions for borrowing federal funds and institute a monitoring and enforcement mechanism.

EXPECTED RESULTS

In the long term, the following results could be expected from the above actions:

(a) improved water service in urban areas;

(b) increased productivity in areas where inadequate water supplies constitute a development constraint;

(c) lower health care costs;

(d) financial self-sufficiency of the sector.

Yugoslavia: Policy Matrix and Five Year Action Program

Area	Policy Objectives	Actions Taken by the Government	Further Measures Recommended	Proposed Timing 86	87	88	89	90
A. Macroeconomic Framework	Growth with sustainable macroeconomic balance.	Public Sector Budget in surplus and surplus in Current Account of the Balance of Payments.	Monitoring of macroeconomic performance agreement on medium-term plan. Enhanced IMF monitoring. Continuation of cautious macroeconomic policies allowing sustainable macro balances; implementation of reform measures to improve resource allocation.	X	X	X	X	X
B. Price Policy	More efficient resource allocation. Setting administered prices to reflect opportunity costs.	Most prices have been decontrolled since Jan. 1985. The administered prices have been periodically increased.	Closing the gap between administered prices and opportunity cost. Continued implementation of new price law limiting administrative interventions and price subsidies.	X	X	X	X	X
C. Foreign Exchange Allocation System	To establish a market-based mechanism for foreign exchange allocation and maintain international competitiveness.	Exchange rate was substantially devalued in real terms in 1982/84. Laws for improvement in the allocation system have been passed in Jan. 1986.	Introduction of a satisfactory market for foreign exchange which will lead to a free market for FX.	X	X	X	X	X
D. Foreign Trade	To liberalize imports.		Gradual reduction of quantitative restrictions in parallel with supporting exchange rate and tariff measures.	x	x	x		
E. Investment Allocation	To improve investment selection and coordination.	Social Compact on investment criteria was adopted by all parties concerned in Sept. 85.	Implementation of social compact and preparing operational guidelines.	X				
			Adoption of joint development programs containing least cost development approaches in major infrastructure sectors.	X	X			
	To ensure economic use of investible resources.	Periodic increases in interest rates.	Increase interest rates to positive real levels and unification of lending rate structure by 1987.	X	X			
	To monitor trends in investment pattern and identify problems.	Poor reporting.	Improve reporting format for monitoring progress in investment and identifying. problem areas.	X				

Area	Policy Objectives	Actions Taken by the Government	Further Measures Recommended	Proposed Timing 86	87	88	89	90
F. Financial Discipline	To reduce transfer of losses to other enterprises or communities.	Legislation has been adopted that restricts income of workers in firms that operate at a loss or default on payments and phases out the use of reserve funds to cover losses.	Implementation of the legislation and adoption of suitable monitoring system. Monitoring of arrears due to banks from enterprises and deferred foreign exchange losses strengthening the role of SDK in initiating bankrupcy proceedings.	X				
	To encourage prudent financial portfolio management by commercial banks.	Adoption of a new law on the basis of the Banking and Credit System.	To limit the share of single borrowers in the total loan portfolio of a bank and limit the share of any single member founder in the bank's equity.	X	X			
G. Financial Sector	To reduce distortions in the financial market and improve efficiency of financial intermediation.		Specific recommendations to be worked out after completion of the review of banks in connection with financial discipline.			X	X	X
H. Regional Development	To improve mobility of factors of production and eliminate the regional barriers to trade.		Specific measures to be worked out in connection with a study on regional development which is part of our FY88 economic and sector work program.				X	X

(MSchrenk, 12/9/85)
(1st draft)

COUNTRY STUDY: YUGOSLAVIA

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YUGOSLAVIA

I. THE CURRENT STATE OF AFFAIRS

A System Constraints

1. Yugoslavia's peculiar economic system - the legal framework and the country's ideology which determines the means and ends of economic policy - create unique development problems. This affects both the diagnosis of the present economic situation, and the options available for the future. Most importantly, the system sets institutional parameters for both the range of Government actions and the approach of the Bank. The three most relevant system features affecting the economy are (1) regionalization; (2) socialism; and (3) self-management.

2. Regionalization: To accommodate the ethnic diversity of its constituent parts, Yugoslavia Yugoslavia opted after WW II for a federal constitution. It ascribes many policy-making powers to the eight member republics and autonomous provinces (RAPs) rather than the center. Moreover, as a defense of the federal structure against centralist encroachments, it requires for many country-wide decisions, which in most other countries are within the executive power of the

central government, the promulgation of laws and other special legal instruments. Agreement on these, in turn, requires unanimous consent of all members, which extends to legislative actions. This devolution of decision-making power severely hampers the speed and determination with which the Government structure, comprising both the center and the RAPs, can arrive at and carry out decisions on system changes and economic policies. It hampers no less operations of the Bank in the context of specific operations, whenever country-wide policies are involved.

3. <u>Socialism:</u> After WW II Yugoslavia has adopted socialist principles to regulate its political and economic affairs. The basic economic premise is the domination of social ownership of the means of production, with the private sector restricted to family farms and small units in handicrafts and services. The elimination of private property and control from most of the microeconomic decision-making has major effects on the way policies affect macroeconomic variables, because of the de facto elimination of all rewards and penalties to capital.

4. <u>Selfmanagement:</u> Within the broad framework of socialism, Yugoslavia defined "workers' selfmanagement" as the principle for organizing economic units. The socially owned assets of firms are entrusted to the workers community which has the legal right to elect its managers and to earn income from the use of assets, and the duty to maintain their value and viability, including control of investment. This translates on principle into the absence of formal

power of state organs over the affairs of enterprises. No less important is the limited power of state organs over managers, as well as of managers over actions of enterprises. Since this affects the effectiveness of financial rewards and penalties on decisions, this limits further the scope for control over microeconomic actions through application of conventional macroeconomic policies.

5. As a result of this constitutional development throughout the 1960s and 1970s, and into the 1980s, the Federal Government ceased to be THE GOVERNMENT, and in many instances responsibility as well as right for taking executive actions became a matter of arrangement between several administrative and political bodies, with relative weights changing from case-to-case and following rules which remained impenetrable to outside observers. In many instances it is more difficult for the Bank to identify and to approach the locus of executive power - if there is one in the first place - than in all other socialist and in most non-socialist market economies. This has induced some outside observers to consider Yugoslavia de facto as a confederation rather than a federation.

B. Major Economic Development, 1973-1985

6. During most of the 1970s, Yugoslavia passed through a phase of almost uninterrupted growth. Table 1 present summary indicators:

Table 1: Main Economic Indicators, 1973-1979

Average Real Growth Rates (%):	
GDP	6.5
Gross fixed investment	8.0
Total consumption p.c.	5.6
Labor productivity	1.8
Net income per worker	3.4
Exports of goods	2.6
Imports of goods	7.1
Real Exchange rate	-7.7
Implicit GSP deflator	18.2
Average Shares in GDP (%):	
Total investment	32.9 (31.4 in GNP)
Gross domestic savings	27.3 (30.6 GNS/GNP)

Source: IBRD; Fed. Statistical Office

7. Output, investment and consumption increased at a brisk pace, propelled by a high investment rate and easy foreign borrowing. Other variables, however, show the causes or the effects of emerging imbalances. Investment growth itself became increasingly a problem, since at such growth rates and levels the absorptive capacity was bound to suffer at the margin. Supply of savings, if the large inflows of workers remittances are included, were a minor cause of friction. The average ICOR of around 5 was not exceptionally high, but the margin of investment over output growth indicates a rise in

the ICOR over the period. Interest rates were highly negative. Net income per worker grew ahead of labor productivity, increasing unit cost of output. Both the high growth of domestic absorption (consumption as well as investment) and the cost push from rising remuneration contributed to inflationary pressures. This affected the external balance. The exchange rate was not adjusted sufficiently to neutralize these cost increases and the domestic boom absorbed most of the domestic output. The result was a slow growth of exports and a fast growth of imports, worsening the balance of payment position, although rising workers' remittances prevented a degree of deterioration which one would expect from the growth rates. But the figures suggest that the momentum of the 1970s could not continue much longer when the second oil price shock and its repercussion hit Yugoslavia severely.

8. The sudden shift from rapid growth to stagnation under the influence of a rigorous stabilization program is summarized in the following data:

Table 2: Main Indicators 1979-1985

Average Real Growth Rates (%):		
GDP	1.7	
Gross fixed investment	-3.1	
Total consumption p.c.	-1.1	
Labor productivity	0	(industry; 1979-1983)
Employment	2.6	(1979-1983)
Net income p.w.	-5.1	(1979-1983)
Exports of goods	1.7	(1979-1984)
Imports of goods	-5.2	(1979-1984)
Inflation rate (CPI)	45	
Share in GDP (%):		
Total investment	32.6	(1979-1984)
Gross domestic savings	31.9	(1979-1983)

Source: Annex Table 1; Federal Statistical Office

9. While average consumption per capita fell marginally, gross fixed investment contracted, but the average ratio to GDP declined only very slightly. Savings performance actually improved (workers' remittances, although their real volume is declining, continue to contribute to gross national savings). The comparison of growth rates of productivity, employment and average net incomes shows a unique pattern of a socialist country in distribution the social costs of adjustment. Instead of dismissing workers to adjust to falling output and to tighten productivity while keeping real wages of those

employed more or less constant, Yugoslavia increased employment by rates well above the natural growth rate of about 1.1%, adjusting instead in productivity and, most markedly, average real incomes.

10. The balance of payment crisis was effectively resolved during this period (see Annex Table 1); the current account improved consistently from a deficit of around $3.7 billion in 1979 (around 5.4% of GDP) to an estimated surplus of around $0.6 billion in 1985. Consequently, total debt, including short-term debt and debt in non-convertible currency, peaked in 1981 at $19.4 billion and declined continuously to an estimated $17.6 billion by end 1985. Medium and long-term debt peaked in 1983 at $17.3 billion and is expected to fall to $16.8 billion by end 1985. However, the figures show that the improvement was hardly the result of an expansion of exports but mostly of a steep contraction of imports, reflecting the fact that as late as 1983 the stabilization policy, although a success in balances, was not supported by a momentum of recovery.

11. The relative debt burden has somewhat declined during the stabilization period. The ratio of debt (MLT) to exports peaked in 1979 at 134%, fluctuated since, and is expected to have dropped to about 119% by the end of 1985. Similarly the debt service ratio peaked in 1979 at almost 30%, is declining since and is now expected to reach about 25% in 1985. It should be noted that the debt service data for 1984 show exaggerated interest charges and reduced amortization, resulting from technical effects from rescheduling.

12. While stabilization was reasonably successful with respect to the variables discussed above, it failed completely in coping with the endemic inflationary forces. The average rate of 45% in table 2 actually masks a recent upsurge to around 77% over the twelve months ending September 1985. The causes of inflation shifted increasing to cost push factors. Most important among these were in the recent years the rapidly rising costs of imports and credits as rapid devaluation of the dinar and steeply rising interest rates were catching up with the cumulative effects of distortions during the 1970s and into the 1980s. In 1985, the deregulation of the price system brought another inflationary push. The low wage drag, an effect of the remuneration system based on sharing of enterprise income rather than contractual wages and salaries, contributed to the cost push momentum.

C. Stabilization and Adjustment Measures.

13. To cope with the eroded cost competitiveness of Yugoslav products in international competition, the authorities began gradually, after 1980, to adjust the exchange rate which had changed little during most of the 1970s in spite of high domestic inflation. The decisive corrections were undertaken in 1983 and 1984, when the aggregate devaluation came to 85% and 68% (compared to rates of inflation of 54% and 41%). Since July 1984, the nominal exchange rate has been adjusted regularly to reflect the difference in inflation between Yugoslavia and its main trading partners. At this stage, the Government's policy is to maintain the real exchange

rate constant.

14. Although fiscal deficits were only a minor factor of the growing imbalances during the 1970s, the Government took a more restrictive position after 1980. While fiscal budgets were in balance after 1981, the fiscal system, characterized by large regional budgets and numerous earmarked taxes and quasi-taxes, is not well suited for macroeconomic policy. Perhaps the most important contribution of fiscal policy to stabilization is the contraction of the public sector from 37% of GSP to 29% in 1984. [1]

15. The stringent fiscal policy was accompanied by a restrictive monetary policy. Both the growth of credit and of money supply were consistently below the nominal growth of GSP. However, the monetary policy was largely circumvented through increasing arrears in debt service payments to banks or current suppliers' claims, amounting to an expansion of involuntary credits reflected in a rapid growth in velocity of circulation (rising from 3.4 in 1980 to 4.9 by 1983).

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[1] The Yugoslav National Accounts are for Gross Social Product; the major difference to GNP is the exclusion of services not directly related to production of goods from the aggregate.

16. Interest rates were raised substantially in 1982 and 1983, but remained still negative, although at lower levels as in 1981. In 1984 the speed of adjustment accelerated, and by mid-1985 real time deposit rates had become positive, while average real lending rates, lagging behind the deposit rates, were approaching positive levels.

17. The price policy changed substantially since the early 1980s. Up to 1982-83 the authorities tried to contain inflationary pressures by active price policy aimed at containment of price increases. The policy was, as the continuing high rates of inflation indicate, unsuccessful. And the distribution of jurisdiction over prices between the Federation and the RAPs increasingly led to inter-regional price distortions. More importantly, the price system became increasingly distorted because energy prices and prices for basic infrastructure fell increasingly behind their opportunity cost. Starting 1983, the authorities started adjusting these basic prices, while continuing its efforts to contain all other prices administratively. In January 1985, a new law on prices was introduced which discontinued all administrative price intervention except for these basic prices. These recent moves to correct the mistakes of the earlier price policy had a significant short-term impact on the price level, as particularly the upsurge of inflation in 1985 demonstrates.

D. Capital Inflows

18. As stated in para 10-11 above, debt outstanding and disbursed has peaked in 1981 at $19.4 billion if short-term debt is included, and in 1983 at $17.3 billion for MLT loans; short-term debt is expected to have declined to around 5% by 1985. By the end of 1984, the composition of debt was as follows:

Table 3 Foreign Debt, OaD, End 1984

($ million)

Medium-and Long-term		18,977
Public		(8,660)
of which	IBRD	(2,047)
	IMF	(1,947)
	Kuwait	(747)
	Germany F.R	(589)
	USA	(581)
	USSR	(481)
	France	(275)
	Libya	(170)
	Austria	(158)
Private		(8,370)
Short term		(837)

Source: EPD 12/03/85

Of loans to public debtors, almost 50% are extended by financial institutions, 24% by multilateral lenders (mostly World Bank), and about 26% by bilateral agencies; no suppliers' credits are reported. It should be noted that from the borrowers point of view the distinction between "public" and "private" is irrelevant. Debtors in the latter category are also units within the social sector, and through inter-firm or inter-bank arrangements on liability, the security of the two categories is all but identical.

19. A major international assistance package was put together in early 1983. Managed by the IMF, it included 15 OECD governments, the Bank for International Settlement (BIS), international commercial banks, the European Investment Bank (EIB) and the World Bank. The package, which totaled about $4.4 billion in medium- and long-term commitments, included some $1.6 billion from commercial banks, including $600 million in new financing and $980million in refinancing. Yugoslavia received from the IMF the equivalent of $590 million, while from the Bank and other multilateral lenders it got about $350 million, including a Structural Adjustment Loan in the amount of $275 million and project lending. The balance of the package included suppliers' credits from non-government sources. Of the total, approximately $1.3 billion was in the form of refinancing of 1983 maturities.

20. A similar package, on a smaller scale and somewhat differently constituted, was put together for 1984. Totaling about $3.2 billion, it came from the same sources as in 1983, but with only

$200 million in new financing from commercial banks. Of the total, about $2.1 billion involved refinancing of 1984 maturities. The terms for the 1984 debt rescheduling were a significant improvement over 1983, with longer revised maturities and lower costs. They clearly reflected a recognition by the international financial community of Yugoslavia's efforts to stabilize its economy and to establish a basis for sustained growth and structural adjustment.

21. In March of 1985, the official lenders of the Paris Club agreed to reschedule 90% of the original maturities in the amount of $694 million coming due between January 1985 and May 15, 1986, when the present stand-by arrangement with the IMF expires; the agreed upon repayment period was nine years, with a grace period of four years. Negotiations with commercial banks, running in parallel, led in August to an agreement to reschedule maturities falling due between 1985 and 1988, and on continuous monitoring of economic developments by the IMF under enhanced surveillance beyond the period of the present standby arrangement.(1991) Reportedly no new resources are included in either agreement.

E. The Role of the World Bank in promoting Adjustment

22. The World Bank took an active role in Yugoslavia's stabilization program mainly through its first Structural Adjustment Loan, approved by the Board on June 28, 1983. The main conditionalities of SAL I can be summarized as follows:

23. Foreign Trade and Foreign Exchange:

(a) Preparation of a program for increased mobility of foreign exchange and the activation of a foreign exchange market.

(b) Creation of an Export Development Fund, to be financed from SAL receipts, to provide import credits to exporters.

(c) Preparation of a program for a gradual phase-out of selective export incentives.

(d) Reduction of quantitative import restrictions to 20% of the total and preparation of a program for a gradual phase-out of import restrictions, to be implemented pari passu with the phase-out of foreign exchange allocation.

(e) Continued devaluation of the dinar to retain constant real exchange rates.

24. Price Policies:

(f) Phase-out of price controls, with the exception of agreed areas of administrative price adjustment and maintenance, as mentioned below.

(g) Maintenance of petroleum and petroleum product prices to international levels; gradual adjustment of prices for domestic natural gas to import prices; development of a policy to increase domestic prices for coal, lignite and electricity to long-term marginal cost, to be implemented over a period of 4-5 years.

(h) Gradual increase of railway tariffs with the goal of eliminating subsidies by 1990.

(i) Adjustment of transport fuel taxation to the level required for financing investment and maintenance of the road system.

25. Investment and Financing:

(j) Agreement on a core investment program for the energy sector.

(k) semi-annual reports on progress in realization of a priority investment program.

(l) Conclusion of a Social Compact on economic criteria for project evaluation.

(m) Gradual increase of real lending rates to reach positive levels, depending on recipients and purposes between 1986 to 1989.

(n) Change-over from constant to current prices in the financial planning of banks.

(o) Promulgation and implementation of legal changes regarding access of loss-making enterprises to reserve funds, payment of personal incomes and institution of bankruptcy proceedings.

26. Sectorial Tasks:

(p) Carrying out of a number of sub-sector studies with a view to defining a national strategy and to improving their efficiency.

(q) Carrying out of a number of energy conservation studies.

27. Compliance with the conditionalities was mixed; in some areas implementation was well ahead of the action program, in others it lagged behind. In general the areas of incomplete compliance were

those where the system problems, mentioned in section A, were particularly severe, that is to say, where the hands of the Federal Government are tied severely for constitutional reasons. Nevertheless, on the basis of the overall record, the second tranche was released on August 20, 1984.

28. Preparatory work for a second Structural Adjustment Loan is presently under way. An appraisal mission visited Yugoslavia in November 1985. Although a substantive dialogue is on-going, major areas where views are far apart remain. These relate in particular to interest adjustment and to the liberalization of foreign economic relations. The Government still hopes for a SAL II in FY86, but FY87 appears more likely.

F. The Role of the IMF

29. The IMF extended a series of standby arrangements:

May	1979	SDR	69.25 million
June	1980		339.325
Jan.	1980		1,662
April	1984		370
May	1985		300

30. The June 1980 arrangement was for a three-year period, and the amount is equivalent to 400% of Yugoslavia's quota. The performance criteria included ceilings on total domestic bank credits, the budget of the Federation, debt in convertible currency,

exchange rate adjustment, and adjustment of deposit rates. The Bank and the Fund work closely together, including participation in missions. No further standby arrangements are presently being considered. The Government is, however, expected to request enhanced surveillance by the IMF in early 1986.

II. CONSTRAINTS ON LONG-TERM GROWTH

A. Domestic Policies

31. Regarding debt, there is general recognition in Yugoslavia of the unsustainability of the profligacy in foreign borrowing during the late 1970s and into the 1980s. A somber consensus has been reached that Yugoslavia has to start reducing its outstanding foreign debt, and a beginning has been made with the turn-around in total burden of MLT debt after 1983. All indications support the presumption that this consensus is universally shared by all politically relevant forces and that it is likely to shape the design of the forthcoming five-year plan 1986, although the profile of the reduction in debt is still debated. Consequently, a very conservative borrowing policy may be expected to prevail for years to come.

32. Regarding further adjustment efforts, their scope and momentum is difficult to predict, essentially for internal political reasons. The immediate stabilization measures taken during the most recent years, although unprecedented in the recent economic history of Yugoslavia, were comparatively easy to take because the country had

little choice under the acute threat of external illiquidity and the pressure of creditors and international organizations. The structural changes which now lie ahead are no longer emergency measures but involve major changes in the economic system, such as shifts of economic power and control from the RAPs to the Federation or a shift of control over the accumulation from enterprises to banks, for which a consensus will be very difficult to reach. It is particularly difficult within the Yugoslav constitutional framework (see paras 1-5) which is designed to precisely to make such system changes difficult.

Therefore, although the so-called Stabilization Program - a blueprint for medium-term structural change drawn up in a collective effort of the most respected researchers and research organizations of the country with which the Bank is largely in agreement - was adopted by the Federal Assembly as a guide for the five-year period 1986-90, not all of the proposed changes of the framework may be realized or realized in due time, with uncertain consequences for the growth prospects.

B.. External Constraints

33. Political expediency and response to the serious belt-tightening efforts of Yugoslavia led to a flexible attitude of external lenders to Yugoslavia, as exhibited in the successful multi-year rescheduling exercises in 1983, 1984, and 1985 of bank credits. However, this does not change the fact that Yugoslavia continues to be unfavorably ranked by commercial lenders in terms of

creditworthyness. For example, Yugoslavia is consistently placed below Brazil and Mexico, and, after 1983, Egypt, and of the major borrowing countries only Argentina had a consistently lower rating; in March 1985, Yugoslavia's comparative rating was 62nd of a total of 109 countries. Given the tightened application of creditworthyness criteria by commercial lenders, any increase of Yugoslavia's borrowing capacity seems presently difficult to imagine. In this respect the Yugoslav determination to reduce total foreign debt may at least in part be a realistic reflection of the external constraints.

34. A potential second major external constraint is the unbalanced trade mix of the country. For the period 1981-1983, the following aggregate commodity trade flows are reported:

Table 3. Trade Flows by Area

(in billion dinar) [1]

	Exports	Imports	Balance
OECD, Europe	423 (22.2%)	970 (37.6%)	-547
CMEA, Europe	1,011 (53.1%)	842 (32.7%)	169
Rest of the W.	471 (24.7%)	766 (29.7%)	-295
Total	1,905 (100%)	2,578 (100%)	-673

Source: Statistical Yearbook, Yugoslavia

CMEA is the source of more than one half of the export earnings, and Yugoslavia is running a slight surplus. On the other hand, Yugoslavia covered less than one half of its imports by exports in relation with OECD, Europe, the major single trading area for convertible currency trade. With the rest of the world, accounting for roughly one quarter each for exports and imports, Yugoslavia is also running a substantial trade deficit. The implications of this trade pattern, should it persist in the future, on growth prospects and debt repayment could be severe.

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[1] Since the annual data are in current dinars, the 3-year aggregates are an indication of the respective orders of magnitude rather than an exact description of actual flows. In services, Yugoslavia has a considerable surplus with OECD Europe, so that the composite deficit is somewhat reduced.

35. Yugoslavia's main exports to OECD Europe are either in low- to medium-technology manufactured goods where the competition from the low labor cost NICs is fierce, and/or where protective measures from the recipient countries are becoming stronger. The second area of Yugoslavia's export potential is food and food products, but the EEC markets become increasingly impenetrable. On the other hand, most of the critical capital good imports come from the OECD countries. Export receipts for invisibles - workers' remittances and tourism receipts - make the balance with these countries less acute than the comparison of merchandise trade suggests, but workers' remittances are declining, and Yugoslavia's growth potential of tourism - from both the supply and the demand side - is less than certain. Regarding trade with the rest of the world, an unknown, but reportedly not insignificant portion is in the form of countertrade which normally generates little, if any fungible convertible currency earnings. In the trade with CMEA virtually no convertible currency is generated. However, most of Yugoslavia's debt is with the OECD area and in convertible currency. Thus, Yugoslavia's room for maneuver regarding debt servicing is presently, and is likely to remain in the next few years a good deal more narrow than aggregate trade data suggest.

ANNEX TABLE 1: COUNTRY DATA - YUGOSLAVIA

		1978	1979	1980	1981	1982	1983	1984	1985 1/
Real GDP growth	%	8.5	5.5	2.3	1.4	0.5	1.3	2.1	2.6
Total Cons. growth per capita	%	12.0	0.3	0	-2.2	-0.2	-0.9	-1.3	-0.3
Investment/GDP	%	34.3	38.3	35.0	35.8	33.3	31.1	29.3	32.3
Gross dom. savings/GDP	%	29.5	31.4	30.9	33.7	32.4	31.3	30.1	33.1
Fiscal deficits/GDP	%	-0.5	0	-1.2	-0.1	0.1	0	0	0
Debt/exports 2/	%	131	134	113	107	107	131	123	119
Interest/exports 2/	%	6.8	8.0	12.0	12.2	12.2	11.5	16.9	12.7
Debt Serv. paymts./exports 2/	%	22.0	29.8	29.3	24.5	25.5	24.2	28.0	25.2
Terms of trade	%	102.9	101.2	100.0	96.9	97.4	97.3	94.4	83.6
Real export growth	%	4.8	2.6	10.4	0.5	-11.5	-0.7	10.0	
Real import growth	%	2.5	12.0	-8.6	-10.8	-15.3	-5.6	4.8	
Rate of inflation (CPI)	%	14	27	30	40	33	54	41	77 3/
Current Account balance	b$	-1.28	-3.67	-2.32	-0.96	-0.47	0.27	0.40	0.50
Debt, OD, MLT	b$	11.0	13.7	15.6	16.9	16.5	17.3	17.0	16.8
Capital outflow/flight	b$								

Sources: EPd, Institute for Statistics.

1/ Estimates

2/ Computed on total exports of goods and services

3/ III 1985/III 1984

Table
Major Features of Structural Adjustment Programs

	Bolivia	Chile	Ivory Coast I	Ivory Coast II	Philippines I	Philippines II	Yugoslavia
I. TRADE POLICY							
Tariff reform and import liberalization		X			X	X	X
Export incentives and improved institutional support		X	X	X	X	X	X
II. RESOURCE MOBILIZATION							
Budget Policy							X
Domestic Savings Policy		X					X
Strengthening of institutional capacity to manage external borrowing	X		X				X
Public enterprise financial performance	X			X			X
III. EFFICIENT USE OF RESOURCES							
Public investment program revision and review of structural priorities	X	X	X	X			X
Pricing Policy:							
- Agriculture	X	X	X	X			X
- Energy	X					X	X
Incentive System:							
- Industry				X	X	X	X
Energy conservation measures						X	X
Energy - Development of indigenous sources		X					
IV. INSTITUTIONAL REFORMS							
Strengthening of institutional capacity to formulate and implement public investment program		X	X	X			
Instutional efficiency of public sector enterprises	X	X	X	X			
Improved institutional support in agriculture (marketing, etc.)		X	X	X			
Institutional improvements in industry and sub-sector programs				X	X	X	

Sources: World Bank, 'Progress Report on Structural Adjustment Lending', 5-23-84, &, various SAL Reports.

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

→ D-2C

DATE November 1, 1985

TO Mr. S. El Serafy, CPDDR

FROM Wafik Grais, Senior Economist, EM1DB

EXTENSION 3-2442

SUBJECT <u>YUGOSLAVIA: Country Studies on "Towards Sustained Economic Growth in Heavily Indebted Countries.</u>

1. As you know, the team of economists on Yugoslavia will be away on a SAL appraisal mission beginning November 1st. We will, therefore, unfortunately not be able to contribute as fullly and directly as we would like to the paper on Yugoslavia requested by your Department. As we agreed, we will provide you with the information we have readily available and of course will participate in the review of the paper.

2. I would like however to stress that this is a positive initiative to which we would have wished to participate more fully. It is only the timing constraint and the trade-off between a SAL appraisal and the suggested paper which does not allow us to provide you with a positive response.

3. You will find attached a white cover report and a paper on Yugoslavia's macroeconomic performance over 1970-84. The first chapter of the report, the paper and the recent SAL II Initiating Memorandum should provide sufficient information and views on the recent adjustment of the economy and a preliminary analysis of prospects.

cc. /without attachments: Messrs. Hasan, Lari, Harrison, Pant, Farsad, Rangachar, Kavelsky, Choksi, Dubey.

Does this mean that beyond a preliminary analysis they haven't done much? A