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THE ECONOMIC DEVELOPMENT OF YUGOSLAVIA

(in six volumes)

VOLUME IV

IX. Resource Mobilization and Allocation, 1947-71
X. Resource Mobilization and Allocation, Prospects
XI. Stabilization: Institutions, Instruments and Policies
XII. The Balance of Payments and Foreign Trade
XIII. Capital Flows and External Debt
XIV. Development Problems and Prospects

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Europe, Middle East and North Africa Region

Public Disclosure Authorized

CURRENCY EQUIVALENTS

Before January 23, 1971

1 US dollar = 12.5 dinars

1 Dinar = 8 US cents

From January 23, 1971 to December 22, 1971*

1 US dollar = 15.0 dinars

1 Dinar = 6.67 US cents

From December 22, 1971 to February 23, 1972

1 US dollar = 17.0 dinars

1 Dinar = 5.89 US cents

From February 23, 1973 to July 12, 1973

Maintained a central rate of

1 US dollar = 17.0 dinars

1 Dinar = 5.89 US cents

Since July 12, 1973

The Dinar has been floating.

The rate of July 12, was

1 US dollar = 15.50 dinars

1 Dinar = 6.45 US cents

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* All conversions of 1971 data into dollars in this Report have been made at this exchange rate.

IX. RESOURCE MOBILIZATION AND ALLOCATION - 1947-71

Introduction

9.1 Changes in monetary and fiscal institutions and policies have constituted both a part of and a response to the progress of decentralization in Yugoslavia. During the era of rigid central planning, about 90 percent of domestic savings was mobilized and allocated through the National Budget. By 1971 it was the economic enterprises and households which accounted for over 90 percent of domestic saving formation. Parallel to the gradual increase in enterprise autonomy, the all-encompassing National Budget was decomposed into federal, republic and communal budgets and extrabudgetary funds. Until the mid-1960s the State retained a major role in savings mobilization and allocation through the system of social investment funds. It was not until these were abolished in 1963 that investment banking really came into its own, though the banking system for "short-term operations" had already developed a long way since the mono-bank days of central planning. With the abolition of social investment funds and certain taxes which financed them, and the devolution of their assets and liabilities to banks, the role of investment banking in resource mobilization/allocation was significantly increased. The reduction in the State's fiscal burden on enterprise income (roughly value added), coupled with the consolidation of enterprise autonomy in accordance with the 1963 Constitution, led to the increased importance of savings by enterprices and households - the latter from increased personal incomes. With a much higher proportion of decentralized autonomous savings, the potential role of efficient financial intermediation has increased a potential which remains to be fully developed. The relatively slow development of financial mechanisms and instruments was in part due to the inflation in the post-Reform period. The extension of market forces after the Reform was accompanied on the one hand by strong investment demand arising from the low real interest rates, partial insulation of enterprises from financial risk and a desire to catch up technologically with Western Europe, while on the other, by a prolonged consumption boom fed by increased allocation to personal incomes from enterprise incomes and "demonstration effects" passed on by Yugoslav workers in Western Europe. These factors lent an inflationary bias to the Yugoslav economy and brought the problem of short-term demand management to the foreground. Selective price control has not reduced these inflationary pressures -- if anything, it has increased the costs of inflation by distorting the relative price structure. Monetary policy has had an impact but its efficiency has been limited by a number of features including the partial insulation of enterprises from financial constraints by patron State units whether republics or communes. The fiscal manifold, composed of a multitude of budgetary and extra-budgetary units, with independent revenue and expenditure authority, has proved to be a clumsy tool for coordinated demand management.

9.2 Thus the 1965-71 period, has been characterized by these twin foci of policy concerns:

(a) mobilization and allocation of resources according to ambitious Plan targets in a context of highly decentralized savings/investment decision;

(b) the management of aggregate demand to encourage rapid economic growth without running into western-developed-economy-type "overheating" problems of inflation and/or excessive balance of payments deficits.

The 1971 Constitutional Amendments have not materially altered these policy concerns. The further devolution of State economic power to republics and communes have, if anything, increased the problems of coordinating economic management. The Amendments further increased the share of social Product (gross material product) at the command of the enterprises. This, together with the fact that enterprises accounted for about half of total domestic savings in 1971, led to the institution of incomes policy agreements in each republic in an effort to stabilize, perhaps raise, the rate of enterprise savings. While these agreements may turn out to be powerful instruments for shoring up enterprise savings and weakening inflationary pressures, the main current concern on the resources side is with improving the mechanism for their allocation. Commercial banks, virtually the sole financial intermediaries, have a number of structural defects which suggest the need for reform or development of alternative modes of financial intermediation. Improvements in the financial mechanism are likely to be closely linked with the success of the present stabilization policies. Such improvements in resource allocation appear to be most urgently needed in the less-developed republics. This chapter, and the one following, focus on questions of resource mobilization and allocation. Chapter XI is concerned with issues in stabilization policy. Section A of this chapter briefly outlines the system of resource management during the central planning years. Section B covers the period 1952-63 describing the development of enterprise autonomy, banks and the new system of social investment funds, and the implications of these changes for the structure of savings in the economy. Section C describes the mid-1960's Economic Reforms and examines their impact in the post-Reforms period 1965-71, paying special attention to (1) trends and structure of savings, (2) the new role of financial intermediation, and (3) the quality of resource allocation.

A. Central Planning 1947-51

9.3 In this period production was centrally planned and administratively controlled and enterprises merely acted as agents for carrying out the annual plans, which laid down production quotas, factor inputs to be used and rules for allocation of the product. The National Budget operated as a component of the central planning mechanism. In addition to the classical tax expenditure functions, the National Budget was the vehicle for appropriating and deploying the surpluses of social sector enterprises. In this way the mobilization and allocation of savings and investment in the social sector was under full administrative control, leaving no intermediation role to the financial

mechanism. Through taxes on income and turnover the fiscal system also channelled some private sector resources into the social sector via the National Budget 1/.

9.4 The financial mechanism during this period was relatively simple. In effect, it consisted of a mono-bank system (the National Bank with its 400 odd branches) designed to provide money as a unit of account and means of payment. For the social sector, monetary policy was concerned mainly with meeting the transactions demand for money through short-term credits. Monetary policy did have a limited role in affecting expenditure decisions in the private sector 2/.

9.5 Though the structure of administrative planning was subsequently dismantled, the process occurred at different speeds for different sectors. For example, administered prices continued to prevail in important segments of the economy until the end of the 1960's, with considerable impact on inter-sectoral and inter-regional resource allocation.

B. Decentralization, 1952-63

9.6 The state retained considerable, though gradually diminishing, control over the mobilization and allocation of resources throughout this period. Prices of goods and services in major segments of the economy remained under state control. Until 1957, when the "Net Income System" was first introduced to enterprises, the state continued to regulate wages and salaries. By setting the rates of the "interest on business funds (capital) of enterprises" (a form of tax on socially owned capital) and the terms of lending from the new system of social investment funds, the state effectively decreed the cost of capital to enterprises. Though the planning mechanism was decentralized and "indicating" the state wielded enormous influence over sectoral choices through the deployment of the social investment funds. Despite major changes in the system of foreign trade and exchange, it remained the most tightly controlled segment of the economy.

9.7 However, the steps towards decentralization should not be minimized. After 1957 wages and salaries were increasingly determined by enterprises, which also took over an increasing role in voluntary savings formation. The banking mechanism developed rapidly. Though banks were not allowed to engage in investment crediting until 1963, the foundations of the investment banking system were laid during this period 3/.

1/ There were further resource transfers through fixing relatively low private sector prices for products delivered to the social sector.

2/ Useful discussions of this role contained in Dimitrijevic and Macesich Money and Finance in Yugoslavia, and Hauvonen.

3/ See Chapter I.

Social Investment Funds

9.8 The all-encompassing National Budget was decentralized vertically across the Federal, Republican and Communal governments, and horizontally (at each of these independent levels) across budgetary and extra-budgetary transactions. While budgetary transactions were concerned with fairly classical public expenditure functions, the extrabudgetary operations included the new system of social investment funds. Unlike proper financial intermediaries, the social investment funds lent their resources but did not borrow them in the first place, thus creating no assets for primary savers. These semi-financial intermediaries relied on fiscal resources of various kinds 1/ (mainly the tax on owned capital of enterprises and contributions levied on the income of enterprises) which were then channelled to enterprises in the form of credits according to the economic plans of the relevant government unit. Some idea of the relative distribution of the resources of these funds across different levels of government may be obtained from Table 9.1.

Table 9.1: ASSETS OF SOCIAL INVESTMENT FUNDS AT END 1963

	(million dinars)	Percent
General Investment Fund	21,021	66.8
Republican Investment Funds	6,304	20.0
District and Communal Investment Funds	4,158	13.2
Total	**31,483**	**100.0**

Source: Sekulic, loc. cit.

9.9 The Social investment funds were not legally independent agencies. Their assets were managed by banks in conformity with plans of government units. For example, in the case of the General Investment Fund, the sectoral distribution of resources was determined by priorities in the annual Federal plans, leaving the allocation to specific enterprises up to the managing banks (mainly the Yugoslav Investment Bank in this case). The terms of credits were agreed upon with the Federal Executive Council. Parallel procedures existed for investment loan funds at other levels of government. Thus the banks acted largely as agents of the state units, with little control over regional and sectoral allocation of funds, although they gradually took over the important role of supervising the terms and conditions of each individual credit. However, even toward the end of the period, state influence in the

1/ For a fuller description of these funds are Sekulic "Investment Capital of Socio-Political Communities," Yugoslav Survey, Nov. 1970.

allocation of these investment funds often reached to individual credits, which were granted on socio-political rather than economic grounds 1/.

9.10 Two other kinds of investment funds were created at Republican and Communal levels during this period:

(a) Housing Funds (1955) fed from levies on the income of enterprises and deployed to finance housing projects in the social sector;

(b) Joint Reserve Funds (1962), again financed through compulsory contributions of enterprises, and used to credit enterprises in temporary difficulties.

In both cases the appropriate state unit had the most say in the allocation of these resources. By 1963, all the investment loan funds numbered nearly two thousand.

The Changing Role of Enterprises

9.11 Enterprise command over resources increased significantly after 1957 and by 1963 their contribution to voluntary savings formation was sizeable. Though the share of enterprises in total domestic savings was already 29 percent in 1953, most of it represented compulsory savings according to rules decreed by the State. In 1957, with the adoption of the "Net Income System," the base was laid for growing worker control over enterprising accumulation decisions. In fact, the system underwent significant changes after 1957, especially in 1969. But the principle of treating the payments to labor as a part of "net income" rather than an element of operating costs remained as the distinguishing feature of all variants of the system.

9.12 Table 9.2 presents the functional breakdown of gross revenues earned by an enterprise according to the "Net Income System" after the definitional changes adopted in 1969. 2/ It is clear from the table that:

1/ See Sukulic op.cit. and Hauvonen op.cit. In the early 1950's there was an attempt to allocate these investment credits on market criteria through "investment auctions." The attempt was abandoned largely because the profitability incentives embedded in the distorted price structure indicated sectoral choices which were at variance with planned priorities, and the "irresponsible" approach of enterprise in making bids.

2/ The main differences with the variants prevailing before were:

(i) Some of the "contractual obligations" in the post-1969 system were formerly charged against operating cost;

(ii) After 1966, depreciation consisted of a newly-instituted legal minimum component plus a voluntary accelerated component.

Table 9.2: THE NET INCOME SYSTEM

I. Gross Revenue
II. Operating Costs
III. Social Product (Gross Value Added = I-II)
IV. Depreciation (Legal + accelerated)
V. Net Income A (Net Value Added = III-IV)
  1. Obligations
    A. Contractual Obligations
      (a) Interest and service charges on bank credit
      (b) Insurance premia
      (c) Contributions to chambers of commerce, etc.
    B. Statutory Obligations
      (a) Interest on "business fund" - abolished in 1971
      (b) Turnover tax
      (c) Legally imposed contributions for water, land, housing
      (d) Other legal obligations
  2. Net Income B
    A. Gross Personal Incomes
      (a) Net Personal Incomes (take-home wages)
      (b) Contributions from personal incomes including those for education, social insurance, etc.
    B. Enterprise Funds (allocations to)
      (a) Reserve Fund
      (b) "Business Fund"
      (c) Welfare Fund

Source: Adapted from Gorupic and Paij, Workers' Self-Management in Yugoslav Undertakings.

the enterprise did not have full autonomy on the allocation of Net Income A because of contractual and statutory obligations and certain mandatory deductions from gross personal incomes. A better estimate of the distributional authority of the enterprise is obtained by adding together "net personal incomes", "enterprise funds" and "depreciation" (to be called residual enterprise income, REI) and comparing it to the social product generated in the enterprise 1/. Between 1958, when enterprises were first put on the "Net Income System", and 1963, the share of gross value added under enterprise control showed a mild upward trend (Table 9.3). The major increases in this share occurred later, with abolition of social investment funds in 1963 and 1964 and other tax changes associated with the 1965 Economic Reforms.

1/ The comparison is preferred in terms of gross (of depreciation) concepts because depreciation included varying proportions of voluntary and legally fixed elements during the last two decades.

Table 9.3: SHARE OF ENTERPRISE REI IN GROSS VALUE ADDED
(percent)

1958	1959	1960	1961	1962	1963
44	47	48	50	49	49

Source: Based on data from Statistical Yearbook of Yugoslavia, Federal Institute of Statistics.

Trends in the Structure of Savings

Table 9.4: STRUCTURE OF TOTAL SAVINGS, 1950-63
(Percent)

	1950 /a	1953	1958	1963
State	90	54	48	45
Federal	90	47	25	18
Government		(n.a.)	(0)	(0)
Investment Loan Funds		(n.a.)	(25)	(18)
Other State Units		7	23	27
Government		(n.a.)	(6)	(11)
Investment Loan Funds		(n.a.)	(17)	(16)
Enterprises		29	42	35
Households and Private Producers		10	9	9
Other (including Unclassified)		7	1	11
Total	100	100	100	100
Decentralized Savings Share /b	10	53	75	82
Voluntary Savings Share /a	10	19	33	38
GNS as Percent of GNP	24	31	30	35

/a Estimates from Dimitrijevic and Masecic .

/b Decentralized - non-federal.

Sources: Annual Reports of the National Bank of Yugoslavia, Dimitrijevic and Macesic op. cit. and mission estimates of national income.

9.13 The impact of these institutional innovations on the mobilization of savings is shown in Table 9.4. First, there was a significant increase in voluntary savings emanating from changes in enterprise control over value added. Secondly, there was a dramatic increase in the share of "decentralized savings" reflecting both the "returning of resources to the economy" by giving increased autonomy to enterprises and the devolution of fiscal authority within the state sector towards republics and communes. Consequently, after the initial structural changes bewteen 1950 and 1953, the share of the state in savings declined much less than the share of the Federation because the role of non-Federal State units increased. Finally, the importance of social investment funds during the entire period is clearly brought out; they accounted for 42 percent of total savings in 1958 and 34 percent in 1963 1/.

The Development of Banks

9.14 The banking system developed rapidly after 1955, when the mono-bank system of the central planning era was dismantled. Table 9.5 summarizes the banking institutions existing at the end of 1963.

9.15 Banks were not allowed to mobilize time-deposits or engage in investment credits until 1963. But the experience gained during this transitional period in managing the investible resources of the social investment funds, provided a valuable foundation for the pivotal role of investment banking in resource allocation after 1963.

9.16 An important nonbank financial institution, the Social Accounting Service, was created in 1962 (previously it had been an arm of the National Bank) to police the conformity of all transactions with the various earmarking provisions prevailing, and to provide a comprehensive accounting and statistical service.

1/ The sectoral breakdown of savings is based on the Money Flow accounts of the National Bank. Strict comparability with Yugoslav national accounts data (prepared independently) is not assured, but broad trends are probably accurate. Both the money flow data and the Yugoslav national accounts on income and product include an element of capital gains on inventory, which is consistent with usual national income accounting practice. While a correction for this has been incorporated in the mission's national income estimates (see Statistical Note) and subsequent discussion of savings, this correction, positively correlated with inflation, was small until 1963, and has been omitted from Tables 9.3 and 9.4 above.

Table 9.5: BANKING SYSTEM AT END 1963

Bank	Year Established	Purpose
Federal		
National Bank (including 6 Republican offices)		Central Bank operations.
Yugoslav Investment Bank	1955	Manage resources of the General Investment Fund and long-term foreign credits.
Yugoslav Bank for Foreign Trade (Jugobanka)	1955	Provide credit for foreign trade operations.
Yugoslav Agricultural Bank	1959	For credits to socialized agricultural sector.
Postal Savings Bank	1959	Accepts savings deposits, but places its resources at the disposal of National Bank.
Republic		
Republic Banks (6)	1961	Manage investment policy of Republic government.
Communes		
Communal Banks (220)	1955	Engage in short-term commercial operations and manage communal social investment funds.

Sources: Hauvonen op. cit. and Dimitrijevic and Macesic op. cit.

C. Decentralization: 1964-71

9.17 1965 is usually singled out as the year of the Economic Reform. In fact, the changes in institutions and policy which were important in the monetary and fiscal fields occurred over 1963-66. The major changes which occurred during this period were: (a) abolition of the social investment funds, and the devolution of their assets and liabilities to the banks (mainly and to government bodies; (b) abolition of some of the taxes which financed

these funds; (c) strengthening of enterprise autonomy over the disposition of value added; (d) passage of new laws regulating the formation and function of the banking system. These changes and their impact on mobilization and allocation of resources and stabilization policy are discussed below.

(1) Trends and Structure of Savings

9.18 The institutional changes between 1963 and 1966 altered the distribution of national income in favor of enterprises and households, and away from the state. This had two fundamental consequences. First, gross national savings (GNS) as a proportion of GNP declined significantly from 33 percent in 1960-63 to 29 percent in 1967 (Table 9.6) implying that the marginal propensity to save of enterprises and households was lower than that of state units at whose expense their incomes had increased. Second, the institutional changes dramatically altered the sectoral structure of savings.

Table 9.6: TRENDS IN AGGREGATE SAVING AND INVESTMENT
(percent shares; current prices)

	1960-63	1966	1967	1968	1969	1970	1971 /a
1. GNS/GNP	33.2	32.6	29.3	27.8	28.2	28.4	27.7
2. GDS/GDP	32.7	32.0	28.8	27.2	27.1	26.4	24.7
3. NFI/GNP	-0.2	-0.1	0.2	0.4	1.0	2.2	3.4
4. GDI/GDP	35.5	33.0	30.3	29.0	29.4	31.6	31.0
5. (GNS-GDI)/GNP /b	-2.3	0.0	-1.0	-1.0	-1.0	-2.4	-2.2

/a 1971 estimates are provisional.

/b Deficit (-) on the current account of the balance of payments.

Source: Mission estimates of national income, Statistical Annex Table 2.1 to 2.4.

9.19 The decline in the rate of aggregate savings between 1960-63 and 1967 should not, by itself, be viewed as a reflection of poor performance. Increasing the share of consumption in national product was a deliberate objective of the Reform 1/. After this initial decline the GNS ratio remained

1/ This does not mean that a trend decline in the aggregate savings rate may be viewed with equanimity. Given ambitious investment targets in the 1971-75 Social Plan, stabilizing the rate of aggregate saving at the 1970 level is important. See Chapter X.

remarkably stable until 1970, indicating an impressive performance in maintaining the high savings ratio of 28-29 percent. However, the ratio of gross domestic savings (GDS) to GDP declined further after 1967. As an index of savings performance, the GDS ratio is misleading in a context of large and growing net factor income from abroad (NFI) - after 1967 Yugoslavia benefited from a surge of worker remittances from abroad 1/.

9.20 The institutional changes also dramatically altered the sectoral structure of savings. Table 9.7 presents the sectoral composition of domestic savings according to two sets of data. The unadjusted ratios are based on current price data as available in Yugoslav statistical sources. The adjusted ratios incorporate an inventory evaluation adjustment (also present in the aggregate savings data) 2/. The Yugoslav National Bank's money flow accounts (on which tables 9.7, 9.10, 9.16, 9.17, and 9.18 are based) have been periodically revised. As a result, the data prior to 1963 are not fully comparable to that for subsequent years. But conclusions based on broad trends remain sustainable. During 1973 a new revision was undertaken. The resulting changes for earlier years were very minor, and since the details of these changes were not available at the time of revision of this report, the older figures were allowed to stand. The 1972 data, compiled only on the new basis, is therefore not completely comparable to earlier years.

1/ The national income accounts for Yugoslav (and for many other countries) estimate consumption as a residual, by subtracting independently estimated investment from available resources (=GDP plus the deficit on goods and nonfactor services account in the balance of payments). This estimate of consumption is appropriate for the GNP concept of income. GNS, which is defined as GNP minus consumption, correctly measures the country's savings effort from available income (GNP). However, GDS, which is defined as GDP minus consumption makes the unsupported assumption that all of net factor income from abroad is saved. The GNS figures in Table 9.6 also include net current transfers from abroad. Though much less than net factor incomes, this item, which is excluded from GNP does bias the GNS ratio upwards slightly as a measure of savings performance. However, as a ratio of GNP, there was no observable trend in this item, implying that its inclusion in GNP does not bias the trend in savings performance.

2/ Briefly, the Yugoslav data on product and income include an element of unrealized capital gain on inventory, which is inconsistent with national income accounting methodology. To achieve consistency and comparability, this element has been estimated and excluded from the income and saving figures (see Appendix I).

Table 9.7: STRUCTURE OF SAVINGS
(percent)

A. Unadjusted Data

	1960-63	1967	1968	1969	1970	1971	1972
State	36	23	24	20	15	3	9
Federal	14	11	10	7	5	-4	..
(a) Government	(-9)	(2)	(2)	(1)	(-3)	(-4)	..
(b) Investment Loan Funds	(23)	(9)	(8)	(6)	(7)	(0)	..
Other State Units	22	12	13	13	10	7	..
(a) Government	(8)	(4)	(4)	(5)	(4)	2	..
(b) Investment Loan Funds	(14)	(8)	(9)	(8)	(6)	(5)	..
Economic Enterprises	45	49	52	45	45	58	49
Other Social Sector Organizations a/	6	8	9	10	9	8	10
Households and Private Producers	9	26	26	31	28	35	35
Unclassified	4	-6	-11	-6	3	-4	-3
TOTAL	100	100	100	100	100	100	100

B. Adjusted Data b/

State	39	24	24	22	18	4
Federal	16	11	11	7	6	-4
(a) Government	(-8)	(2)	(3)	(0)	(-3)	(-4)
(b) Investment Loan Funds	(24)	(9)	(8)	(7)	(9)	(0)
Other State Units	23	13	13	15	12	8
(a) Government	(8)	(4)	(4)	(5)	(4)	(3)
(b) Investment Loan Funds	(15)	(9)	(9)	(10)	(8)	(5)
Economic Enterprises	42	48	51	38	34	46
Other Social Sector Organizations a/	6	8	9	12	11	10
Households and Private Producers	10	26	27	35	33	44
Unclassified	3	-6	-11	-7	3	-5
TOTAL	100	100	100	100	100	100
GNS/GNP (current prices)	33	29	28	28	28	28
GDS/GDP (current prices)	32	29	27	27	26	25

a/ Includes social insurance organizations and banks in their capacity as working organizations, not intermediaries.
b/ Adjusted for inventory evaluation (see Appendix I: Statistical Note).

Sources: Annual Reports, Yugoslav National Bank and mission estimates (see Statistical Appendix, Table 6.2). The unadjusted data (A) are based on the Money Flow accounts of the National Bank. Strict comparability with Yugoslav national accounts data (prepared independently) is not assured, but broad trends are probably accurate.

Both sets of data reveal two important features:

(i) the sharp decline in the State's role in savings mobilization, associated with the abolition of the social investment funds. From an average share of 38 percent in 1960-63 (36 percent for the unadjusted data), the State's share fell to 18 percent in 1970 (15 percent for the unadjusted data) 1/. Though spread over all levels of the State, the decline was swiftest at the Federal level, due mainly to low or negative Federal budget current surpluses;

(ii) corresponding increases in the share of households and private producers and enterprises. While the share of households increased steadily, the enterprise share declined after 1968, reflecting a fall in the rate of enterprising savings from income at their command. (See para 9.21.) The adjusted data show lower shares for enterprises than the unadjusted data. This is because the inventory valuation adjustment (downward) is concentrated on the income and savings of this sector 2/.

Enterprise Savings

9.21 Between 1963 and 1965 the system of social investment funds was largely abolished, along with some of the taxes on enterprise income, which had financed these funds. As a consequence, the proportion of gross value added under the distributional authority of the enterprise increased from an average of 47 percent in 1960-63 to an average of 58 percent in 1967-71 3/.

1/ The 1971 figures reflect changes due to the Constitutional Amendments, and are discussed in Section V.

2/ The size of the adjustment, and hence, the discrepancy between the two sets of data is positively related to the rate of inflation during the year, the source of the unrealized capital gains on inventory.

3/ These figures from Statistical Appendix, Table 6.3 refer to data adjusted for inventory evaluation. The corresponding percentage for unadjusted data are 51 and 61, respectively.

Table 9.8: ENTERPRISE SAVING RATE OUT OF "RESIDUAL ENTERPRISE INCOME" /a
(percent)

	1960-63	1964	1965	1967	1968	1969	1970	1971
A. Unadjusted Data	42	45	47	43	42	37	37	41
B. Adjusted Data /b	38	33	34	42	41	31	28	32

/a Enterprise Savings = Depreciation + allocations to "Enterprise Funds"

"Residual Enterprise Income" (REI) = Enterprise Savings + Net Personal Receipts of Workers.

/b A = Ratios based on current price data as available in Yugoslav statistical sources.
B = Adjusted for inventory evaluation.

Sources: Statistical Yearbook of Yugoslavia and mission corrections for inventory valuation. (See Statistical Appendix, Table 6.5.)

The increase in proportion of income under the distributional authority of the enterprise was accompanied, particularly after 1968, by a significant decline in the rate of enterprise savings out of "residual enterprise income" (REI) (Table 9.8.), suggesting a tendency of workers to vote increasing proportions of personal income distribution to themselves. This trend is accentuated in the adjusted series 1/. The apparent improvement in savings performance by enterprises in 1971 is partly illusory. As a result of the Constitutional Amendments the "interest on business funds" - tax 2/, which was an extra-budgetary revenue source to the Federation, was abolished. But enterprises were instead required to grant loans to the Federal Fund for Underdeveloped Regions. This replacement of a tax by a compulsory loan, shifted the savings to the enterprises' accounts, but such savings do not represent a voluntary increase.

Savings of Households and Private Producers

9.22 The rapid post-1965 growth of savings by households and private producers, in both absolute and relative terms, was a direct result of the Economic Reform. The Reform increased the share of net personal receipts in value

1/ Note that this observation contrasts strongly with the assertions of stable enterprise savings performance in the "Korac study." Aside from the inventory adjustment factor, the differencesaarise from choice of differing concepts of enterprise income and saving. Those adopted here seem more appropriate.

2/ The same levy is sometimes referred to as the "tax on business capital" in the Yugoslav literature.

added in both the social and private sectors of the economy. (Table 9.9.) In the social sector this increase was due to the rise in the share of REI in gross value added resulting from the reduction in the tax burden coupled with an initially unchanged, and subsequently declining, enterprise savings rate out of REI 1/. In the private sector the increased importance of personal receipts in value added may be ascribed to the Reform-induced rise in relative prices of agricultural products, which increased private farm incomes significantly.

Table 9.9: SHARE OF NET PERSONAL RECEIPTS IN SOCIAL PRODUCT (percent)

	1960	1963	1967	1970
Social Sector	28.1	28.2	35.7	37.0
Private Sector	72.0	71.4	77.7	80.5
Total Economy	38.9	37.9	45.2	45.0

Source: Statistical Yearbook of Yugoslavia, Federal Institute of Statistics.

The surge in workers remittances from abroad after 1966 and the increased activity in the private services sector also contributed to the growth of disposable incomes of "households and private producers." This increase in the share of GNP accruing to this sector was the main factor behind both the increased share of consumption (lower aggregate savings) in GNP after 1966, and the rapid increase in the share of gross savings done by "households and private producers." Depending on whether one chooses the adjusted or unadjusted data, the share of this sector in total domestic savings increased to either 44 or 35 percent respectively, by 1971, from a pre-Reform base of about 10 percent.

9.23 In judging the savings performance of this sector the ratio of savings to net personal receipts is not an adequate indicator. The inclusion of private producers in the savings data requires the expansion of the corresponding income concept to include gross value added in the private sector, not just net personal receipts. Social insurance benefits should also be included as well as workers remittances from abroad. The most readily available and inclusive income concept is the total current receipts of this sector as defined in the National Bank's money-flow tables, from which the savings data originate 2/. This ratio (Table 9.10) rose from average of 7 percent between 1960-63 to a range around 15-17 percent after the Reform. This performance is particularly encouraging given (a) the relatively poor financial incentives

1/ For definition of "residual enterprise income" (REI) see Table 9.8.

2/ It is subject to the criticism of being gross of production costs incurred by private producers.

for saving that existed during this period 1/ and (b) the wide ranging social insurance provided by the state which dilutes the precautionary motive in savings. While no adequate investigation of the determinants of household savings in Yugoslavia has yet been conducted, it seems plausible that income and the rate of change in income are important determinants 2/.

Table 9.10: RATIO OF SAVINGS TO "INCOME" BY HOUSEHOLDS AND PRIVATE PRODUCERS

1960-63	1967	1968	1969	1970	1971
7	16	15	17	15	17

Source: Annual Reports, National Bank of Yugoslavia.

(2) Financial Intermediation

9.24 The changing pattern of savings generation was accompanied by parallel changes in the institutions for resource mobilization and allocation. The reduction of the State role and the growing share of decentralized autonomous savings by non-State units substantially increased the potential role of the financial mechanism (institutions, instruments and rules) in sustaining an adequate level of savings and securing efficient intermediation of this decentralized savings to appropriate investing units. With the abolition of the social investment funds, the burden fell on the newly reformed banking structure. In 1963 the General Investment Fund was abolished and its assets (from past credits) and liabilities (from incomplete commitments) were transferred to the three specialized all-Yugoslav banks, chiefly the Yugoslav Investment Bank. In the next two years Republican and Communal social investment funds were abolished and a similar transfer of their assets and liabilities to the corresponding banks in their territory took place 3/.

The Rise of Investment Banking

9.25 The swift replacement of the State by investment banks in channeling investment resources is revealed in Table 9.11. While the share of the State in total domestic finance of fixed investment fell from 60 percent in 1960-63 to 16 percent in 1970, that of banks increased from 3 percent to 51 percent.

1/ The record of financial saving was, as a result, less encouraging.

2/ A draft study of the Capital Market, prepared by a team of Yugoslav officials and economists suggested these and other hypotheses, but failed to provide empirical discrimination. This is clearly an important area for future study.

3/ See Sekulic op. cit. for details.

Table 9.11: DOMESTIC SOURCES OF FINANCE FOR FIXED INVESTMENT /a
(percent)

	1960-63	1964	1965	1966	1969	1970	1971	1972
1. Economic Organizations	30	26	29	39	28	27	27	30
2. Other Social Organizations	7	6	8	7	6	6	7	8
3. State Finance	60	36	27	15	16	16	15	20
(a) Federal	(33)	(7)	(3)	(6)	(9)	(9)	(7)	(2)
(b) Republic	(8)	(8)	(4)	(3)	(3)	(2)	(4)	(14)
(c) Communes	(19)	(21)	(20)	(6)	(4)	(4)	(4)	(4)
4. Banks	3	32	36	39	49	51	51	42
Total	100	100	100	100	100	100	100	100

/a Includes all investments financed out of social resources plus private investment financed through bank credit.

Source: Statistical Bilten, various issues, 1972 and 1973.

9.26 For banks to cope with their new investment role, reform was necessary. The pre-1963 banks were largely creatures of the government units within whose territory they were obliged to operate. In nearly all cases the banks had been established by these state units, which also appointed their management. To adapt banks to their new expanded role, the Banking and Credit Law (March 1965) was passed. The new legislation was designed to accomplish three main goals:

(a) decrease the influence of government units and increase that of enterprises in the allocative decisions of banks, and thus, hopefully expand the role of economic criteria;

(b) empower banks to operate across the entire country, and to take on the new task of mobilizing fresh investment resources through savings deposits; and

(c) stimulate merger of the large number of communal banks into a smaller number of more efficient units (now termed "business banks").

9.27 Table 9.12 demonstrates rapid fulfillment of the third goal, and points up the rising dominance of "mixed" (commercial plus investment) banks.

Table 9.12: NUMBER OF BUSINESS BANKS AT THE END OF YEAR

	1963	1966	1967	1968	1969	1970
Communal Banks	220	-	-	-	-	-
Commercial Banks	-	62	54	28	22	-
"Mixed" Banks	-	40	40	36	36	55
Investment Banks /a	-	9	9	9	9	9
Total	220	111	103	73	67	64

/a These are the transforms of the three Federal specialized banks and the eight Republican banks which existed at the end of 1963 (see Table 9.5).

Source: Dimitrijevic and Macesich op. cit.

The number of banks is a little misleading. In 1968 the 10 largest banks accounted for nearly 60 percent of short-term credits, while nearly all investment credits were concentrated in 10 banks.

9.28 However, the de-etatization of banks was diluted by the State's continued influence over the allocation of the resources transferred from the abolished social investment funds. In 1966, the State units, especially the Republican authorities exercised their right to withdraw most of these transferred resources (usually referred to as "State Capital") from the credit funds of banks. While a small part of the withdrawn resources was retained by the state units for extra-budgetary investment in the economy, the bulk was relent to the banks in the form of credits for the financing of specified projects or purposes. In this way the State retained considerable control over the allocation of "State Capital" 1/. Even after the withdrawal of Federal "State Capital" from the banks' balance sheets in 1969 about 30 percent of the business banks' stock of investment resources (liabilities) were accounted for by the item "credit for investment financing," which consisted mainly of funds earmarked by government units. (Table 9.13.)

1/ In October 1969, there was a further change, when the Federal Government decided to allocate this "State Capital" in its own name. The assets and liabilities corresponding to the earlier arrangements whereby the government credited the banks which, in turn, credited the final year, were shifted from the balance sheets of the banks to special Federal accounts (see Annual Report, 1969, National Bank of Yugoslavia). Despite the formal balance sheet changes, the banks continued to administer these resources on a commission basis, resulting in no effective change in the allocative procedure.

Table 9.13: BALANCE SHEET OF INVESTMENT OPERATIONS OF BUSINESS BANKS AT END OF YEAR a/

	million dinars			Percent		
	1969	1970	1971	1969	1970	1971
Assets (Uses)						
Investment Credits	66.3	83.5	99.4	70.8	70.6	70.9
Housing Credits b/	17.3	21.9	26.1	18.5	18.5	18.6
Investment Credits in Foreign Exchange	2.4	5.3	6.5	2.6	4.5	4.6
Unused Sources	4.1	3.7	3.0	4.4	3.1	2.1
Other	3.6	3.9	5.2	3.7	3.3	3.8
Total	93.7	118.3	140.2	100.0	100.0	100.0
Liabilities (Sources)						
Credit Funds (equity)	13.8	14.4	14.3	14.7	12.2	10.1
Time Deposits c/	20.1	25.9	28.5	21.5	21.9	20.3
Bonds c/	0.4	0.6	1.1	0.4	0.5	0.8
Restricted Deposits	3.3	4.7	6.1	3.5	4.0	4.4
Credits Obtained for Financing Investment a/	28.7	34.2	41.7	30.6	28.9	29.7
Foreign Borrowing c/	3.4	6.3	10.9	3.6	5.3	7.8
Use of Short-term Resources d/	2.0	3.3	1.3	2.1	2.8	0.9
Funds for Housing b/	18.2	21.7	25.3	19.4	18.3	18.1
Other	3.8	7.2	11.1	4.2	6.1	7.9

a/ Inter-bank dinar credits for investment finance have been netted out of both assets and liabilities.

b/ In 1966, the resources of the investment loan funds for housing, which had been established in 1955 at Republican and communal levels, were transferred to the banks' investment operation balance sheets.

c/ Of greater than one year maturity.

d/ Legal provisions and National Bank regulations could allow use of short-term resources for investment purposes under specified circumstances.

Source: Annual Reports, 1969-71, National Bank of Yugoslavia.

9.29 The advent of banks in investment financing was accompanied by a new system of accounting. Business banks were required to prepare two sets of balance sheets, one for short-term operations and the other for investment (long-term) operations. While short-term credits could be granted against both short and long-term resources, investment credits could only be granted against specified investment resources. Short-term resources consisted of sight deposits and all bank bonds, time-deposits and foreign credits of less than one year maturity. Long-term resources are classified in Table 9.14. Out of these resources nearly all investment credits, other than housing, were directed to enterprises.

9.30 The performance of business banks in mobilizing "free" investment resources was mediocre. Even towards the end of the period only about 42 percent of the increment in investment resources (liabilities) could be regarded as freely formed. (See Table 9.14.) And even this is an overestimate since time deposits often represented a kind of involuntary "matching" deposit which allowed the depositor (typically, enterprises) better access to bank credits 1/. A greater proportion of investment resources, 44 percent, was formed out of earmarked contribution or interest on past credits of abolished investment loan funds, which were put at the disposal of banks for specific purposes. These ratios are more indicative of the continued role of State units in investment credit allocation than of the overall financial mobilization performance of the banking system. For that, the growth of short-term banking system liabilities have to be included in the picture. The short/long accounting distinction diverts attention from the fact, that what really matters for intermediations potential is the stability in holdings of financial liabilities. A permanent increase in holdings of short-term bank deposits allows real resource intermediation, irrespective of any legal short/long distinction. The performance of banks and other financial institutions in stimulating financial savings and investment is discussed in greater detail in later sections.

1/ A great number of time deposits are compensatory transaction (i.e. a prerequisite for granting of investment credits or housing construction credits).

Table 9.14: FLOW OF INVESTMENT RESOURCES INTO BUSINESS BANKS

	In million dinars		Percent		
	1970	1971	1970	1971	Average
"Free" Resources	10.9	8.6	44.3	39.3	41.8
Credit Funds	0.6	-0.1	2.4	-0.5	1.0
Time Deposits	5.8	2.5	23.6	11.4	17.5
Bonds	0.2	0.5	0.8	2.3	1.6
Foreign Borrowing	2.9	4.3	11.8	19.6	15.6
Restricted Deposits	1.4	1.4	5.7	6.5	6.1
Earmarked Resources	9.0	11.1	36.6	50.7	43.6
Credits Obtained for Financing Investment	5.5	7.5	22.4	34.3	28.3
Funds for Housing	3.5	3.6	14.2	16.4	15.3
Other (Including Use of Short-term Resources)	4.7	2.2	19.1	10.0	14.6
Total	24.6	21.9	100.0	100.0	100.0

Source: Derived from Table 9.13.

Other Financial Intermediaries

9.31 By 1966 the only extant category of investment loan funds was the Joint Reserve Funds established in 1962. Shortly thereafter two new funds at the Federal level were established: the Special Fund for Financing of Accelerated Development of Less Developed Regions and the Fund for Financing of Export Credits. And, as noted earlier, portions of "State Capital" withdrawn from the bank's accounts, in 1966 and 1969 were used to set up extra-budgetary accounts for financing investment at different levels of government. Interest and repayments of past credits served to finance this new breed of investment loan funds, which grew up after 1966. The two new Federal funds mentioned above, and the Federal Fund for Financing Investment 1/ also received revenue from the "interest on business funds of enterprises" - tax which still remained in force. Both in terms of savings generation and

1/ This, like the new investment loan funds at other levels of government, was simply an extra-budgetary account - not an independent entity - set up to accommodate the "State Capital" withdrawn from the banks in 1969.

investment financing the new set of investment loan funds were far less important than the pre-Reform system of social investment funds 1/.

9.32 Social Security Institutions are essentially non-government self-managed bodies which existed at Republican and Communal levels. Financed mainly through compulsory contributions levied on personal incomes, the bodies are organized on a current expenditures equals current receipts basis, with no scope for premium reserves which could be deployed on a financial market. There are a small amount of premia-funded life insurance businesses; but the magnitude is negligible, and in any case, requirements to invest these funds solely in bank deposits made them a rather inefficient form of intermediation.

9.33 Finally, one should note that the constitutional character of Yugoslav socialism ruled out the institution of equity capital as understood in capitalist economies. This placed a constraint on resource mobilization and allocation, since the potential availability of venture capital was not fully exploited.

Mobilization of Financial Resources: Performance

9.34 The substantial transfer of resource intermediation from State organs to business banks implies a substitution of fiscal flows by financial flows. The subsequent growth in financial investment of nonfinancial sectors (sometimes called "ultimate lending") after 1965, as a proportion of both GNP and savings, certainly underlines the expanded role of the financial mechanism. (Table 9.15) 2/. But these aggregate trends should not be freely used as indices of performance in mobilizing financial resources. A deeper look at the composition of financial investment suggests considerable scope for improvement.

1/ Briefly, the Yugoslav data on product and income include an element of unrealized capital gain on inventory, which is inconsistent with national income accounting methodology. To achieve consistency and comparability, this element has been estimated and excluded from the income and saving figures (see Appendix I).

2/ Non-financial sectors comprise enterprises and other work organizations, households and governments (excluding their investment loan funds). For any unit or sector, financial investment is the gross increase in holdings of financial assets and represents that unit's gross supply of financial resources.

Table 9.15: FINANCIAL INVESTMENT BY DOMESTIC NON-FINANCIAL SECTORS

	1958	1963	1967	1968	1969	1970	1971
Financial Investment as Percent of:							
1. Gross National Savings	33	42	62	92	91	99	113
2. Gross National Product	10	15	18	26	26	28	32
Adjusted Financial Investment as Percent of: /a							
3. Gross National Savings	12	29	26	52	49	50	40
4. Gross National Product	4	10	8	14	14	14	11

/a Adjusted to exclude financial investments in "direct credit," which consists mainly of involuntary trade credit.

Sources: Annual Reports, National Bank; mission estimates of GNS and GNP in current market prices.

9.35 A disaggregation of these financial investments by type of financial instruments reveals two salient features. (Table 9.16.) First, a large and increasing proportion of financial **investments** is in the form of "direct credits," mainly inter-enterprise trade-credit. Second, the rest of the financial investments is composed exclusively of liabilities of the banking system. At least two reasons militate against the inclusion of "direct credits" in any aggregate index of financial development. To begin with, the allocation of such direct credits are not subject to a market test or any other unified selection process. Furthermore, in Yugoslavia, much of those direct credits consist, especially in recent years, of involuntary trade credit 1/. This uncontrolled expansion in unpaid bills is symptomatic of a failure in the financial system, and should not be included in any index purporting to measure financial performance. Cleaned of "direct credits" the ratios of financial investment to GNS and GNP do not reveal a rising trend after 1968 (Table 9.15.) The second feature, the predominance of banking system liabilities as vehicles for financial investment, is not a cause for concern as long as banks are regarded as efficient agents for allocation. As pointed out later there are doubts that they are. And in that context, the absence of alternative financial channels between borrowers and lenders is disquieting. An examination of a stock index of financial growth, the ratio of financial (excluding "direct") liabilities held by non-financial sectors

1/ This is the "illiquidity" problem which dominates discussion of short-term economy policy.

to GNP, reveals the same trends 1/. This ratio climbed from a base of 0.55 in 1962 to 0.67 in 1968, as a result of the Reforms, and stagnated thereafter; it was 0.66 in 1971.

9.36 Finally, the temporally changing term-structure of annual ultimate borrowing by domestic non-financial sectors suggests that the financial system has not been able to replace the social investment funds as a reliable source of long-term finance to spending units in the economy. In 1963, the final year of the social investment funds, 53 percent of the new funds made available to non-financial ultimate borrowers were long- and medium-term credits, that is, with maturities in excess of one year. In contrast, this proportion averaged only 40 percent for the years 1968-70 2/. There is every reason to believe that this shortening term-structure of incremental borrowing by spending units was a result of supply constraints and did not reflect a change in borrower preferences in favor of shorter loans.

1/ Given the predominance of banking system liabilities in Yugoslavia, this is almost equivalent to the ratio of banking system liabilities to GNP, a ratio often favored in the literature as an index of financial maturity.

2/ See Dimitrijevic and Macesich op.cit.

Table 9.16: FINANCIAL INVESTMENTS OF DOMESTIC NON-FINANCIAL SECTORS BY INSTRUMENTS (percentage shares)

	1958	1963	1967	1968	1969	1970	1971
Money	16.1	33.7	-6.5	16.7	9.9	12.2	7.2
Currency	7.0	10.0	4.8	4.8	6.2	5.8	4.8
Deposits	9.1	23.7	-11.3	11.9	3.7	6.4	2.4
Deposits	24.8	14.6	38.5	26.8	34.6	30.1	23.8
Savings and Other							
Sight Deposits	25.5	-6.5	3.8	4.5	6.8	4.9	1.8
Restricted Deposits		17.5	2.9	5.1	7.3	5.2	2.0
Time Deposits		11.6	20.0	11.0	16.6	14.0	6.2
Foreign Exchange Deposits	-0.7	-8.1	11.8	6.2	3.9	6.0	13.8
Securities		3.5	-0.6	0.6	1.0	2.6	2.3
Government		1.6	-	1.0	0.4	2.0	1.6
Banks		1.9	-0.6	0.4	0.2	0.6	0.7
Economic Organizations		-	-	-	0.4	-	-
Contributions to Credit Funds of Banks		-	2.7	1.8	1.7	0.7	0.5
Direct Credits	62.8	31.5	58.9	43.8	46.8	49.5	65.2
Unclassified	-3.7	16.7	7.0	10.3	6.0	4.9	1.0
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Sources: Annual Reports of Yugoslav National Bank and Capital Market Study (for 1958 and 1963).

9.37 Evidence of poor performance in financial mobilization is also revealed by the trends in net supply of financial resources by different sectors in the economy. Taking the total of all positive financial savings 1/ by different sectors in the economy as ratios to GNP and GNS, the evidence shows (Table 9.17) a sharp decline between 1963 and 1967 followed by stagnation in these ratios. Apparently the loss of financial saving associated with the abolition of the social investment funds was not adequately compensated for by increases in other sectors like "Households and Private Producers".

1/ Financial saving of a unit or sector is the excess of gross saving over real investment. It is the net supply of financial resources by the sector.

Table 9.17: FINANCIAL SAVINGS OF DOMESTIC SECTORS /a

	1958	1963	1967	1968	1969	1970	1971	1972
Financial Savings as Percent of:								
Gross National Savings	51	46	35	30	32	31	23	26
Gross National Product	15	16	10	8	9	9	7	9
Percent Share in Financial Savings of:								
Households and Private Procedures	6	2	28	16	31	29	72	62
Investment Loan Funds	92	79	55	62	50	50	21	25
Federal	(55)	(42)	(29)	(30)	(22)	(26)	(1)	
Other	(37)	(37)	(26)	(32)	(28)	(24)	(20)	
Percent Share in Total Savings:								
Households and Private Producers	9	10	27	27	35	33	44	
Investment Loan Funds	44	36	18	17	17	15	6	
Federal	(26)	(19)	(9)	(8)	(7)	(7)	(0)	
Other	(18)	(17)	(9)	(9)	(10)	(8)	(6)	

/a The total of financial savings in this table comprises all positive amounts by all sectors. Negative amounts (for example, enterprise generally shows negative financial savings) are excluded.

Sources: Annual Reports, National Bank of Yugoslavia.

9.38 Table 9.17 also reveals the continued importance of investment loan funds (the new generation) in supplying net financial resources. Until 1970 half or more of positive financial savings came from these sources. It is interesting to compare the shares in positive financial savings with those in total savings. Between 1967 and 1970 the investment loan funds accounted for only 15-18 percent of total savings, while their share of financial savings varied around 50-60 percent. There is no correspondingly dramatic difference in the shares of the "Household, etc." sector. The reason is simple. Investment loan funds put their entire savings into financial assets 1/. The "Household, etc." sector, on the other hand, allocates its savings between real and financial assets. (Table 9.18.) And the time profile of the share allocated to financial savings until 1970 suggests considerable scope for financial resource mobilization in this sector. It is too early to judge whether the significantly increased share in 1971 reflects an upward trend or temporary adjustment factors associated with the 1971 Constitutional Amendments.

1/ This is simply an implication of their role as semi-financial intermediaries.

Table 9.18: SAVINGS OF HOUSEHOLDS AND PRIVATE PRODUCERS
(percent shares)

	1958	1963	1967	1968	1969	1970	1971	1972
Savings in Real Assets	68	91	65	83	70	71	56	56
Savings in Financial Assets	32	9	35	17	30	29	44	44

Source: Annual Reports, National Bank of Yugoslavia.

Problems in Financial Resource Mobilization

9.39 The undistinguished performance in mobilizing financial resources, documented above, was due to a number of factors operating in the post-Reform era.

(a) Legal limits on bank lending interest rates;

(b) Inflation;

(c) Absence of bond markets; and

(d) Historical aversion to financial investment.

9.40 With bank liabilities constituting the main vehicle for voluntary financial investments, the effective rate of interest on such deposits was undoubtedly a significant determinant of their volume and growth. Table 9.19 juxtaposes the relevant rates with the rate of change in prices.

Table 9.19: INTEREST RATES AND INFLATION

	1966	1967	1968	1969	1970	1971
Retail Prices (percent change during year)	7	5	6	10	11	18
Interest Rate on Sight Savings Deposits	5	6	6	6	6	6
Interest Rate on Time Savings Deposits	6	7	7	7.5	7.5	7.5
Interest Rate on Bank Credits	8	8	10	8	8	8

Sources: Annual Reports, National Bank and Dimitrijevic and Masesich.

It is obvious from this table that the real rates of interest on sight and time savings deposits were extremely low or negative throughout the period. They offered little encouragement for financial investments in bank liabilities, especially to households (enterprises with large deposits often received non-interest benefits such as improved access to credits). Indeed, financial investments in these instruments would probably have been much less, but for the "compensatory transactions" aspect (see para. 9.31) which eased access to bank credit by potential borrowers. The interest rate limits on bank lending clearly held down the rates they could offer on their own deposits 1/.

9.41 Aside from a general inhibiting influence on all financial investments, inflation and inflationary expectations biased them towards short-term instruments which allow an investor a quicker opportunity to switch his portfolio towards preferred assets (perhaps non-financial) if his expectations of real return are frustrated by inflation. The rapid growth in the share of "direct credits," (Table 9.16) mainly "involuntary" accounts receivable from the lenders' viewpoint, probably also reflected the encouragement to all fixed interest borrowing, including accounts payable, that an inflationary climate provides.

9.42 The share of financial investments in bonds was observed to grow somewhat. But nearly all the increase was attributable to bonds of state units, which were often placed in a semicoercive manner. In 1970 enterprises were allowed to float long-term bonds with interest rates which were not subject to the constraint on bank lending. However, there has been little response in this field. Inflation aside, the absence of a security market, which can ensure liquidity and reduce risk, is regarded as an important destimulant. The only condition under which bonds may become relatively liquid is the participation of banks in bond issue either on their own behalf or as guarantors. Such participation on a sufficiently large scale could lead to the creation of a bond market in which bonds are actively traded with banks being ready buyers. This would be greatly helped by the extension of some rediscounting facilities by the National Bank to such bonds. Such developments are yet to occur.

9.43 Finally, the development of financial investment and savings in Yugoslavia must be seen in a historical context. The experience of virtually complete depreciation of financial investments during the First and Second World Wars has left a legacy of bias against financial investments in general, and bank deposits in particular. This adverse conditioning remains an important determinant of portfolio behavior amongst households and private producers. The distrust of bank deposits may be seen in high proportion of the financial assets portfolio devoted to currency. As late as 1968, currency holdings accounted for 37 percent of all financial assets held by households

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1/ It has been argued (and subsequent experience after freeing of interest rates supports the argument) that even without such interest rate ceilings, business banks would have held lending (and hence deposit) rates down, because the banks' ownership-management structure allows domination by borrowing Founder Member enterprises (see below Section V).

and private producers 1/. Seen in this prospective, the developments in financial mobilization by banks in the few short years since the Reforms, are less discouraging.

(3) Resource Allocation:

9.44 Measuring the overall efficiency of investment allocation is notoriously impracticable. The approach adopted here will be to identify the institutions responsible for various aspects of allocation and gauge the efficiency of their policies qualitatively. Allocative efficiency in Yugoslavia may be seen in at least three dimensions: interenterprise, intersectoral and interregional2/. The first two dimensions were the results of interplay between banks, enterprises and state units, with banks and enterprises increasing their influence at the expense of state units, over time. Though, in theory, banks could play a major role in interrepublic allocation, the "territorialization" of their operations left this field to the State. The federal government assumed overall responsibility for inter-regional transfers of subsidized finance, using the Special Fund for Underdeveloped Regions as a channel, but leaving intraregional allocation of these resources in the hands of republican governments and banks.

9.45 Before proceeding with the discussion along these lines, it is important to emphasize a general point about the post 1965 situation. Since the Reform, banks, enterprise and other investment allocating agents in the social sector have operated in an environment of excess demand for investible resources. On the supply side, the relatively unsatisfactory performance in mobilizing financial resources has already been discussed at considerable length. Investment demand, on the other hand, has been sustained at a high level by a number of factors:

(i) the interest-rate ceiling on bank credits, coupled with inflation, cheapened the effective price of capital 3/. This was reinforced by the partial insulation of enterprises from financial risk, owing to implicit standby support from patron state units;

1/ The subsequent decline in this ratio to 32 percent in 1971, is due mainly to the opportunities to hold foreign exchange accounts (a preferred asset in terms of expected real returns) opened by the rise of worker remittances from abroad.

2/ The factor-proportions aspect is considered elsewhere in this report. See Chapter III.

3/ Compared to bank credit interest ceiling of 8 percent the nominal opportunity cost of using own funds was slightly higher, since it consisted of the "interest on business funds" (tax on Business Capital), which averaged 3-4 percent (but varying across sectors) plus the opportunity foregone on time-deposits of 6 percent.

(ii) the desire to "catch up" technologically with Western Europe placed heavy demands for new, capital-intensive methods of production;

(iii) the demands created by restructuring the economy according to more market-signalled lines of production;

(iv) the worker-management system biased enterprise growth in favor of capital-intensive processes, given the overall incentive to maximize value added per existing employed worker, over time. This tendency was strengthened by the prevalence of wage-based taxes which increased the relative cost of additional labor to the enterprise; and relative cost of additional labor to the enterprise;

(v) the high demand for investment in social infrastructure; and

(vi) the cheapening of imported capital equipment due to dinar overvaluation.

9.46 Excess demand, by definition, is an **ex ante concept**. Consequently, it is hard to point to **ex** poste data which can prove its existence. Inflation and balance of payments deficits on current account, are consistent with the hypothesis of excess demand, but may also be symptomatic of supply factors like cost-push and "structural" export/import aspects. In addition to the **a priori factors** mentioned above, some data on enterprise financing lend weight to the hypothesis of excess demand. Table 9.20 shows that, as compared to the pre-Reform period, gross borrowing as a percentage of real investment increased from 99 percent to 136 percent, even though the net utilization of external resources by enterprises (financial dissaving) declined slightly. It is interesting that the post-Reform data on gross borrowing show a much higher proportion of "direct credits" 44 percent as compared to 24 percent. These trade credits, mainly accounts payable to other enterprises, do not constitute net sources of finance to the enterprise sector as a whole. However, they may plausibly be interpreted as vehicles through which enterprises attempt unsuccessfully, to appropriate resources. Their increased share in total enterprise borrowing does suggest sharper competition for scarce resources by enterprises 1/. Such observations are consistent with the hypothesis of excess demand.

1/ There are, of course, other reasons for the rising share of "direct credits." In particular, the move to a more market-oriented economy could be expected to lead to a greater role for trade credit between enterprises. The real issue is how much of these credits were involuntary. Informal indications suggest that much of them were.

Table 9.20: ENTERPRISE FINANCING OF INVESTMENT

	1960-63 /a	1967-71
Gross Borrowing as Percent of Investment /b	99	136
Net Borrowing as Percent of Investment /b	46	41
Share of "Direct Credits" in Gross Borrowing	24	44

/a 1962 data have been excluded, since enforced mutual cancellation of debts led to negative entries under "direct credits," which would have exaggerated the difference with post-Reform data.

/b Investment data have been adjusted for inventory valuation factor.

Sources: Annual Reports, Yugoslav National Bank and mission estimates of inventory correction.

Inter-Enterprise Allocation

9.47 Given this situation of excess demand for investment funds, and the neglect of the interest-rate mechanism for rationing credit, efficient investment allocation depended on the application of consistent and appropriate project selection criteria, which could substitute for, or improve upon, the inhibited market forces. There was no systematic development and application of such criteria during this period. In the last couple of years interest in project selection criteria has grown, spearheaded by the larger banks which have an all-Yugoslav outlook. Though such interest offers encouragement for the future, until 1971, the impact of these innovations was small.

9.48 To begin with, the domain over which allocation decisions were taken was severly fragmented by a number of factors. First, the continued importance of the state in allocating funds, nominally channeled through banks, led to a "terriotorialization," by boundaries of state units, of the arena for investment allocation. Second, though the banks could deploy their "free" resources across territorial boundaries, the effective control of their credit policies by founder enterprises tended to limit their domain of investment allocation of these firms. Such a compartementalization of the capital market suggests that the financial mechanism often failed to match the best investment opportunities with the availability of funds. Within this fragmented capital market, a wide variety of project-selection criteria was employed, including in some cases, largely political ones. Typically, state units, banks and large enterprises in a region mutually supported each other, which

often led to the downplaying of purely economic criteria in investment decisions 1/.

9.49 By failing to pay its trade debts on schedule, an enterprise may preempt resources for its own use at the expense of other enterprises. Though the growth in involuntary trade credit is not to be a source of net finance for the enterprise sector as a whole, it is a vehicle for inter-enterprise competition for scarce resources 2/. There was no guarantee that in such a competition, more efficient enterprises would win out. In a system of venture capital there is some presumption that inefficient enterprises would be more squeezed for funds in a scarcity situation, since the costs of financial irresponsibility are relatively higher and include bankruptucy. But bankruptcy, the ultimate sanction in a system of venture capital, while legally possible has seldom been used.

Enterprises are generally successful in persuading patron socio-political committies and creditor banks in bailing them out of a sticky financial situation. This partial cushioning from the risks of insolvency encouraged expenditure in excess of available financial resources by even inefficient enterprises with the expansion of involuntary trade credit acting as the medium for such real resource competition 3/.

9.50 The past history of state sponsorship of economic enterprises also played a role in sustaining a large number of loss-making enterprises in operation. Even if these enterprises did not grow, support of their existing operations through subsidized credits and grants (often channeled through the Joint Reserve Funds which are mainly controlled by state units) implied examples of suboptimal interenterprise resource allocation.

1/ "By using their influence, the socio-political communities obtained Bank credits for the financing of projects which had no adequate economic basis and in return the socio-political communitiew would protect them in cases of application and implementation of sanctions foreseen in the case of violation of policy rules as regards liquidity... and other credit policy measures." The quotation is from a study of the Capital Market, this is being done in Yugoslavia by a team headed by Mr. Dimitrijevic of the National Bank.

2/ The "illiquidity" problem reflected in the expansion of involuntary trade credit is sometimes seen as a symptom working capital shortage. But there was sufficient fundibility between short and long sources and uses of funds, for "illiquidity" to be symptomatic of a more general scarcity of investment resources.

3/ For recent policy measures to improve financial responsibility, see below. Enterprises were not alone in this problem of "uncovered investment." State units also acted similarly with their direct investments.

Intersectoral Allocation

9.51 Most of the remarks on inter-enterprise allocation are equally applicable here, except that the state units play a greater part in intersectoral allocation through the medium of the Social Plans. To the extent that intersectoral allocation is based on money prices of goods and factors, the foreign-trade and payments system and selective price control influenced choices, though the departures from international relative product prices were much less after the Reform than before. The under-pricing of capital through interest rates ceilings and the "over-pricing" of labor due to wage-based taxes 1/, biased incentives in favor of capital-intensive sectors. These incentives, together with the structural bias in favor of capital-intensive growth of worker-managed enterprises may help account for the capital-intensive course of Yugoslav industrial development.

Interregional Allocation

9.52 Official Yugoslav policy repeatedly emphasized the need to ensure equitable inter-regional resource allocation. Specifially, government policy was aimed at narrowing the gap in per capita income between the underdeveloped regions (the Republics of Macedonia, Montenegro and Bosnia-Herzegovina and the Autonomous Region of Kosovo) and the rest of Yugoslavia 2/. This was accepted as a Federal responsibility and discharged through the Special Fund for Underdeveloped Regions. During the 1966-70 Plan period, this Fund transferred the equivalent of 1.85 percent of the Yugoslav social product in the form of investment credits, for relending, to investment banks in the designated underdeveloped regions. In this way 27 percent of investment in these areas was financed through funds originating from the special Fund. Another 17 percent of investment finance came in the form of Federal participation in infra-structure projects. These latter resources were channeled through the Federal Fund for Investment Finance 3/. In addition, current transfers from the Federal budget of about one percent of the Yugoslav social product annually, were weighed in favor of the power Republics.

9.53 The credits from the Frderal Fund for Underdeveloped Regions to the investment banks in these areas were on highly concessionary terms: 1 percent interest and 30-year maturity for highway projects, 2 percent and 20 years for heavy industry, transport, agriculture and tourism, and 4 percent and 15 years for all other purposes. Though the intra-regional allocation of these funds was left in the hands of the recipient investment

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1/ In 1970, proportional taxes and contributions on net personal incomes in the social sector increased the cost of labor to the enterprise by about 45 percent.

2/ For characteristics of the inter-regional problems see Chapter VIII.

3/ Unlike the Federal Fund for Underdeveloped Regions this was not a legal entity but just an extra-budgetary investment account.

bank and its corresponding Republican Government, the terms of the ultimate loans had to match those mentioned above. This reflection of the concessional terms to the final user did not encourage efficient use of the scarce capital transferred. Even if subsidies were deemed necessary to the final user, cheap capital hardly seemed to be justified, in a situation where most underdeveloped regions were facing serious unemployment problems 1/. Resource allocation is likely to have been more efficient if the investment banks in these regions had relent the concessionary loans from the Special Fund at higher rates and used the profits to provide output or employment-related subsidies, if subsidies to final users were considered necessary.

9.54 The confinement of bank and enterprise activity within Republican boundaries has already been mentioned. Within an underdeveloped Republic the problems of inter-sectoral and inter-enterprise allocation are considerably magnified relative to the developed Republics. The fragmentation of the capital market is sharper and state intervention with non-economic criteria was more frequent. These problems are reflected in the low productivity of investment, both in terms of ICORs and labor productivity ratios.

9.55 Finally, the selective price control policy which operated during the post-Reform era is believed to have contributed to unintended inter-regional resource transfers in the wrong direction. For example, holding down energy prices operated as a tax on Bosnia-Herzegovina, Kosovo and Montenegro, which were net exporters of power. The implied subsidy accrued to the net importers, the developed Republics 2/.

9.56 From the discussion above, it is clear that the mechanisms and policies for investment allocation left considerable scope for improvement. Basically, the improvements in factor allocative mechanisms had not kept pace with those in the product markets. An aggregate index of resource allocational efficiency does not exist. The objections to using ICORs as an index of resource allocational efficiency are numerous and well known, especially in a country like Yugoslavia, where relative prices have been subject to varying degrees of administrative control. However, as crude guides, the data on ICORs are consistent with the view that resource allocation efficiency, a prime goal of the Reform, did not improve dramatically 3/.

9.57 Some of the "distortive" features in resource allocation discussed earlier, like the enterprise bias towards capital-intensive expansion, were embedded in the Yugoslav system of worker-managed enterprises. But others, like the interest-rate ceiling, wage-based taxes, the fragmentation of the capital market and lending policies to final users in Underdeveloped Regions, were susceptible to policy reform. Perhaps the most encouraging aspect of the potential for improvements in this field, is that the bulk of allocative deficiencies fall into the latter category.

1/ See Chapter III.

2/ See Chapter VIII.

3/ See Chapters II and III.

X: RESOURCE MOBILIZATION AND ALLOCATION: PROSPECTS

1. Institutional Changes, 1971

10.1 The changes initiated by the 1971 Constitutional amendments particularly in the area of tax and expenditure policy, are still in process. The significant changes in the realm of fiscal and financial institutions are summarized in this section. Section 2 discusses the prospects for domestic resource mobilization in the new environment. Section 3 continues the discussion of Chapter IX of some issues in resource allocation. The final section raises some questions about the efficiency of public expenditure and revenues.

Changes in the Fiscal System

10.2 The expenditure responsibilities of the federal government were reduced -- in particular, its extrabudgetary investment role was abolished. The assets and liabilities of the Federal Fund for Financing Investments were decentralized to the republics on the basis of past credits, except in the case of expenditure on ongoing projects in the less-developed republics and provinces. These expenditure responsibilities were temporarily (for two years) retained with the Federation and channeled through the federal budget. To finance them, the repayments and interest on past credits to these regions were also kept with the Federation and transferred to the revenue side of the federal budget. (See Statistical Annex, Table 5.1.) Both the Special Fund for Underdeveloped Republics and the Fund for Export Credit and Insurance are continuing in operation, but share the responsibility for financing is now shared with republics and enterprises.

10.3 The revenues of the Federation were drastically altered. Only customs duties and minor fees and charges remained as budgetary resources. The federal tax on personal income was abolished and the receipts from the federal turnover tax were turned over to the republics. Since the Federation's budgetary expenditure responsibilities remained largely unchanged (defense, administration and various transfers to other public bodies), the abolition of these taxes created a financing gap. The excess of budget expenditure over revenues is now financed by contributions from individual republics in proportion to their share in Yugoslav social product. The "tax on business capital," formerly an extrabudgetary resource for the Federation, was also abolished. The Special Fund for Underdeveloped Republics is now financed through compulsory loans from enterprises, calculated on the old base of "business capital." Unlike before, the rates (of loan amounts to the base) are set independently by each republic and may vary. Indeed, republics are free to meet their obligation of transferring 1.94 percent of their social product to the Fund through alternative devices, but none have departed from the practice of the compulsory loan from enterprises.

10.4 While the Constitutional amendments, and attendant laws have codified the Federal-Republic fiscal relationships, the restructuring of expenditure roles and revenues of the Republican and communal llevel is still in process. The issues involved are discussed in Section 3.

Changes in Financial Institutions

10.5 Two laws governed the changes in the banking system. The "National Bank Law" created eight new republican (and provincial) National Banks, one for each Republic and Province. In fact, these new banks simply represented an increase in autonomy of the former branches of the National Bank. Their increased authority was limited to the allocation (by purpose) of central bank rediscounts. Under the new system a significant proportion (40 percent in 1972) of the planned amount of rediscounts is delegated to the Republican National Banks to distribute according to purposes determined in the republic governments. Under the new law the 9-man Board of Governors of the Yugoslav National Bank includes all the eight Governors of the republican and provincial National Banks. This delegation was in response to criticisms, that the earlier National Bank monopoly over deciding the type (by purpose) of credits eligible for rediscounting, had undesirable, differential regional effects. For example, rediscounting of export credits primarily favored the developed republics. The proportion of planned rediscounts to be delegated to republics and provinces, and the shares of each unit, are reviewed by the Inter-Republican Committee on monetary questions and decided by the Federal Executive Council 1/. In practice, since the Governor for each Republican National Bank is a member of the 9-man Board of Governors of the Yugoslav National Bank, rediscount proposals are fairly easily agreed upon. Overall monetary policy continues to be proposed and executed by the Yugoslav National Bank. And the Federal Executive Council and Federal Assembly continues to be the final arbiters on annual "monetary policy resolutions". The effective control over monetary instruments, other than rediscounting, remains with the Yugoslav National Bank, though Republican views are represented in its Board of Governors.

10.6 The role of "other banks" underwent several significant changes:

(a) All business banks were made "universal", i.e. allowed to engage in both commercial and investment credit business;

(b) The relatively minor innovations in ownership-management structure, if anything, strengthened the power of founder members over a bank's general credit policy;

(c) Ceilings on bank lending interest rates were abolished;

(d) The short/long distinction of bank balance sheets and operations was removed. However, reserve requirements for all sight deposits (except savings) remained different from those on time (and sight savings) deposits. The legal maximum on the first was brought down from 35 to 30 percent. The second was kept at 3 percent;

(e) The allocation to bank reserve funds was legally increased; this was a part of a set of measures aimed at penalizing bank "illiquidity" (temporary inability to meet its obligations) in the hope that banks would be less ready to support financial irresponsibility by client enterprises;

1/ One of the five-high-level coordinating committees created by the Constitutional Amendments. See Chapter I.

(f) Founder members now have unlimited liability;

(g) The old anonymous "credit funds" have been abolished;

(h) The law also removed legal barriers to the creation of non-bank financial institutions.

10.7 One should also take note of the "Law on Securities" passed somewhat earlier. This enables introduction of a new kind of securities "Certificates of Ownership" which could be issued by one enterprise and held by another, allowing the latter a claim on profits. Individuals are disallowed from trading in these quasi-shares. Despite its potential significance, there has been hardly any use of this instrument for raising funds. The lack of an established market is undoubtedly the major inhibiting factor. But their potential for improved inter-enterprise allocation is strong.

Incomes Policy Framework [1/]

10.8 The Constitutional amendments provided for the institutions of social agreements and self-management agreements on incomes. Each republic could formulate an incomes policy establishing guidelines for personal income payments in different enterprises. Broadly, incomes policy was aimed at (i) influencing and harmonizing the savings behavior of enterprises and (ii) reducing personal income (wage) differentials across workers, both for the same skill category across branches and enterprises, and over the entire range of personal incomes paid in the social sector. The social agreements on incomes are tripartite arrangements between the republican government, trade unions and Chambers of Economy. The principles of the social agreement are implemented through self-management agreements, which apply to industrial branches and groups of enterprises, and take into consideration the special circumstances of the relevant branch or group.

2. Prospects for Domestic Resource Mobilization

Domestic Resource Requirements

10.9 The prospects for savings generation have at least two important dimensions: (a) the requirements for aggregate savings, and (b) the mobilization of an adequate share of these savings for use in the social sector. The Federal Social Plan for 1971-75 does not provide a thorough analysis of resource requirements. For example, there is no overall savings target, let alone disaggregation by sector. However, some implications for aggregate savings may be pieced together. The Plan projects a domestic investment (including both "economic" and "non-economic") rate of 34.9 percent out of social product in 1975, compared to an actual achievement of 33.8 percent in 1970. The 1975 projection may be converted to a rate out of GNP of 30.7

1/ The term "income policy" is used here as a short hand for the complicated agreements on the distribution of value added in enterprises in Yugoslavia. Its connotation is rather difficult from that in capitalist economies. See Annex IV on Incomes Policy.

percent 1/. Background documents to the Plan project that net foreign capital inflow will finance about 6 percent of total investment. Thus 94 percent of gross investment will have to be financed from domestic resources. This reduces to a target of GNS/GNP ratio of 28.9 percent in 1975. In terms of recent history (Table 10.1) this rate of aggregate savings is at the upper end of the range experienced between 1967 and 1971, and somewhat higher than results in the last couple of years. The further erosion of the state saving role in 1971 means that this saving will have to be generated, almost entirely by non-state units: enterprises, other social sector organizations, households and private producers. Enterprise savings behavior and the efficiency of the financial system in encouraging savings by households and private producers, are crucial to the realization of the Plan's ambitious savings target.

Table 10.1: KEY TRENDS IN SAVINGS BEHAVIOR, 1967-71
(percentages)

	1967	1968	1969	1970	1971	1972
GNS/GNP (current prices)	29.3	27.8	28.2	28.4	27.7	-
Share of Savings by Non-State Units						
(a) Unadjusted Data	77	76	80	85	97	91
(b) Adjusted Data /a	76	76	78	82	96	-
Share of Savings by Households and Private Producers						
(a) Unadjusted Data	26	26	31	28	35	35
(b) Adjusted Data /a	26	27	35	33	44	-
Financial Savings/GNS	35	30	32	31	23	-

/a Adjusted for inventory evaluation factor.

Sources: Tables 9.6 and 9.7.

10.10 Even if the aggregate savings target is achieved, there is no guarantee that the resources can be intermediated to appropriate sectors. The Plan does not, unfortunately, disaggregate the investment program by sectors, either social/private or enterprise/household/state, etc. Consequently it was not possible to compute a resource gap (investment minus savings) for the social sector, which could then be used as a target for financial intermediation 2/.

1/ Between 1966 and 1970 GNP was, on average, 13.5 percent higher than the social product in current prices. The conversion assumes constancy of this relation.

2/ The Plan does provide projected sources of investment finance by allocative agent. But this information cannot be transformed into savings-investment gaps and surpluses by sector.

However, the growing importance of savings by private producers and households, coupled with the declining ratio of financial savings to GNS suggests need for a major effort to mobilize savings from the private sector, for channelling to social sector enterprises 1/. The prospects for such an effort are discussed below.

Enterprise Savings/Incomes Policy

10.11 The increased importance of enterprises in aggregate savings and the recent background of a declining savings rate added up to a strong case for instituting incomes policy to stabilize (perhaps raise) the rate of enterprise savings.

10.12 Prior to 1971, several features combined to put adverse pressure on the rate of enterprise savings:

(a) The availability of cheap credit biased enterprises in favor of borrowed funds. As pointed out earlier, the opportunity cost of using own resources for financing investment was slightly higher than bank loans.

(b) The relatively high wage payments by capital-intensive sectors created strong pressures for increasing personal incomes in other sectors.

(c) The "demonstration effects" from Western Europe for increasing consumption, noted earlier.

(d) Yugoslav enterprises were under considerable pressure to allocate higher personal incomes to prevent qualified workers, especially in the developed Republic, from migrating in response to higher incomes in Western Europe.

(e) The social security system, which computed pensions on the basis of the final few years of service by a worker, embodied an incentive, amongst older workers, to vote high shares of personal incomes (i.e., low enterprise savings).

10.13 The incomes policy agreements, which were gradually instituted in the various republics during 1972, were aimed at countering these pressures towards lower enterprise savings rates. While the policies vary across republics, they have certain features in common. For example, all of them relate the total personal incomes that an enterprise can pay out (and hence, by elimination, enterprise savings) to "enterprise income per standardized

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1/ The current phase of the study on Capital Markets being carried out in Yugoslavia is focusing on such financial imbalances in the Plan. Its results should quantify the implicit targets (and potential shortfalls) for financial intermediation.

worker" 1/. Enterprises with higher "enterprise income per standardized worker" are allowed to pay higher "personal incomes per standardized worker," but are also required to save at a higher rate out of enterprise income. The "standardized" work force of an enterprise is computed on the basis of skill coefficients (weights) which purport to reduce each skill category into equivalent units of unskilled labor, which could then be aggregated into a unique total. The skill coefficients are common with a republic but vary slightly across them. The functions and schedules, relating, allowed "personal income payments per standardized worker" to "enterprise income per standardized worker" as generally based on sample data enterprises from previous years. For policing the agreements, most republics rely on direct control through the Social Accounting Service. In Slovenia, a progressive tax was established for personal income payments in excess of incomes policy norms.

10.14 Analytically, the incomes policy device may be viewed as an attempt to isolate the return to "owned" capital ("business capital") of an enterprise and protect this return from distribution in the form of personal incomes. Under the unmodified worker self-management system, enterprise differences in personal income for labor with similar skill (the differences were sometimes 300-400 percent) were due to both differences in efficiency as well as in capital endowments. Capital-intensive branches could afford to pay much higher wages (personal incomes) by distributing part of the return to capital as wages. In a system where all capital is supposed to be socially owned, personal income differences due to varying capital endowments seemed inappropriate. A possible approach would have been to charge a socially agreed accounting price for "owned" capital, which would then determine the division of enterprise income between savings (return to "owned" capital) and personal incomes. The old "tax on business capital" was a weak attempt at this. Instead, most of the incomes agreements attempt to isolate the return to labor, decree this as allowable personal income payments, and obtain the return to "owned" capital as a residual in the form of savings. Consequently, correct identification of the return to "owned" capital presupposes correct identification of the return to labor 2/. Since labor is not homogeneous, but consists of many different skill categories, the attempt to first isolate the total wage bill, which, in some sense, corresponds to the notion of "payment according to work", is very difficult.

10.15 The existing incomes agreements are subject to certain criticisms. First, the economic meaning of the skill coefficients is not clear. It is unlikely that they represent ratios of marginal products. They are, in any case, at such a high level of aggregation that it would seem difficult to police reclassifications at enterprise initiative to permit higher personal income payments. Second, the use of historical enterprise data to frame

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1/ The concept of enterprise income varies across republics. However, in all variants it excludes legally-required depreciation, unlike the concept of "residual enterprise income" used in this report earlier.

2/ This is necessary but not sufficient. Correct identification of the return to "owned" capital also requires that other factor payments, such as interest on bank credit, reflect efficiency prices, which they do not.

schedules relating enterprise incomes to allowable personal incomes (and hence savings) vests the past experience with an aura of optimality which it may not deserve. Third, except, for the incomes agreements of Serbia and Montenegro, there is no way of assuring an average savings rate for all enterprises in a republic. While these considerations are important for the long-term evolution of an efficient incomes policy, they may be downgraded for the moment on the grounds that the overriding concern at present is with developing a constitutionally feasible policy instrument for an improvement in the rate of enterprise accumulation.

10.16 Finally, it is clear that these incomes agreements constitute a dimunition of self-management autonomy of enterprises. However, it can be argued that since "owned" capital in an enterprise is really socially owned, the society has a right to intervene in the allocation of the return. Incomes agreements may then be interpreted as an exercise of this societal right.

10.17 Viewed as a practical instrument of policy it is still too early to gauge the success of incomes policy agreements. Potentially, it is a powerful instrument for stabilizing, perhaps raising, the rate of enterprise savings. One feature which has already attracted attention is the possible effects of divergent republican policies, for example, their impact on location of new enterprises. Coordination and harmonization of basic principles and concepts is recognized as an important project. A Coordinating Commission is currently working on achieving such an agreement across republics.

Resource Mobilization by Banks: The Role of Interest Rates

10.18 With the reduction of the Federal investment financing role in 1971, banks have become even more important in the task of mobilizing financial resources. The removal of the legal ceiling on bank lending rates has led to a small increase in all interest rates, but not enough to compensate for inflation. Banks now arrive at a "gentlemen's agreements" on lending rates. Towards the end of 1972 these jointly agreed rates averaged around 12 percent. Deposit rates varied from 7.5 percent on sight savings to 10 percent on time deposits above 2 years' maturity. Inflation during 1972 is estimated to have been around 15 percent and the rate is not expected to decline lower than 10 percent in 1973. Clearly, the rates on savings deposits offer little encouragement for financial saving.

10.19 Several factors impede a major increase in interest rates to promote improved financial mobilization and allocation. First, banks in Yugoslavia are not independent profit maximizing institutions. "Financial capitalism" is ideologically frowned upon. Rather, banks are organizations run by, and in the interests of, their founder members, mainly borrowing enterprise. Thus banks have been compared to cooperatives "whose aim is to ensure to members ... benefits ... irrespective of their own (the banks') profits 1/. This does not mean that banks cannot refuse individual founder

1/ The ongoing study of the Capital Market referred to earlier accords prime importance to "borrower control" of bank policy in explaining the low interest rate structure.

enterprise credit on occasion. But it does mean that the overall credit and interest policy of banks is decided jointly by an Assembly dominated by enterprises who are also the chief borrowers from the bank. By itself, founder member control of bank policy does not explain the readiness with which banks jointly acquiesce in a policy of cheap real rates of interest. If the interest-sensitivity of financial savings in bank deposits was high, it would be in the interest of banks and their patron enterprises to raise the interest rate structure to encourage more financial savings, so long as the costs of doing so were outweighed by the benefits accruing to the enterprises-bank complex from additional investment enabled by the incremental resources. There seems to be a prevailing belief that in fact the interest-sensitivity of financial savings is low. This belief, combined with effective founder member control of bank policy, explains the resistance to significant upward interest rate adjustments 1/. This resistance is strengthened on the deposits side by an ideological bias against high rates of "unearned" (by labor) remuneration from private financial assets ("financial capitalism", again).

10.20 In fact, the evidence on the interest-elasticity of financial saving is far from clear. The historical record of legally constrained nominal rates of interest impeded empirical investigation since variations in real rates were low. The mediocre record of financial mobilization is consistent with a high interest-elasticity of financial savings. The incentives for financial mobilization were poor during 1965-71. In any case, in a relatively young and rapidly developing financial system, the past record on interest-sensitivity may be misleading about future behavioral prospects. The success that banks have recently had increasing deposits in foreign exchange accounts from households and private producers, indicates considerable sensitivity to real returns on the part of these agents. In 1971, the devaluation windfalls on these assets more than compensated for inflationary erosion. By the end of 1971 domestic foreign exchange accounts constituted 18 percent of financial assets held by "households and private producers", compared to 4 percent in 1967. Admittedly, this increase may be largely attributed to the increased supply of foreign currency-denominated resources in the form of worker remittances; these increased from 90 million dollars in 1967 to 650 million in 1971. But banks do testify to increasing household interest in holding these financial assets, like foreign exchange accounts, which provide some hedge against inflation. This growing sensitivity to real returns in private portfolio behavior should be exploited to increase the share of financial savings in savings and perhaps to increase private savings as a whole.

10.21 The real return on bank deposits may be improved by either:

(a) increasing nominal interest rates offered by banks, or
(b) reducing the rate of inflation, or
(c) linking the value of bank deposits to a price level index, i.e. "indexing".

1/ The interest-rate issue is complicated by the past history of allocative distortions stemming from earlier non-market investment mistakes and price control. Both have left a legacy of loss-making enterprises, which exert a pressure for low interest rates (a form of subsidy).

The first alternative may be accomplished either by persuading banks and "owner" enterprises that the interest-elasticity of financial saving is higher than they believe, or by reforming the banks to give more weight to savers in formulating bank interest and credit policy. The current prospects, however, of a bank reform which reduces the policy prerogative of founder enterprises are limited. Even if such reform went through, uncertainty about future rates of inflation would make it difficult for banks to compensate for inflationary expectations through money interest rates on long-term contracts. However, some increase in money interest rates under the existing institutional set up should still be possible and in the current inflationary context, is clearly desirable.

120.22 Though reducing inflation has been a major policy goal for several years, the result so far has not been too encouraging. The introduction and strict implementation of the new incomes agreements may weaken the inflationary process, but on balance, the tools for controlling inflation would appear to need further improvement. (Chapter XI). Part of the difficulty is that in a situation of "sticky" nominal interest rates price level changes (and the expectations they induce) feed back to fuel inflationary pressure via low real costs of capital, which encourage excessive investment demand.

10.23 If inflation continues to be an intractable problem, the proposal of "indexing" or value-linking of financial assets and liabilities may have to be seriously considered. Compared to compensatory revisions in money interest rates, value-linking is far more effective in reducing uncertainty about real rates of return. In Yugoslavia, value-linking is a particularly attractive practical proposition given the relatively simple composition of financial assets and liabilities, most of which pertain to the banking system. One would, of course, face the usual problems of which index to link to and precisely what assets and liabilities should be "indexed". For example, in Yugoslavia, it might be important to include the category of "direct credits" in the "indexing" exercises; otherwise the "illiquidity" problem may be aggravated. Neither of these problems would appear to be insurmountable, though a thorough study of possible pitfalls is necessary before such a radical solution is adopted 1/. Value-linking should not, of course, be a substitute for controlling inflation. There are other costs of inflation such as, inter-sectoral incentive distortions, balance of payments pressures and undesired income distributional effects, which would still argue for effective anti-inflationary measures.

10.24 Improvements in the real rates of return are also likely to benefit the term-structure and composition of financial investments. Outside the banks, the most promising (in the long run) alternative channels of financial intermediation are enterprise bonds and premium life insurance. As pointed out earlier, the development of the bond market will require enthusiastic participation by banks. The long-term scope for funded life insurance is

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1/ The experience in other countries such as Brazil, Finland and Israel which have introduced value-linked financial instruments to alleviate inflation-induced distortions of savings and investment while not conclusive is not discouraging.

believed to be sizeable. And the increased supply of long-term funds would certainly be welcome. But to encourage growth, life insurance institutions must be able to invest in instruments which offer adequate real rates of return. Consequently, as with financial saving in bank deposits, life insurance development depends on the successful control of inflation, or insulation from destimulant effects via "indexing". From an allocative viewpoint, both enterprise bonds and funded life deserve to be developed to breach the virtual monopoly of banks over financial intermediation.

3. Resource Allocation

10.25 The analysis of recourse allocation during 1965-71 (Chapter IX) remains applicable. The jointly agreed limits on bank lending interest rates still imply low or negative real rates 1/. An increase in real interest rates, through any of the means discussed above should improve the allocation of credit amongst competing users and uses, and by raising the cost of capital, reduce the bias in favor of capital-intensive techniques and sectors. The increase in the cost of capital should also encourage more efficient use of existing capital stock. With the present low real interest rates the chronic excess demand for investible resources continues and banks and state units remain important in the non-price rationing. There are some encouraging signs that banks are increasingly turning to vigorous project analysis techniques in making allocation decisions. But the fragmentation of the capital market continues to limit the benefits of this trend. The most serious effort at improving resource allocation has been aimed at the "illiquidity" phenomenon, which reached crisis proportions in 1971.

"Illiquidity" and Resource Allocation

10.26 "Illiquidity", the inability to meet financial obligations on schedule, is mainly a manifestation of excess demand in the capital market. The growth in involuntary inter-enterprise trade credit reflects, and is a vehicle for, a fierce competition for scarce resources. The danger to efficient inter-enterprise allocation stems from the ability of inefficient enterprises to preempt resources from more efficient ones through this means. At bottom, this "irresponsible" financial behavior reflects the lack of an adequate framework of penalties and incentives. As long as patron state units and banks insulate enterprises from the risk of bankruptcy, it remains difficult to impose financial responsibility. But bankruptcy, as was noted earlier, is unsuited for an economic system where venture capital is absent. Conceptually, what is required is a financial sanction which is appropriate for the ownership management structure of Yugoslav enterprises.

10.27 The self-management system vests decision-making authority with workers. Thus, designing sanctions aimed at worker-managers, would appear to be the correct approach 2/. Recognizing this, the Federal government has

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1/ It should be noted that banks sometimes lend to non-founder enterprises (and very occasionally to founders) at nominal interest rates as high as 25 percent. But the volume of such lending is believed to be small, in the order of 5 percent of total credits.

2/ Bankruptcy is certainly a sanction against the enterprise's workers. But because it is too drastic, it invites rescue operations by patron state units and banks.

recently passed laws, effective January 1973, which limit personal income payments in an enterprise guilty of prolonged net accounts payable (the detailed conditions are specified) to 90 percent of the past year's level until the obligations are fulfilled. New laws are on their way to extend this sanction to officials and personnel of state units which are guilty of similar prolonged net debts. This is an interesting departure from previous anti-"illiquidity" measures which concentrated on eliminating investment by "illiquid" enterprises and state units through various account-blocking devices. The latter type of measures continue in effect, as well as several others, all part of a three-year phased attack on the problem. The measures taken since the beginning of 1972 include:

(i) Multilateral cancellation of debts organized by the Social Accounting Service (SAS). Enterprises with net debts were forced to issue special bonds (acceptance certificates) of a limited maturity. If these were not paid on time, the expenditure accounts of the enterprise at the SAS were blocked;

(ii) Increase in the allocations to reserve funds of enterprises. These increments can only be used for specified purposes such as reducing net accounts payable;

(iii) "Sanation laws": this is a complicated multi-stage process, in effect from January 1973, which attempts to bring order to the processes of creditor support for enterprise in financial difficulties. If creditors cannot, or will not, see the enterprise through its period of financial difficulties, bankruptcy proceedings have to be initiated;

(iv) To apply corrective pressure on net creditor enterprises, a new law requires that 25 percent of net receivables outstanding beyond 90 days be regraded as a cost in the enterprise's net income statement. After a second 90 days another 25 percent of net receivables is counted as cost. Thus, by threatening to shrink the net income available for allocation to savings and wages, creditor enterprises are given incentives to speed collection of receivables.

10.28 Some of the above measures, particularly the "Sanation" laws also apply to enterprises making repeated losses. The case of loss-making 1/ enterprises should, strictly speaking, be separated from the more common case of "illiquidity" arising from unpaid debts, discussed above. The existence of a large number of loss-making enterprises, in part reflects the process of adjustment from a controlled economic system to one where market factors dominate. Some enterprises set up at state initiative in the 1950's have subsequently been found to be uneconomic in terms of the prices which prevailed after the liberalization of foreign trade and domestic markets. In some cases losses may be attributed to residual, and selective, price

1/ "Losses" incur when an enterprise cannot cover personal incomes from net enterprise income.

control by the state. Recognizing the special adjustment problems for such enterprises, new laws have recently restructured the Joint Reserve Funds. Resources continue to come from compulsory contributions by enterprises. These resources can now only be used for sustaining minimum personal incomes in loss-making enterprises, and for retraining labor to ease shifts to more viable sectors. The control over the allocation of these resources has also shifted from state units to self-management bodies dominated by enterprise representatives. In this way, it is hoped that the resources will be used for aiding market-induced inter-sectoral resource shifts, rather than for bailing out financially-irresponsible enterprises, which have close connections with state units.

10.29 It is too early to judge the impact of all these measures, many of which became effective in January 1973. The anti-illiquidity sanctions aimed at personal incomes may well be very effective. According to recent newspaper reports, "it is estimated that in the economy (the enterprise sector) about 1,000,000 persons will be affected by the measures on reducing personal incomes because of illiquidity, while outside the economy personal incomes of about 1.2 million persons will be frozen" 1/. As for eliminating fresh investment by "illiquid" and loss-making enterprise, by the end of 1972 about 10 percent of all enterprises had their accounts at SAS blocked. This represents almost a doubling of "blocked enterprises" as a result of measures taken during 1972.

10.30 Past experience, however, should restrain optimism about the result of these measures. The Social Accounting Service, the chief policing agent, remains inadequately staffed with inspectors. Their number needs to be increased. State units have in the past, and may again, interfere with the implementation of anti-"illiquidity" regulations. But, the backing of the Communist Party plus the new and austere political climate, suggest a higher probability of success for the implementation of these regulations. By damping "uncovered investments", the new austerity should also reduce disproportion in the capital market which fuel the problem of "illiquidity".

10.31 Finally, one should note that excess demand for investment resources is a key cause of the "illiquidity" phenomenon. Any increase in supply of reduction in ex ante demand should reduce excess demand, and hence the competition for resources which generates "illiquidity". Increased enterprise savings through the manipulation of incomes policy, improved financial mobilization and intermediation and the reduction in investment demand via increased real interest rates can all aid in containing the "illiquidity" phenomenon 2/.

1/ Borha, December 22, 1972.

2/ The importance of reducing excess demand for investible resources to alleviate illiquidity is realized in official circles. Hence the classification of the law on upward revaluation of fixed assets as an anti-"illiquidity" measure. The increased mandatory savings.

Inter-Regional Allocation

10.32 The Special Fund for Underdeveloped Regions remains the key institution responsible for inter-Republic resource transfers. Each Republic contributes 1.94 percent of its Social Product for allocation by the Fund. Under the allocations recently finalized for the 1971-75 period special attention is being devoted to the least developed region, the Autonomous Province of Kosovo 1/. The resources, obtained so far through compulsory enterprise loans decreed by the responsible Republics, are lent to intermediating banks in the power regions for 15 years at 4 percent interest. Unlike before, the banks in these regions are free, in consultation with corresponding republican governments, to determine the terms to the final borrower. However, the policy of passing on the concessionary terms to final users remains in operation. This policy needs to be reexamined for reasons outlined earlier. (Para. 9).

10.33 The gradual phasing out (to be complete by 1973) of the Federal role in direct financing of infrastructure projects (para 10.2) is likely to reduce the net transfer of resources to the poorer areas. Though the abolition of certain Federal taxes has increased the resources available to the republics, the benefits are likely to be disproportionately small for the poorer regions, owing to the small size of the social sector (the main source of the previous Federal tax revenues) in these regions.

10.34 The system of Federal budgetary grants for current social services expenditure in the poorer republics was another major source of funds in the past. These grants will continue, but under the new system of joint republican financing of the Federal budget, they are likely to come in for continuous scrutiny. There is a draft Federal law proposing to transfer the equivalent of 0.83 percent of the Yugoslav social product to the poorer regions through such Federal grants during 1971-75.

10.35 The prospects for inter-Republic resource transfers through banks and enterprises remain poor, as long as the generalized excess demand for investible resources persist throughout the country and the quality of economic infrastructure and services in poorer regions remain markedly lower than in the rest of the country. The 1971 Constitutional changes did not promote voluntary inter-Republic resource mobility. If anything, the further devolution of State of economic power to the Republics, strengthened the geographical territorialization of the capital market.

10.36 Within the republics, the respective governments have launched programs to promote development in backward areas. The main tools are direct investment by republican governments and subsidization of interest rates on credit to enterprises to induce location in such areas. Once again, the choice of the capital price as the mode of subsidy seems inappropriate and at variance with employment objectives in these backward areas.

1/ Of the 1.94 percent of Social Product targetted for such transfers 0.09 percent (the increment over the 1966-70 ratio) is reserved for Kosovo.

4. Public Expenditure and Revenue: Some Issues

10.37 Despite the phasing out of the state in saving and "economic" investment, the gross flow of public expenditures, including social security payments, remains very high, about 30 ppercent of GNP 1/. It is concerned mainly with providing:

(a) classical public goods like administration, 8defense and justice;

(b) "special public policy" expenditures, such as those to promote exports, regional development and subsidies to specific industrial sectors;

(c) social insurance and education.

The second category is partly in the budget, but mostly outside in various extra-budgetary institutions and accounts. The third is almost wholly extra-budgetary.

10.38 So far, the 1971 Constitutional amendment and ensuing laws have defined the Federal expeenditure role and Federal-republic relations. The definition of republican-communal roles and relations are still in process. Essentially, the discussion centers on the following issues:

(i) Should public expenditure roles at republic and communal levels be reorganized? In particular, should there be some reform of the current framework of extra-budgetary expenditures?

(ii) What sort of revenue system should be adopted to finance the necessary state role?

Expenditure System

10.39 There seem to be two somewhat contradictory tendencies. First, the term of "returning resources to the economy" may be seen in the creation of new "interest communities" for certain kinds of expenditures. These would give more representation to citizens (who receive the service), institutions (like schools, which administer the service) and enterprise/workers (who pay for the service). The second theme reflects disenchantment with the past proliferation of extra-budgetary funds and institutions. The proliferation is easy to understand in terms of the historical thrust towards decentralization and self-management. But, it is now felt that the institutional fragmentation of public expenditure has gone too far. Administrative costs have risen too high and coordination has become increasingly difficult 2/. Basically, reorganization will attempt to recapture some of the lost economies of scale in public expenditure. For example, the new "interest communities" are to be regionalized in each republic to embrace quite a few communes.

1/ If payments by Social Insurance Funds (mainly for pensions and health) are excluded, the ratio drops to approximately 19 percent.

2/ A recent report claimed that there were 2,000 extra-budgetary funds in Serbia alone. Of these 70 were Road Funds.

10.40 The problem of uneconomic scale in public expenditures is likely to persist in Yugoslavia. It is a cost implied in the decentralization of the state's expenditure responsibilities. For example, the decentralization of the Federal role for infrastructure investment financing, removes an agent capable of financing and coordinating major projects like the Belgrade-Bar railway. Reforms, like those mentioned above, are best viewed as attempts to mimimize the costs of decentralization subject to fundamental, political and institutional constraints.

The Revenue System

10.41 The current discussions on revenue reform focus on rationalizing and improving incentives for enterprises in the social sector. Since the institution of the "Net Income System" in 1958, revenues have relied increasingly upon proportional taxes and contributions based on personal incomes. (Statistical Annex, Table 5.8). Table 10.2 disaggregates the fiscal burden on enterprise value added by base of revenue instruments. By 1968, 46 percent of the total was accounted for by revenues based on personal incomes, compared to 28 percent in 1959. With the recent abolition of the "tax on business capital", the proportion has probably increased further. By 1971, even after the abolition of the Federal income tax on social sector wages, contributions and taxes on personal incomes amounted to 40 percent of net personal incomes ("take home" wages) earned in all economic organizations in the social sector.

Table 10.2: PERCENT COMPOSITION OF REVENUES ON ENTERPRISE VALUE ADDED, BY BASE

Base	1959	1963	1968
A. Capital Stock	16.8	19.4	22.9
B. Turnover	20.7	21.9	28.7
C. Net Income	31.1	19.9	0.4
D. Personal Incomes	27.8	36.5	45.9
E. Other	3.6	2.3	2.1
TOTAL	100.0	100.0	100.0

Source: Adapted from Corupic and Paj op. cit.

10.42 This concentration on personal income taxes is criticized on the following grounds:

(i) they increase the relative cost of labor and thus bias production choices in favor of capital-intensive techniques and sectors;

(ii) the tax-take is invariant with business conditions, so that poorly performing enterprises have to pay as much as successful ones (if the wage bill is equal);

(iii) More generally, the fact that the State's draft on resources does not change with the business cycle is viewed critically, since the State no longer contributes significantly to the economic sector via productive investment.

10.43 The main aim of revenue reform is to substitute some of these personal income taxes with alternative taxes based on some variant of enterprise income while putting the residual wage taxes on a more genuinely contributory footing. During the mission's visit, official discussions were under way to decide on the most appropriate base for the new tax. Though the new taxes would be republican, a serious effort was being made to ensure inter-republic harmony on questions of the tax base, rates, maximum allowable depreciation rates, definition of payee, etc. Whichever tax is adopted, it will have to be consistent with the incomes policy agreements.

XI. STABILIZATION: INSTITUTIONS, INSTRUMENTS AND POLICIES 1/

Introduction

11.1 The implementation of the 1965 Reforms created a new problem of short-term economic management. With the extension of the role of the market, the freeing of foreign trade, and the growth of enterprise autonomy, Yugoslavia began to experience external and internal imbalance problems typical of demand-determined Western economies 2/. In Yugoslavia, there was a bias towards "overheating" due to (a) the consumption pressures emanating from increased share of personal receipts in social product and the "demonstration effects" from Western Europe passed on through freer trade and migrant workers; and (b) the investment demand stemming from the under-pricing of capital, partial insulation of enterprises from financial risk, and ambitious Plan goals to modernize the capital stock.

11.2 Unfortunately, the decentralization process did not provide the government with adequate instruments for economic management. On the contrary, the erosion and dispersion of state economic authority severely constrained governmental control over major macro-economic variables. Fiscal authority was fragmented across numerous public entities, which made its coordinated use for stabilization policy cumbersome. Domestic stabilization policy relied almost exclusively on monetary tools. These were also targetted on the external balance goals, where they were bolstered by foreign trade and payments measures including the resource to exchange rate changes in recent years. First, a discussion of the policy framework. Sections 1 and 2 describe the fiscal and monetary systems in operation after the Economic Reforms. Section 3 discusses the nature of the stabilization policy problems. Section 4 reviews the recent experience in stabilization policy and Section 5 sketches the prospects for aggregate economic management after the 1971 constitutional amendments.

A. The Fiscal System

11.3 Though the scale of public expenditure and revenues remained quite large after the Reform (the gross flows were nearly a third of GDP), suggesting a vast potential for anticyclical fiscal policy, the commitment to decentralization had led to the dispersion of fiscal power to numerous independent points of control. Dispersion existed vertically across the three levels of government (Federal, Republic and Communal) and horizontally at each level between strictly budgetary expenditures and several extra-budgetary institutions. Under the decentralized regime only the "essential state role" remained in the budget. Other activities, including social services and

1/ This Chapter draws heavily on the IBRD Economic Reports for 1971 and 1972.

2/ Such imbalances also existed in pre-Reform years. But the state could more easily suppress them through administrative control. Economic management through indirect instruments became a major policy concern after the Reform.

investment financing, were financed through extra-budgetary institutions where the principles of self-management could be brought into practice. This two-dimensional dispersion characterized both the structure of public expenditure and that of public revenues and severely limited the potential for demand management through either expenditure control or tax policy.

Public Expenditure Roles

11.4 The Federal Budget was spent largely on classical state items such as defense, administration and some current grant items. This reflected a deliberate policy of reducing Federal current expenditure to the minimum state role that had to be centralized at the Federal level. To the extent the Federation took an additional responsibilities these were exercised through extra-budgetary institutions. The Special Fund for Underdeveloped Republics and Regions has been discussed. The Federal Fund for Financing Exports was also a legal entity providing resources for export credit and financing. These credits were administered through 18 authorized business banks. The Federal Fund for Financing Investment was not a legal entity, but simply an extra-budgetary account through which the Federation participated in financing major infrastructure projects such as the Belgrade-Bar Railway and the Djerdap project. In addition to these Funds there were some extra-budgetary special purpose accounts, or funds such as the Fund for the Reconstruction of Skopje, which was wound up in 1970. The operations of these all-Federal extra-budgetary institutions are aggregated in Statistical Annex Table 5.3.

11.5 Expenditure roles in the Republics and Communes were similarly divided between budget and extra-budgetary institutions. The latter controlled a much greater share of public expenditures at these levels than for the Federation, mainly because the social service expenditures were concentrated in Republican and Communal extra-budgetary institutions and defense was a very minor item in budgets of these levels. The precise structure of extra-budgetary institutions varied across Republics, but there were broad similarities. The most important items of extra-budgetary expenditure were education and social insurance (health, pensions, etc.). These were administered by the Communities for Education and Social Insurance Funds, respectively. They were essentially self-managed entities financed by contributions levied on personal incomes. Republics and Communes also engaged in extra-budgetary investment financing. There were both extra-budgetary investment accounts, repositories of former "State Capital" (see paragraph 9.27) and independent Joint Reserve Funds. These were financed by compulsory contributions from enterprise value added, and the resources were used to support enterprises in financial difficulties. The other major items of extra-budgetary expenditure were for various current and infrastructure maintenance services, which were also administered by bodies such as the Road Funds and Water Funds. These depended on earmarked taxes, fees and other charges for their revenue. In addition to the Funds, there were some extra-budgetary special purpose accounts, or funds such as the Fund for the Reconstruction of Skopje, which was wound up in 1970.

11.6 A comprehensive consolidation and functional classification of this highly-fragmented body of public expenditure is beyond the scope of this report. A rough consolidation and classification based on data supplied by Yugoslav authorities is presented in Table 11.1. It should be noted that though the final total gives the volume of public expenditure which may be potentially manipulated for aggregate demand management, it exaggerates the public sector's draft on national product, since it includes gross values of various transfers and intermediation operations.

Public Revenues

11.7 Decentralization is again the key element in understanding the revenue structure. The creation of multiple institutions for public expenditure implied a parallel revenue structure whereby these institutions could retain some financial independence. This was achieved through a combination of three different devices: independent revenues from original taxing power, revenue sharing and earmarking, and inter-budgetary grants. The need for independent revenues from original taxing power was accepted as early as 1952 when the Republics and the Communes were given independent taxing power. The post-1965 tax system also provided for independence of revenue sources for certain horizontally-decentralized institutions. Thus at the Federal level the "tax on Business Capital" was explicitly designed to enable financing of Federal extra-budgetary expenditure and provide about 40 percent of the current inflow to this account. (Statistical Appendix Table 5.3) At the republic level both the Education Communities and the Social Insurance Funds had independent sources of revenue obtained from contributions on personal income levied at rates determined by these institutions within limits set by law.

11.8 These attempts at providing financial independence through independent tax power did not however suffice to finance the extraordinarily fragmented expenditure system described above. Hence it was supplemented by a very complex system of revenue sharing and earmarking whereby a part of the revenue from a tax levied by one authority was siphoned directly into another. The precise details of tax sharing arrangements varied between republics but in general they were of two types:

(i) Horizontal: tax revenues from certain taxes were often shared at each governmental level in a specified proportion between the budget and extra-budgetary institutions at the same level.

(ii) Vertical: tax revenues accruing from the original taxing power of a higher governmental level were shared between the budget at that level and either the budget or an extra-budgetary fund at a lower level.

In addition to revenue sharing there were inter-budgetary grants between budgets at different governmental levels (Federal budget grants to Republican budgets and Republican budget grants to Communal budgets) and budgetary grants to extra-budgetary institutions such as Road Funds and Education Communities.

Table 11.1: PUBLIC SECTOR EXPENDITURES, 1967-70

(percent of total)

	1967	1968	1969	1970
A. Budgetary				
1. National Defense	14.2	15.8	14.7	13.8
2. Administration	11.2	10.6	10.4	10.5
3. Grants and Subsidies to Social Sector	2.7	2.4	2.0	2.2
4. Social Security and Health Protection	1.7	2.8	2.9	2.8
5. Communal Activities	1.0	1.1	1.2	1.2
6. Regional Development	0.3	0.5	0.6	0.5
7. Grants to Non-Budget Institutions	2.7	2.8	3.1	2.9
8. Non-economic Investments	2.9	3.0	2.9	2.8
9. Other	1.2	1.0	1.3	1.3
Sub-total	37.9	40.2	39.1	38.0
Of which:				
Federal Share	(20.2)	(20.7)	(19.3)	(18.6
Republican & Communal Share	(17.7)	(19.5)	(19.8)	(19.4
B. Extra-Budgetary				
1. Social Insurance	30.1	30.1	28.4	30.1
2. Education	10.9	11.6	12.5	13.0
3. Export Credit Finance	2.2	1.8	2.2	2.4
4. Investments	13.0	14.4	14.9	14.9
5. Other	5.9	1.8	2.9	1.6
Sub-total	62.1	59.8	60.9	62.0
Of which:				
Federal Share	(14.3)	(12.9)	(15.2)	(14.0
Republican & Communal Share	(47.8)	(46.9)	(45.7)	(48.0
C. Total Public Expenditure	100.0	100.0	100.0	100.0
D. Public Expenditure as Percent of GNP (market prices)	32.2	31.4	31.6	31.6

Source: Federal Chamber of Economy, Belgrade

11.9 The fiscal instruments underlying this complex revenue system were themselves fairly simple in design. The major direct taxes were those on gross personal incomes and a tax on the capital value of owned assets of an enterprise. The major indirect taxes are customs duties and turnover taxes. The main source of non-tax revenues were contributions to the Social Insurance Funds and Communities for Education. Table 11.2 presents a rough consolidation of the various public revenues. A brief commentary of the major taxes follows:

(a) The direct taxes on personal income were an important source of revenue for all three levels of government. Direct budgetary taxation of personal income existed for three classes of income -- personal income from employment contracts (wages), income from work for self-employed persons such as artisans, professional work, authors, entertainers, etc., and agricultural income 1/ in the private sector. Each class was taxed according to a separate schedule specifying proportional rates of taxation. The Federal tax for each class was common to all Republics but the rates of Republican and Communal taxation for each class varied between Republics. In addition to these proportional taxes, there was a Communal progressive "tax on total earned income from all sources" which had an exemption of 20,000 dinars per family and progressive rates from 3 to 70 percent of taxable income. Though potentially an important resource to local authorities, the tax was reportedly subject to massive evasion. Contributions for Social Insurance and Education were "contributory" in name only, as they took the form of compulsory proportional "contributions" (taxes) on personal income. These revenues accrued directly to the independent extra-budgetary institutions concerned. Surpluses generated were held with the banking system on their account.

(b) the tax on "Business Capital" of an enterprise was levied at different rates for different sectors on the accumulated "Business Funds" (analogous to equity) of an enterprise. It averaged at 3-4 percent during this period. As a Federal tax, the revenues fed the extra-budgetary operations of the Federation.

1/ Agricultural income is calculated on a cadastral basis and is fixed in money terms over a given period, no allowance being made for price inflation. Agricultural income estimated on this basis substantially understates income from private farming. Hence the apparently high rates of taxations on this class of income.

Table 11.2: PUBLIC SECTOR REVENUES, 1967-70

(percent of total)

	1967	1968	1969	1970
A. Tax Revenues				
1. Direct Taxes	53.7	54.4	53.9	55.2
Taxes on Business Capital	7.6	7.5	7.1	5.5
Taxes on Personal Income	22.9	22.7	20.8	22.0
Social Insurance Contributions	23.2	24.2	26.0	27.7
2. Indirect Taxes	29.5	30.2	31.3	34.1
Turnover Taxes	23.1	23.4	24.9	26.6
Customs Duties	6.3	6.8	6.4	7.6
Sub-total	83.2	84.6	85.2	89.3
B. Non-Tax Revenues				
Fees and Charges for Services	1.5	1.4	1.5	1.5
Repayment of Principal and Interest on Investment Credits	3.6	3.2	3.3	2.4
Interest Income from National Bank	1.7	1.3	1.2	1.2
Other Revenue	2.9	4.5	4.1	1.6
Resources of Non-Federal Extra-Budgetary Funds	7.0	5.1	4.6	4.0
Sub-total	16.8	15.4	14.8	10.7
TOTAL	100.0	100.0	100.0	100.0
D. Public Revenues as Percent of GNP (market prices)	31.1	32.0	32.4	31.6

Source: Statistical Appendix Table 5.6.

(c) the system of turnover taxes enabled each governmental level to levy indirect taxes on specified ranges of items. These taxes were levied only at the point of retail or final consumption, so that, unlike the previous period, there was no taxation of intermediate goods entering as inputs into production of other commodities 1/. Federal turnover tax was levied at a fixed rate of 12 percent on all commodities except fuel and alcohol for which the tax rates are higher and certain items, such as educational equipment, children's clothes and food which were exempt from turnover taxation. The Republics and Communes also levied turnover taxes at rates varving between Republics but generally much lower than the Federal rate. Republican tax rates varied between 1.5 and 3.0 percent while communal rates varied between 3 and 6 percent. The taxing power of the Republics and Communes was not absolute but governed by a Federal law which laid down limits and exemptions. These turnover taxes were subject to very complex earmarking provisions.

(d) Customs duties were an important source of revenue accruing directly to the Federal Budget (their effective protective impact is discussed elsewhere in this report).

(e) Other non-tax revenues consisted mainly of interest and repayments on State credits, including those arising from former "State Capital".

Throughout this period there was a downward trend in the rates of taxes, especially Federal ones, in keeping with the goal of "returning resources to the economy".

B. The Monetary System

11.10 The role of money had increased significantly during the decade preceding the 1965 Reforms. With production decisions freed of rigid controls, the expenditure plans of economic units had become increasingly susceptible to liquidity considerations. In essence, changes in money now led to attempts at portfolio adjustments in the stock of real assets. However, complex earmarking provisions continued to dilute the "moneyness" of money. Enterprises were required to hold money balances in a number of functionally-separated accounts 2/, earmarked for different expenditures. Such a fragmentation of the money supply meant that expenditure decisions were more responsive to changes in the components than the aggregate money supply, and changes

1/ The post-1965 turnover taxes were simply single-stage retail sales taxes.

2/ For example, a giro account for current transactions, an investment account for net investment, a depreciation account for replacement and a "collective consumption" account for social needs met by an enterprise.

in the latter had a highly uncertain incidence. The increased role of money suggested greater importance for monetary policy. But monetary policy during this period was characterized by great specificity. The earmarking provisions referred to above, allowed monetary authorities to engage in specific blocking/deblocking of these accounts to influence the composition of aggregate demand. Credit policy was similarly differentiated by purpose; no general purpose credits were available. Towards the end of the period, as the earmarking provisions were gradually relaxed, the control of aggregate money supply and credit became more important. And the instruments for such control increasingly resembled those in a market economy, especially after the transfer of the National Bank's short-term credit operation to other banks in 1961.

11.11 The 1965 Reforms greatly diluted the compartmentalization of the money supply resulting from the system of earmarked accounts operating in the previous period. Thus the "moneyness" of money, and the potential scope for monetary policy, was greatly increased. However, the balance-sheet distinction between short and long operations continued to be a constraint on portfolio behavior of banks and other economic agents. The impact of this constraint was somewhat uncertain since there were ways of parlaying short-term resources into long-term ones by various backdoor means.

Institutional Framework

11.12 The Reforms did not significantly alter the role of the National Bank. The "monetary authorities" consisted of the Federal Assembly (the highest legal authority), the Federal Executive Council, the Secretariat of Finance and the National Bank of Yugoslavia. Monetary policy was framed in the context of annual economic policy resolutions which were voted on by the Federal Assembly. Guided by these resolutions the Federal Executive Council decides on the monetary targets on the basis of proposals prepared by the Yugoslav National Bank. The authority to draft and initiate these resolutions and other proposals gave the National Bank enormous influence over policy formation. Once accepted in the monetary policy resolution, the implementation of the policy targets was the responsibility of the National Bank.

11.13 In 1967, monetary planning based on the money-flow accounts of the National Bank was introduced 1/. Basically, the system involved projecting the money-flow accounts for the upcoming year on the basis of past trends, anticipated institutional and behavioral changes and ultimate economic goals. The methodology was aimed at identifying the increase in money supply consistent with the economic policy goals. Attached to this primary target was the expansion in short-term bank credit. Once these two targets were determined the monetary planning system proceeded to deduce the implications for changes in the supply of "high-powered money", and finally the policy tools through which such changes could be efficiently secured. By 1969 this method of monetary planning was firmly established in the policy-making process.

Targets and Instruments

11.14 The ultimate economic goals of monetary policy were changes in the price level, real product, employment and the balance of payments. The

1/ See Dimitrijevic "The Use of Flow of Funds Accounts in Monetary Planning in Yugoslavia", Review of Income and Wealth, March 1969.

immediate targets were the changes in the supply of money and short-term bank credit. Monetary policy essentially influenced expenditure decisions through operating on the availability of credit. The tools available for securing these immediate targets are schematized in Table 11.3.

Table 11.3: MONETARY POLICY TOOLS

I. Tools for regulating credit capacity of business banks:

1. Tools for regulating changes in high-powered money:
   (a) Rediscount mechanism (selective);
   (b) Special Central Bank credit to business banks;
   (c) Central Bank credit to business banks for liquidity purposes.

2. Tools regulating the money-multiplier:
   (a) Changes in the Reserve Requirement Ratio;
   (b) Changes in the Obligatory Liquidity Ratio;
   (c) Other obligatory deposits with the Central Bank;
   (d) Central Bank Credit to the Federal Government and other direct credit.

II. Other Tools for regulating the supply of bank credit:
   (a) Tools regulating use of (e.g. short v. long) bank resources;
   (b) "Gentlemen's agreements" and moral suasion;
   (c) Credit ceiling.

III. Tools regulating the demand for credit:
   (a) Interest rates, in particular the discount rate of the Central Bank;
   (b) Regulation on creditworthiness for application by business banks.

Source: Adapted from Dimitrijevic and Macesich op. cit.

11.15 The range of tools is impressive 1/. And all were used at sometime or other after 1965. A couple of general points may be noted. First, though the tools tabulated above operate on both the supply of and demand for credit only the former were important in Yugoslavia. This is what one would expect in a situation of excess demand for credit, where the interest rates are precluded from playing an equilibrating role. The rediscount rate of 6 percent was not changed during the period. Second, the rediscounting mechanism was an important vehicle of selective credit policy, aimed at compensating for the lack of well-differentiated financial markets. The strategic instruments during this period were the rediscounting operations, reserve requirement changes (subject to a legal maximum of 35 percent on short-term deposits) and credit ceilings.

C. Instability and Inflation Since 1965

11.16 Relative to stated goals, the policy problems were: wide fluctuations in the rate of growth of real GDP, continuing and increasing inflation,

1/ A detailed description and evaluation of these tools is obviously outside the scope of this report. A clear analysis is provided by Dimitrijevic and Macesich op. cit.

and a growing imbalance on the "goods and non-factor services" account in the balance of payments (Table 11.4).

Table 11.4: SYMPTOMS OF INSTABILITY

	1966	1967	1968	1969	1970	1971	1972
Percentage Change in Retail Prices during Year	7	5	5	8	10	18	14
Percent Change in Cost-of-Living during Year	7	6	6	11	11	18	16
Balance on "Goods and Non-factor Services" Account as percent of GNP (current prices)	-1.0	-1.4	-1.8	-2.3	-5.1	-6.0	
Growth Rate of GDP (1966 prices)	5.0	0.9	3.5	9.3	5.7	7.7	

Sources: Annual Reports, National Bank of Yugoslavia and mission estimates of national income.

11.17 While these trends clearly identify a major role for stabilization policy, the diagnosis of underlying causes is more difficult. The thesis of secular excess demand pressure is certainly consistent with both inflation and balance of trade deficits. However, it is worth noting that both inflation and balance of payments deficits may also result from other causes. Some pressure on the balance of payments was unavoidable in the course of structural change accompanying the establishment of a decentralized market-oriented economy. This is reflected, for example, in the widening deficit in the balance of trade with convertible currency countries, compared with the overall balance. Furthermore, the deficit on "goods and non-factor services" account reflect not just a "spilling over" of excess demand, but also rigid and heavy import requirements associated with a production structure in the process of modernization and development, coupled with limits on export growth. The evolving pattern of imports does suggest increasing use of foreign equipment and raw materials. However, by itself, this does not imply "structural" dependence on imports. While the import equations in the estimated model (see Appendix III on the Projection Model) show close relationships of imports, by categories, with value added (and changes in value added) by broad sectors, they do not allow discrimination between competitive and non-competitive imports 1/. It is only the latter which fit into a "structural" view of imports.

1/ A reason often cited for the increased use of foreign equipment and materials was the easier availability of foreign suppliers' credits compared to the tight domestic credit situation.

11.18 Similarly, alternative explanations of inflation in Yugoslavia are easy to find. In particular, the cost-oriented variants see inflation as a product of autonomous income increases in excess of productivity growth and externally-determined increases in the prices of imports. It is extremely difficult to discriminate between the relative importance of demand and cost factors, especially since they may have changed over time. Econometric investigations, notably those by Bajt and Popov, have so far failed to settle the issue 1/. The problem is that the data are usually consistent with both types of explanation. For example, a close correlation of prices (say, for a given industrial sector) and personal incomes paid would be observed, irrespective of whether increased incomes caused higher prices, or were the result of increased nominal value added arising from demand-induced price increases. Furthermore, even if causality could be reasonably established through the judicious use of lagged variables, the identification of, say, cost-push, would not be the end of the story for policy purposes. The strength of the "cost-push" factors itself may depend on the degree of excess demand.

11.19 Econometric investigation is also complicated by the changing intensity and incidence of price control during the post-Reform period (as late as 1970 nearly half of industrial sales were at controlled prices). Such changes were clearly part of the explanation for significant differences in the rates of inflation in producers' and retail prices, for both agricultural and industrial products (Table 11.5). This problem is magnified for any investigation of inflation which employs sectoral disaggregation (see, for example, Popov op. cit).

Table 11.5: CHAIN INDICES OF PRICES: DATA FOR DECEMBER IN RELATION TO DECEMBER OF PRECEDING YEAR

	1966	1967	1968	1969	1970	1971	1972
Cost of Living	107	106	106	111	111	118	116
General Index of Retail Prices	107	105	105	108	110	118	114
Industrial Products							
Retail	108	104	106	108	111	118	114
Producers'	103	101	101	104	112	116	109
Agricultural Products Retail	104	105	103	107	116	119	121
Producers'	114	91	102	118	115	124	125

Source: Annual Reports, National Bank of Yugoslavia.

1/ A Bajt (Cene i Dohodki 1966-71, Llubljana, 1972) favors a demand-variant, while Popov ("Interbranch Structure of Personal Income", Gledista, 1971) comes down on the side of cost factors. The statistical methodology of both may be questioned.

11.20 The object of these remarks is not nihilism about the study of inflation in Yugoslavia, but rather to caution against accepting single-equation regression results purporting to provide "the" explanation, from which appropriate policy may be deduced 1/. The explanation of the problem favored in the report would include: (a) a major role to excess demand (b) include upward movements in personal incomes as integral mechanism for shoring up private consumption demand and (c) recognize the important role of cost-push factors particularly in certain years e.g. the devaluation of 1971 and the income increases in 1972. The role of inter-industry and inter-enterprise links in personal income pressures (sometimes described as a wage -- wage spiral) is also recognized. The pivotal role of personal income increases in fuelling consumption demand pressures and reducing potential enterprise savings, creates scope for incomes policy as an anti-inflationary device.

11.21 Whatever the correct diagnosis of inflation, anti-inflationary policy during the post-Reform period viewed it as a problem of excess demand and relied on demand-deflation as a corrective. The relative inefficiency of policy, evidenced by the data in Table 11.5, may suggest that the diagnosis was incorrect. But, the inefficiency is more accurately ascribed to the lack of appropriate tools and the environment of financial irresponsibility within which enterprises operated. Monetary policy was the main vehicle for demand management during this period. But before discussing efficiency, it is worth investigating the reasons for the dormant fiscal policy.

D. Stabilization Policy

Limits on Counter-cyclical Expenditure Policy

11.22 Defined in the widest sense to include social expenditures and investment credits by public bodies, public expenditures accounted for about a third of GDP. But the institutional fragmentation of this expenditure made discretionary centralized control very difficult. Table 11.6 summarizes the vertical and horizontal dispersion of public expenditure. If budgetary expenditure is taken as a measure of the portion under effective discretionary control, only 40 percent of public expenditure (13 percent of GDP) fell into this category. Federal budgetary expenditure, potentially more amenable to central discretionary management, constituted only 20 percent of the total (7 percent of GDP) and consisted mainly of irreducible state expenditures such as defense. The commitment to decentralization inhibited direct central control of extra-budgetary expenditures. Of these the Federal expenditures

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1/ A full-blown attempt at econometric discrimination between alternative hypotheses is outside the scope of this report. An important impediment to a successful study is the lack of a good variable to proxy for the pressure of demand. Considering the way the Yugoslav labor market operates, data on vacancies and unemployment do not provide useful bases for such variable. Data on delivery queues in major industries also all not available. A monetarist demand pull explanation, based on identification of well-defined demand and supply functions for money was investigated but did not yield conclusive results.

could have been most easily controlled, but their focus on investment finance (including concessionary transfers to power regions) made them poor vehicles for deflationary demand management.

Table 11.6: STRUCTURE OF PUBLIC EXPENDITURE
(percent)

	1967	1968	1969	1967-69
1. Budgetary	40	41	39	40
Federal	22	22	19	21
Non-Federal	18	19	20	19
2. Extra-budgetary	60	59	61	60
Federal	12	13	14	13
Non-Federal	48	46	47	47
3. Total	100	100	100	100
4. Public Expenditure/GDP	32	32	33	32

11.23 Despite these limitations, two types of deflationary control were attempted during this period:

(i) partial "sterilization" of revenue flows from specified revenue sources. For example, in 1970, revenues from turnover taxes and contributions from personal income were limited to levels planned, with all excess to "sterilized" in special blocked accounts; and

(ii) overall expenditure limits, like the 1971 ceiling on expenditure growth of 10.8 percent over 1970 levels.

Both types of expenditure control suffered from two deficiencies. First, the aggregate deflationary impact was uncertain, and second it was extremely difficult to introduce selectivity in expenditure curbs. For example, indirect control through revenue inflows "sterilization" implied that the direct impact on expenditures was cushioned to the extent a public body was running a surplus. Where surpluses were large enough such measures could leave expenditure unaffected 1/. And since the distribution of surpluses

1/ Since these surpluses were held in the banking sytem this has an indirect effect upon expenditure through reduced availability of resources to the banking system. This effect was, however, identical to the effect upon "general liquidity" of monetary restriction by the National Bank, i.e. it suffered from the shortcomings of monetary policy described in the next section.

(deficits) across the multitude of spending units was somewhat unpredictable, so was the incidence of the expenditure curb through revenue sterilization. Similar problems of uncertain impact existed with the overall expenditure limits. Furthermore, in both cases, where the curbs were successful, the selection between types of expenditure to be reduced (consumption v. investment, for example) depended entirely on the decentralized institutions involved. There was no guarantee that the expenditure cutback (or restrictions, in a growth context) would fall on those expenditure categories which central discretionary policy might prefer.

11.24 Such measures clearly had none of the advantages of flexibility, selectivity and quantitative exactness that are often claimed for fiscal instruments in Western economies. Nevertheless, the oft-voiced support, in Yugoslavia, for increased use of fiscal instruments in stabilization policy referred mainly to the type of expenditure measures outlined above. There was a strong and successful resistance to the use of tax policy as an instrument of demand management.

Limits on Counter-cyclical Tax Policy

11.25 The main reasons why the government was not able to use taxation policy as an instrument of short-term were 1/:

(i) the commitment to reduce the overall tax burden on the economy, and especially reducing the share of the central unit (the Federation) in total tax revenues, and

(ii) the existing earmarking system whereby additional revenues raised were distributed to several independent institutions, making it difficult to ensure that this "mopped-up" purchasing power was not redistributed through autonomously determined expenditure by these bodies.

Of these, the first, was undoubtedly the dominant obstacle, mainly because, any tax increase was viewed as a reversal of the trend to "return resources to the economy". However, the economic case for discretionary authority to increase taxation temporarily remains strong. Aside from control of aggregate demand, discretionary tax manipulations offer scope for discrimination between categories of final demand. In particular, they offer a chance to spread the burden of deflationary demand management to consumption expenditure 2/; investment tends to be the focus of monetary contractions (see below).

1/ There was an atypical attempt to use increases in the Federal turnover tax (as certain categories) as a deflationary instrument in 1970.

2/ It should be pointed out that, without an effective incomes policy, the use of discretionary consumption taxes during this period may have been offset by self-managed enterprises voting higher personal incomes shares out of "residual enterprise income" to sustain the consumption demand.

Monetary Policy Since 1965

11.26 The importance of monetary policy followed from the limitations on fiscal policy discussed above. Table 11.7 justaposes the ultimate targets of monetary policy with changes in money supply1/ and growth rates in real investment and consumption. 1965 was a year of major structural adjustments associated with the Reforms, including devaluation and rationalization of markets and prices. Real investment declined, real GDP stagnated and the retail price index rose 44 percent mainly due to the restructuring of prices (both administrative increases and straightforward de-control) and the increase in dinar import prices. As the secular demand pressures, identified earlier, made themselves felt, the economy recovered in real terms in 1966, the balance of payments moved from surplus to deficit, and prices continued to rise beyond the levels attained as a result of structural adjustments.

Table 11.7: AGGREGATE DEMAND VARIABLES

	1965	1966	1967	1968	1969	1970	1971	1972
Percent Change in Money Supply during year	5	5	-2	24	12	18	14	42
Percent Change in Retail Prices during year	44	7	5	5	8	10	18	14
Balance on "Goods and Non-Factor Services" Account as Percent of GNP (current prices)	0.2	-1.0	-1.4	-1.8	-2.3	-5.1	-6.0	..
Growth Rate of GDP (1966 prices)	1	5	1	4	9	6	8	..
Growth Rate of Gross Domestic Investment (1966 prices)	-7	12	-6	-2	10	12	5	..
Growth Rate of Private Consumption (1966 prices)	2	7	6	7	11	6	10	..

Source: Annual Reports, National Bank of Yugoslavia and mission estimates of national income.

1/ Money supply is defined as currency in circulation, holding on giro accounts and demand deposits used as payment media. There are some demand deposits which are not used so light savings deposits are excluded in banks, and float.

11.27 Beginning in the last quarter of 1966, monetary restrictions were introduced and maintained throughout 1967. As a result the money supply actually declined during the year. The characteristics of this most serious attempt at deflationary demand management through monetary policy are worth drawing out. In terms of the ultimate targets, the pace of inflation was slightly slowed, but the balance of payments deficit was not reduced. More importantly, monetary deflation was clearly inefficient and costly:

(i) The rate of growth of real GDP was sharply reduced, to about 1 percent, illustrating the classic dilemma between stability and growth, when management instruments are too few or too imprecise; and

(ii) The burden of adjustment fell on real investment expenditure which declined by 6 percent 1/. In contrast, private consumption was largely unaffected and grew by 6 percent.

11.28 Monetary policy was reversed in the latter half of 1968: by 1969 the recovery was in full swing, with a real GDP growth of 9 percent and real investment growth of 10 percent. This "go" phase of the cycle was accompanied by a further deterioration of the balance of payments and a faster rise in prices. But, after the sobering experience of 1967, subsequent attempts at monetary deflation in the latter half of 1970, and again in 1971, were relatively mild and, in terms of the targets of inflation and balance of payments, ineffectual.

11.29 The slowing down in the growth of real investment in 1971 was a result of both monetary deflation, and the drop in savings associated with the ongoing institutional changes. The percentage share of gross national savings in GNP fell from 28.4 percent in 1970 to 27.7 percent in 1971 2/. It was this implied shift towards private and public consumption which buoyed aggregate effective demand and contributed to the retail price increases of 18 percent. The two devaluations in 1971 added to the inflationary pressure, both by switching demand to domestic products, and through cost effects.

11.30 The behavior of enterprise in 1971, in the face of a decline in investment funds, lends some insight into the process (as distinct from cause) of inflation, and helps to explain the continued increase in prices (5 percent) during the severe deflation of 1967. Enterprises faced with a credit "squeeze" (but no slowdown in investment demand), attempt to generate resources by (a) not paying bills and thus exacerbating the "illiquidity problem", which in turn puts pressure on policymakers to restore expansionary monetary policy, and (b) raising prices in an attempt to generate

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1/ This includes the effect of a very sharp decline in inventories. This was partly the result of monetary restrictions which had their speediest impact on inventories, owing to the bank balance-sheet distinctions mentioned earlier. But some of the fall in inventories may be ascribed to a secular downward adjustment in the need for inventories, as production adapted to a market orientation.

2/ The 1971 national income figures are subject to revision. There is reason to believe that the share of investment and savings in GNP may be revised downwards, suggesting that the impact of deflation and institutional changes on savings and investment was stronger than the above figures indicate.

own resources for investment. The first move does not generate resources for the enterprise sector as a whole, though it very possibly results in inter-enterprise misallocation. The second move would be successful in raising real savings (and thus reducing aggregate effective demand) only if enterprises are able to impose a marginal savings rate higher than average for the increase in nominal value added under their control 1/. The pressures for personal income distribution from the workers' councils prevented this and thus the strategy of raising prices failed to increase real savings and reduce pressure. If contractionary monetary policy were maintained long enough, enterprises might be discouraged from raising prices in the face of slackening effective demand for their output. But the increase in "illiquidity" to crisis proportions, and the decline in real output and investment are typically too costly to justify prolonged deflation. Expansionary monetary policy is restored before the slackening in effective demand has a chance to discourage price increases 2/.

E. Prospects for Stabilization Policy

11.31 Developments during 1971 and 1972 indicate that, first the resort to exchange rate adjustments to secure external balance was successful and, second, domestic stabilization measures failed to contain inflation. The importance of reducing inflation for better resource mobilization and allocation has already been emphasized. The prospects for achieving this slowdown in the new institutional environment are worth exploring.

Monetary Policy

11.32 In spite of the partial decentralization of Central Bank prerogatives over selection of credits for rediscount monetary policy remains the main centrally-coordinated demand-management tool. However, it suffers from a number of limitations. First, existing policy-making procedures for the issue of high-powered money by the central banking system exhibit certain short-run inflexibilities arising largely from the need to achieve inter-Republic agreement. For example, the unanticipated balance of payments surplus in 1972 called for a reduction in the planned Central Bank issue of high-powered money, if money supply targets were not to be exceeded. Inflexibilities in achieving this reduction was one reason for an increase in money supply of about 42 percent compared to the target of 21 percent. These rigidities are proposed to be reduced in future years by treating the Central Bank high-powered money issues as a forecast (instead of a commitment) in the

1/ The increased nominal taxes and contributions to the State resulting from expansion of the nominal tax base did not operate as an automatic stabilizer for two reasons. First, balanced budget provisions and income-payments goals of Social Security institutions in Yugoslavia often lead to compensatory reductions in tax rates. Secondly, throughout this period, the secular shedding of, or rate reductions in, revenue instruments left State units starved for funds in relation to their expenditure responsibilities. Consequently, revenue increases from the buoyancy of the tax base were quickly spent, unless there were blocking or "sterilization" measures in operation.

2/ See Dimitrijevic "Financial Elements in Inflation" for a similar interpretation of the inflationary process.

high-powered money, if money supply targets were not to be exceeded. Inflexibilities in achieving this reduction was one reason for an increase in money supply of about 42 percent compared to the target of 21 percent. These rigidities are proposed to be reduced in future years by treating the Central Bank high-powered money issues as a forecast (instead of a commitment) in the monetary policy document, which can be adjusted during the course of the year. Second, when faced with balance of payments surpluses, as in 1972, and legal limits on reserve requirements, the lack of a securities market hampers sterilization of unwanted increases in money supply via open market operations.[1/] Both these limitations relate to the immediate tools of monetary policy, and both have cropped up in 1972 owing to the atypical occurrence of a balance of payments surplus. However, the slippage in these tools for controlling the money supply can be overcome through resort to more direct instruments like credit ceilings. It was the use of this instrument which finally slowed the growth of money supply in the latter half of 1972. More generally, existing policy tools concentrate on the supply of money and credit. Now that legal ceilings on interest rates have been removed, the possibility of demand deflation through higher real interest rates needs to be explored.

11.33 A more fundamental limitation of contractionary monetary policy is the high cost in terms of real investment and GDP growth pointed out in Section (4). To the extent monetary policy is effective, its impact is concentrated on investment expenditure. Furthermore, a "credit squeeze" exacerbates the imbalance between demand and supply in the capital market, thus fuelling the competition for scarce resources through involuntary inter-enterprise trade credit, a process whose potential for misallocation has already been explored at length. Of course, to the extent the anti-"illiquidity" program is successful, this particular misallocative potential of monetary management will be diminished.

11.34 Monetary policy will clearly continue to be an important vehicle of domestic demand management. And the partial transfer of some rediscount authority to republican National Banks has certainly increased the flexibility of selective credit policy. But there is a strong case for "spreading" the burden of demand management to other components of final demand, namely consumption, by using the fiscal framework.

Fiscal Policy

11.35 The difficulties of coordinated-demand management through fiscal policy, arising from the fragmentation of public expenditures roles, have been pointed out. The further devolution of Federal fiscal authority to the Republics has accentuated the coordination problem. Though the inter-Republic Committee on financial matters offers a forum for public expenditure coordination, the prospects for flexible expenditure policies, tailored for demand management, are not bright.

11.36 The prospects for using tax policy to absorb purchasing power in period of excess demand are also uncertain. Though the Federal Social Plan includes reference to the use of tax policy to remove "discrepancies between supply and demand", discretionary revenue instruments with the Federation have been reduced in number. True, the Federal government can vary the rates on the Federal turnover tax, but these measures will be ineffective unless

1/ The current moves towards closer linking of monetary policy and foreign borrowing policies will reduce uncertainties in this area.

accompanied by expenditure control at the level of Republics, which now receive the revenue. Otherwise the increased revenue could simply be absorbed by increased public expenditure.

11.37 The prospects for designing a central, discretionary fiscal tool within the given institutional framework are not hopeless. The Federal turnover tax could still be adapted for this purpose. For example, the Federation could impose a temporary surcharge on the existing rates, the revenues from which would be "sterilized" in blocked Republican accounts as a part of deflationary policy. For expansionary policy, the accounts could be deblocked at Federal initiative. To make the proposal consistent with the commitment to Republican autonomy, the purposes for which the money is used could be left for the Republics to determine. By concentrating the surcharge on private consumption goods, this device would spread the burden of deflationary-demand management beyond investment expenditure, the usual target of monetary policy. Like the base rates of the Federal turnover tax, the surcharge could vary across commodities, thus allowing some scope to direct its incidence on to the consumption of people in higher income brackets. There are no legal limitations to implementing such a proposal. The chances of success in reducing consumption demand through such surcharges are much higher now, since incomes policy (if effective) reduces the scope for offsetting increases in the share of personal income voted in enterprises. In this way, the role of fiscal policy in short-term demand management may be bolstered, despite the underlying commitment to "return resources to the economy". Unfortunately, the current discussion of fiscal reform does not appear to place much emphasis on renovating the stabilization role of fiscal policy.

Incomes Policy

11.38 The incomes agreements could, in principle, be used as instruments of short-term stabilization policy. But given the differences in policies across Republics, the prospects for coordination are difficult enough without adding short-term demand management to the existing incomes policy objectives (i) improving enterprises savings rates in the medium-term and (ii) reducing wage differentials across enterprises and branches. In any case, monetary and fiscal policy (with the modifications suggested above) are better suited for short-term management. However, incomes policy, even when directed towards medium-term enterprise savings/personal income behavior, has some potential benefits for anti-inflationary policy. First, by bringing some order to the field of personal income formation the incomes agreements set a limit to the possibilities for autonomous wage increases at the enterprise level. Second, through such limits, the climate for monetary and fiscal management is improved. For example, in the face of consumption taxes, aimed at reducing consumption demand, it is now harder to offset their effect through higher allocations to personal income by enterprise. Third, to the extent that the incomes agreements are successful in improving the rate of enterprise and aggregate savings, they will reduce the secular bias towards excess demand which is believed to have plagued the Yugoslav economy and its management since the Reform of the mid-1960's.

11.39 However, incomes policy should not be regarded as a panacea. In particular, one should recognize the continuing scope for inflationary

behavior by enterprises 1/. An enterprise may raise prices in an attempt to increase the income available for allocation between savings and personal incomes. Price policy is not, at present, coordinated with the incomes agreements 2/. Of course, in a situation of low aggregate demand pressure, such price increases are likely to be greeted with lower sales and incomes and inflationary behavior will be discouraged. The point is that there is nothing in the incomes agreements which prevents excess demand pressure from encouraging price increases by enterprises. The need to manage aggregate demand remains. Finally, one should note that the incomes agreements apply only to the social sector. Private sector income formation remains uncontrolled.

1/ True, enterprises with higher income per standardized worker are required to allocate a higher proportion of their income to savings. But these rules do not operate as an automatic stabilizer in the face of inflation. The schedules linking enterprise income to savings rate requirements are not absolute money terms, but rather are normalized on the average behavior of all enterprises in a Republic. Enterprises with income higher than average are required to save more according to the prescribed schedule (see Annex on Incomes Policy). This means that a general increase in all nominal enterprise incomes does not lead to a higher savings rate for the enterprise sector, as a whole.

2/ The recent establishment of the Secretariat for Market and Prices, one of the objectives of which is to develop, formulate and implement a policy of price regulation and control, may enable better coordination of enterprise price policy with income policy agreements than before.

XII: THE BALANCE OF PAYMENTS AND FOREIGN TRADE

A. Institutional Change and Foreign Exchange and Trade Policy, 1947-72

12.1 During the postwar period the foreign exchange and trade system and policy was an essential and integrated part of overall development policy. The system had two characteristics throughout the period: first it remained from its introduction in practice, though since 1961 not formally, a multiple exchange rate system with all its consequences for price distortions and resource allocation; second, there was continuing effort, after 1952, to reduce the multiplicity in the exchange and trade system and to liberalize and simplify it with the ultimate goal of integrating the Yugoslav economy with the world economy.

Evolution of the Foreign Exchange and Trade System, 1952-60

12.2 The economic boycott of the COMECON 1/ on the one hand and the need for implementing the Five-Year Plan (1947-51) forced Yugoslavia to establish trade and finance relations with the West. This implied the difficult task of creating a foreign exchange system allowing for both an opening of the economy to world markets and at the same time maintaining a controlled socialist economy, at least for a transition period. As a first step, the exchange rate was adjusted. On January 1, 1952, a new official rate of US$1 = 300 dinars replaced the old rate of US$1 = 50 dinars 2/. A foreign exchange market (DOM) was created where exporters could sell part or all of their retention quota 3/, which was in the beginning fixed at 45 percent but later lowered to 20 percent of their total export earnings. A system of differential exchange coefficients combined with export premia varying from commodity-to-commodity by currency of transaction and by republic was established. Thus the domestic price structure continued to be out of line with external prices with the degree of distortion varying from commodity-to-commodity.

12.3 The exchange rate system during the period was meant to secure the minimum volume and necessary structure of exports and imports consistent with production and investment targets. Thus, the export exchange rate was kept low for agriculture products and high for the priority branches of heavy industry, such as non-ferrous and ferrous metallurgy providing strong disincentives for exports of the former and stimulation for the latter. On the import side, a low exchange rate was applied to machinery, equipment and raw materials while the import of consumer goods and luxury items was discouraged by a high exchange rate.

1/ COMECON is more formally known as the CMEA (Council for Mutual Economic Assistance) a grouping of countries including the Soviet Union, Poland, Hungary, Czechoslovakia, Romania, Bulgaria and the Democratic Republic of Germany.

2/ These exchange rates are in terms of old dinars. 100 old dinars = 1 new or current dinar.

3/ The proportion of an enterprise's total foreign exchange earnings which it was permitted to retain.

12.4 As a result, Yugoslavia's exports increased rapidly during the 1950's, industrial exports in constant prices at 15 percent per annum and agricultural exports at about 10 percent. Despite the significant increase in foreign trade, the weaknesses of the system became increasingly apparent. The distorted price structure resulting from the multiple exchange rate system made any profitability calculation impossible. For enterprises it was easier to press for an increase in the export coefficients rather than to improve their efficiency and competitiveness. The relatively low exchange rate for imports increased the pressure on import demand and led to increasing import restrictions. Consequently another reform of the exchange and trade regime was attempted at the beginning of the sixties.

Foreign Exchange and Trade System and Policy 1961-65

12.5 At the beginning of 1961 the foreign exchange and trade system was considerably simplified and liberalized reducing in effect the extreme disparities between domestic and international prices. The multiple exchange rate system was replaced by a single exchange rate of US$1 = 750 dinars combined with a system of custom tariffs, import quotas, retention quotas and foreign exchange allocations. The new exchange rate meant more favorable dinar prices for agricultural exports and less favorable ones for industrial exports. To avoid a large reduction of industrial exports export premia and tax rebates were granted. The premia applied to about half of total exports but, nevertheless, many enterprises, particularly those previously exporting at the maximum effective exchange rate, had to absorb a substantial reduction in the dinar price of exports.

12.6 On the import side, tariffs were tailored to conform to the former foreign exchange rates in order to avoid widespread and drastic price adjustments. The highest tariffs, amounting to 60 percent of the ad valorem value, applied to final consumer goods. Investment goods were subject to duties averaging 34 percent and semi-finished goods and raw materials to duties averaging 10 percent. Yugoslav producers also had the protection of a system of import licensing. Slightly more than 25 percent of imports could be freely imported and another 20 percent required only a general license. Imports of equipment, which represented about 15-20 percent of total imports, were controlled by the Yugoslav Investment Bank; the remaining imports were regulated by quotas.

12.7 The attempt at liberalization and simplification did not succeed. The rising trade deficit during 1962-64 led to increasing import restrictions and expanding export premia and tax rebates, re-establishing in effect the old multiple exchange rate system.

Development Since 1965

12.8 During the Economic Reform the foreign exchange and trade system was revised with the stated objectives to further integrate the Yugoslav economy into the world market, to liberalize foreign trade and finally to achieve the convertibility of the dinar. The dinar was devalued and the new exchange rate fixed at US$1 = 12.50 (new) dinars. Export premia and tax subsidies were

abolished; retention quotas remained, with basic rates ranging from 7 to 20 percent and increasing with rising export shares and export growth rates. (See Table 12.1.) About one quarter of imports was liberalized; the remainder was subject to varying degrees of restriction. Nominal tariff protection was lowered from an average of 23.3 percent to 12.3 percent. The differentiation of rates, however, remained, with rates increasing from nothing for electrical energy to 21 percent and 24 percent for electrical equipment and metal products respectively. The average nominal tariff on imports of industrial goods was 13.6 percent.

Table 12.1: RETENTION QUOTA RATES

	Percentage of Foreign Exchange Retained			
	Basic Goods	Exporters of Selected Capital Goods and Pharma-ceuticals	Exporters of Road Motor Vehicles and Tractors	Exchange Receipts from Catering Services
I. Rates based on ratio of exports sales to total sales				
Export Shares				
0 - 20 percent	7.0	10.0	12.0	20.0
21 - 30 percent	8.4	12.0	14.4	24.0
31 - 40 percent	9.8	14.0	16.8	28.0
41 - 50 percent	11.2	16.0	19.2	32.0
51 - 60 percent	12.6	18.0	21.6	36.0
61 - 100 percent	14.0	20.0	24.0	40.0
II. Incentive rates based on the rate of increase of exports over the past year 1/				
Annual growth of exports				
10 - 25 percent	8.75	12.5	15.0	25.0
Over 25 percent	10.50	15.0	18.0	30.0

III. Special fixed retention rates applying to exports of specific goods and services

Organizing of international fairs	20.00 percent
Newly-mined gold sold to the National Bank	up to 20.00 percent
Hotels	20.00 percent
Representation of foreign firms	50.00 percent
Sales of stamps for philatelic purposes	50.00 percent
Travel agency services and organizing of hunting trips	60.00 percent
Sales of printed matter, films, gramophone records	100.00 percent
Construction, engineering, and other projects abroad	100.00 percent
Foreign exchange receipts of non-economic institutions	100.00 percent

1/ Applicable only to firms whose export sales are less than 20 percent of their total sales.

Source: Data supplied by Yugoslav authorities.

12.9 Since 1967, when the new foreign exchange and trade system became effective, the trend towards simplification and liberalization has continued, though it was at times interrupted by short-term measures to restrict imports when domestic inflation resulted in an increasingly overvalued exchange rate and rising balance of payments pressure. In 1971 entirely liberalized imports accounted for 29 percent and the practically liberalized import categories (LB and GDK category) shared about three quarters of total imports. (See Table 12.2 and 12.3.) In mid-1972 tariffs on 1,000 import items - mainly investment goods, transport equipment and raw materials were reduced by 1 percent to 12 percent. Furthermore, in January 1973 about 1,500 commodity items - mainly raw materials and investment goods, so far imported under the global exchange or commodity quotas were transferred to the completely liberalized import category. As a result in 1973 the entirely liberalized imports are expected to account for around 42 percent of total imports.

Table 12.2: AVERAGE CUSTOMS TARIFFS BY BRANCH OF PRODUCTION, 1967-71

Industry	1967	1969	1971
Electric Power	-	-	-
Coal and coke	.5	1.0	1.3
Petroleum	5.0	6.9	6.8
Iron and Steel	6.7	9.8	8.3
Non-ferrous metals	2.3	3.0	2.7
Non-metallic minerals	9.7	10.3	10.3
Metal Products	24.0	25.1	21.3
Shipbuilding	1.8	1.1	1.7
Electrical Equipment	20.4	21.7	19.4
Chemicals	7.9	10.1	9.8
Construction materials	3.1	5.2	4.2
Wood products	6.1	7.9	6.5
Pulp and paper	7.8	11.4	11.7
Textiles and clothing	9.1	11.2	11.6
Leather and footwear	10.8	13.1	13.4
Rubber products	9.1	7.6	10.5
Food processing	4.6	4.8	3.8
Printing	7.3	12.3	5.5
Tobacco manufacture	16.6	11.8	10.8
Film production	2.3	6.2	3.3
Total Industry	13.6	15.0	13.1
Agriculture	2.4	1.9	1.5
Forestry	.2	.7	.5
Total Agric. and For.			
GRAND TOTAL	12.3	13.9	12.1

Source: Statisticki Bilten: O Radu Caunske Stujbe Za 1971 Godisie.

Table 12.3: DISTRIBUTION OF IMPORTS BY CATEGORIES OF IMPORT CONTROL SYSTEM

(In percent of respective total)

		Liberalized Imports (LB)	Conditionally Free Imports (LBO)	Global Exchange Quota (GDK)	Commodity Quota (DK & RK)	Licenses	Total
Total Imports	(1967)	16.9	24.0	54.4	4.6	0.1	100
	(1971)	28.7	--	45.7	20.3	5.3	100
Reproduction Materials	(1967)	24.7	34.4	39.9	0.9	0.1	100
	(1971)	40.1	--	35.7	22.9	1.3	100
Equipment	(1967)	0.0	0.8	99.1	0.0	0.1	100
	(1971)	1.4	--	79.5	7.6	11.5	100
Consumer Goods	(1967)	9.7	15.3	51.6	23.3	0.1	100
	(1971)	20.4	--	42.6	29.5	7.5	100

Source: Federal Chamber of Economy, Belgrade

12.10 Developments since 1965 indicate, however, that an answer to the key question, how to combine rapid economic growth with balance of payments equilibrium, has not yet been found. With domestic inflation significantly exceeding world inflation, situations of increasing disequilibrium developed. A policy of adjusting exchange rates has generally been adopted rather than greater recourse to trade restrictions and administrative regulations. The dinar was devalued to $1 = 15 dinars in January 1971 and again to $1 = 17 dinars in December 1971 following the international realignment of currencies. On the basis of a simple comparison of inflation rates in Yugoslavia and its main trading partners and assuming that after the 1965 devaluation the exchange rate was close to an equilibrium rate it appears that the exchange rate at the beginning of 1972 was again about equilibrium.

12.11 New foreign exchange and trade regulations were introduced in June 1972. They provide for higher retention quotas, amounting to 20 percent for most exports of goods and services, 45 percent for tourism and 100 percent for exports of branches operating abroad, and reductions in customs duties. Early in 1973, a limited foreign exchange market was also introduced. The market allows only authorized banks to participate on their own and on account of enterprises. The National Bank is to intervene in the market when necessary for maintaining a rate in the range of 2-1/4 percent from the parity. The establishment of the new foreign exchange market implies in practice little change for the functioning of the foreign exchange and trade system. It does, however, provide the possibility of further liberalization of the exchange system.

B. Commodity Trade

1. Regional Trade Structure

12.12 Yugoslavia's regional trade structure after World War II has to be seen in the context of its political situation as a non-aligned country, regionally located between Eastern and Western Europe with a unique economic system which combines elements both of the eastern centrally planned economies and the western market economies. A member neither of the COMECON on the one side nor the EEC or EFTA on the other side, it is often looked at as an intermediary between the two trading blocs. Nevertheless, it had its own difficulties both with the COMECON as well as the West. The former results from mainly differences in the economic system; the latter from trade barriers and high indebtedness.

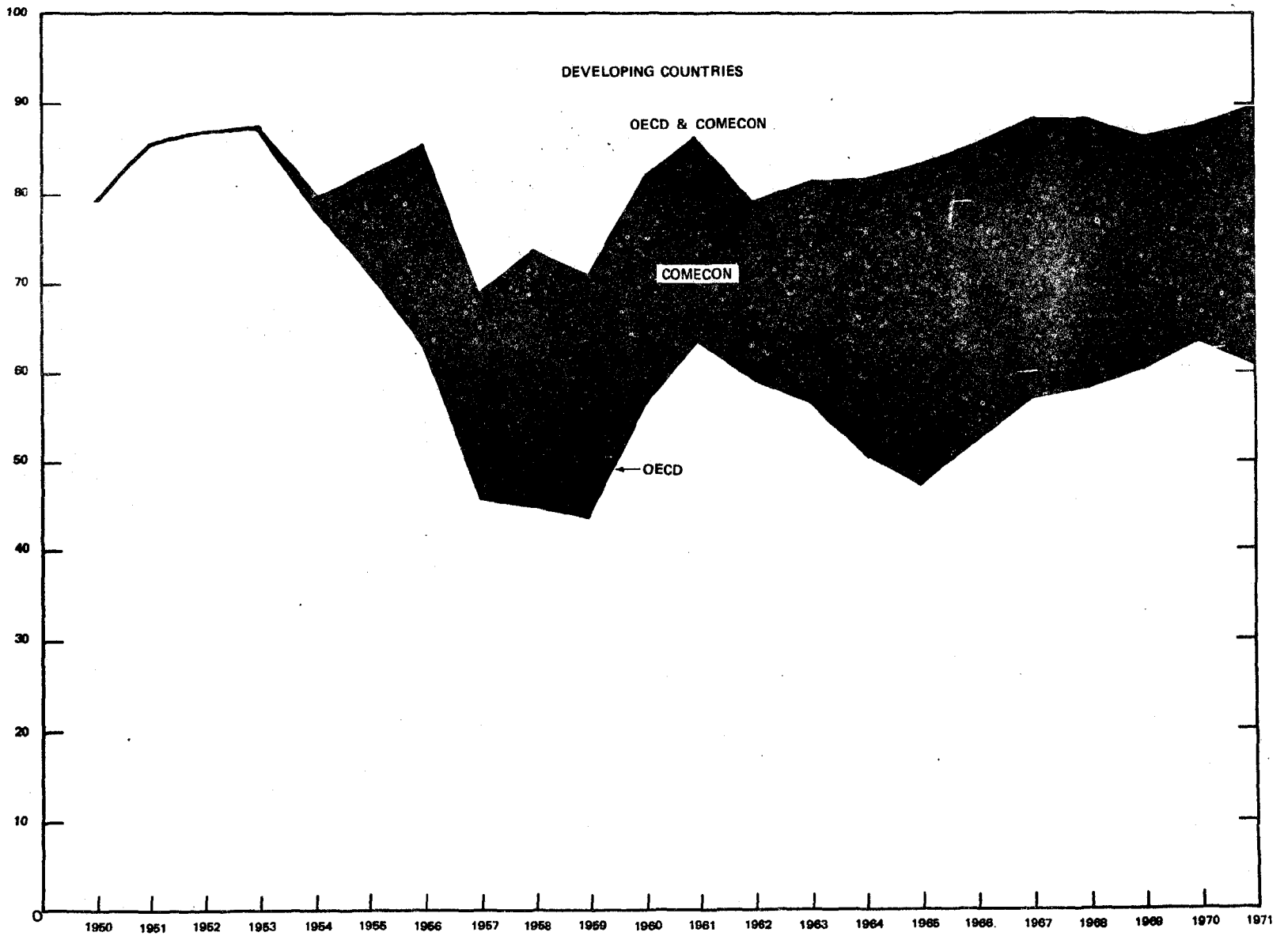
Trade with Comecon Countries

12.13 It was not until 1954 that trade contact broken off in 1950, were reestablished with the East and it took another 10 years to become an observer in COMECON, a status Yugoslavia has maintained since. Following the normalization of political and economic relations with the Soviet Union trade with COMECON countries picked up again and its share reached a peak of 28 percent of total trade in 1958. (See Chart XIV) Since then COMECON's share has been fluctuating. The main trading partners among COMECON countries throughout the whole post war period were the USSR and Czechoslovakia followed by East Germany and Poland.

Chart XIV

GEOGRAPHICAL DISTRIBUTION OF TRADE

(PERCENTAGES)



World Bank — 7509 (R)

12.14 The problems Yugoslavia faces with its eastern trading partners is indicated by the commodity structure of trade. Exports consisted largely of manufactured commodities both in the investment and consumer goods categories. Imports were dominated by fuels and other raw materials. While eastern markets provided vast opportunities, little competition and few marketing difficulties for Yugoslav export products, they were severely limited in supplying goods which Yugoslavia needed. In particular, quality, design and technical sophistication were insufficient for Yugoslav enterprises competing domestically and externally with Western suppliers. Moreover prices of both exports and imports in eastern trade are generally higher than in western trade. As the exchange rate did not differentiate between trade with East and West, exporters were oriented towards eastern markets and importers towards western markets. As a result, the trade balance with the non-convertible currency area tended persistently toward a surplus, as against a deficit with the West. To avoid excessive accumulation of bilateral credit balances, exports were made, at times, conditional on an undertaking to import from such countries. Also, since Yugoslavia has a surplus in the services balance, vis-a-vis the East, the trade balance had to be kept in deficit to balance the overall account. The cumulative merchandise deficit of Yugoslavia during 1961-71 was about $400 million. The large surpluses in the services balance with the East, stemming from tourism and transportation, mainly paid for the trade deficit. Thus, the balance of goods and services was roughly balanced taking the period 1961-71 as a whole. (See Table 12.4.)

Table 12.4: YUGOSLAVIA'S TRADE BALANCE AND BALANCE OF GOODS AND SERVICES BY REGION, 1961-71*

(in millions of US dollars)

	COMECON		OECD	
	Merchandise	Goods & Services	Merchandise	Goods & Services
1961	+ 3	+ 3	- 378	- 395
1962	- 21	- 22	- 214	- 213
1963	- 34	- 32	- 211	- 198
1964	- 73	- 69	- 283	- 281
1965	+ 89	+ 99	- 258	- 267
1966	- 50	- 37	- 276	- 279
1967	- 3	+ 22	- 417	- 286
1968	- 72	- 6	- 493	- 229
1969	- 82	- 12	- 561	- 162
1970	- 46	+ 43	-1,007	- 390
1971	- 108	- 19 e/	-1,106	- 118 e/
1961-71	- 397	+ 8	-5,204	-2,816

* Positive sign indicates a surplus, negative a deficit.

e/ Estimate.

Source: IMF, Balance of Payments Yearbook and National Bank of Yugoslavia.

Trade with the West

12.15 Trade with Western Europe and the United States was first stimulated by the hostile action of the Cominform at the end of the 1940's. The United States started a massive aid program providing economic and military assistance, which helped Yugoslavia to overcome the economic blockade of the East. In the beginning of the 1950's, almost 90 percent of Yugoslavia's merchandise trade was conducted with the West. Throughout the following two decades the West has continued to be the primary source of Yugoslav imports and market for exports. (See Chart XIV). Since 1960 a greater reliance on the OECD market as a source for imports rather than as a market for exports is apparent; while exports to the OECD countries accounted for approximately 50 percent of Yugoslavia's total exports, imports from that area were over 60 percent of total imports. As a result, the trade balance with the OECD area was persistently negative reaching a peak of $1.1 billion in 1971. The deficit on goods and services, however, remained fairly stable as increasing trade deficits were financed by fast rising receipts from tourism and workers' remittances.

12.16 Dividing Yugoslavia's trade with Western markets into three major trading groups (EEC, EFTA and the US) some significant geographical changes become apparent. Yugoslavia's imports from the US declined from 41 percent of total imports in 1955 to a low of 6.6 percent in 1969, with the decrease in US economic assistance to Yugoslavia. The decline is largely due to decreasing imports of wheat. The substantial decrease in the share of the US was offset by increased imports from both, the EEC and EFTA. In 1971, well over 60 percent of Yugoslavia's imports from Western markets (or almost 40 percent of total imports) were from countries of the EEC. Export markets present less pronounced trends. The geographic distribution of exports to the West is relatively stable, though there are slight yearly fluctuations. In the 1960's, exports to the US accounted for around 14 percent, to EEC markets for about 60 percent, and to EFTA for 26 percent of total exports to the West.

12.17 The country distribution of trade reflects the group pattern. On the export side, the relative position of each country is quite stable. In 1955, Italy (23 percent), Germany (19 percent) the US (16 percent) and the UK (13 percent) accounted for the bulk of Yugoslavia's exports to the West. In 1971, the order has changed little. On the import side, there were more significant changes caused mainly by the substantial decline of the purchase of US goods, and increased importance of Germany.

Trade with Developing Countries

12.18 The less developed countries account for a small share of Yugoslavia's foreign trade. It amounted to about 13 percent of total trade betweeen 1965 and 1971, declining from an average of about 22 percent during 1955 to 1961. The largest share of this trade was with the less developed countries of Asia and the Middle East. The less developed countries supply largely raw materials and provide an outlet for Yugoslavia's industrial output. While industrialized countries of the West consider Yugoslavia's industrial products especially

machinery, transport equipment and more sophisticated engineering goods, with some reservations, these products have more favorable market conditions in certain developing countries.

Future Prospects

12.19 Reviewing the prospects of the future development of Yugoslavia's regional trade structure, it appears that factors significant for trade flows in the past will continue to be of major importance. Yugoslavia's trade with COMECON countries is conducted on the basis of bilateral trade agreements. Though some arrangements have been recently changed to provide for the possibility of balancing the accounts in convertible currency, the agreements nevertheless, aim at balancing the trade and services account. The problem Yugoslavia faces in finding suitable import products in eastern markets severely limit the expansion of this trade. However, the credit deal of $540 million with the USSR if fully utilized would permit significant increase in the level of trade. The commodity structure, however, is expected to remain more or less unchanged.

12.20 The Yugoslav interest in maintaining a fair amount of trade with the East has several aspects 1/. The East, and the USSR in particular, exports capital and raw materials which fit the urgent needs of Yugoslavia. The repayment problem is less significant since eastern credits are generally repaid in kind, i.e, with part of the production of projects they were financing or with other exports. There may also be political benefits in having a more balanced distribution of foreign indebtedness between East and West. On the export side eastern markets provide vast opportunities for Yugoslav exports. Vis-a-vis these countries, Yugoslavia, due to its openness to the West, is far ahead concerning quality, design and selection. On the other hand, it faces serious difficulties in exporting to the West, in particular to the EEC, for well-known reasons. The EEC market is highly competitive, protected by tariff walls and characterized by long established trade relations that are difficult to penetrate. Moreover, Yugoslavia has difficulty competing in terms of quality, design and selection in many fields of consumer durables and machinery. In addition, over 90 percent of Yugoslavia's foreign debt is due to Western countries. There may be limits to a further increase in foreign borrowing in amounts required for a fast development of trade with Western countries.

12.21 Though an increasing trade with eastern countries may have significant advantages for Yugoslavia, there are limits to its expansion. Yugoslavia owes its competitive lead over Eastern countries to the persistent exposure of Yugoslav enterprises to western competition and close connection with Western markets. A reorientation of trade relations to the East with less stimulating competition pressure, may lead fairly soon to a loss of the lead in competitiveness. Moreover, the import content from convertible currency areas is

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1/ The Social Development Plan to increase the shares of Eastern trade to about a third of total external trade.

relatively high in many of these exportable consumption goods. Unless the eastern trade is increasingly transacted in convertible currency, it would be hardly to the benefit of Yugoslavia to import for convertible currency, and export these goods for non-convertible currency. There is also a risk of stability of trade involved, both for economic and political reasons. Eastern centralized planned economies are essentially autarkic. This implies that, whenever domestic producers will be able to supply previously imported goods, imports might be severed very abruptly. Further unexpected change in the political relationship with the East has shocked the Yugoslav economy twice. Based on this experience, Yugoslavia might not want to rely too exclusively on the benevolence of one single trading partner.

12.22 Yugoslavia's most important partner will continue to be the West and foremost the enlarged EEC. The importance of the enlarged EEC for Yugoslavia may be illustrated by a few examples: about three quarters of Yugoslavia's trade with Western markets (40 percent of total trade) is currently with countries of the enlarged EEC; Yugoslavia relies for its imports of technology and know how largely on that area; of the 68 joint venture contracts with foreign firms signed by the end of 1972 about two-thirds were with enterprises from the EEC; also about two thirds of the long-term manufacturing cooperation contracts have been concluded with firms from this area; furthermore 65 percent of earnings from tourism and close to 90 percent of workers' remittances originate in countries of the EEC.

12.23 Despite close economic ties with EEC countries, Yugoslavia faces serious difficulties in particular in the field of exports. The EEC market is highly competitive and, even more important, guarded by protective tariff walls and quantity restrictions. Though Yugoslavia has been included in the general preference scheme of the EEC for developing countries, and been one of its major beneficiaries, it still is at a significant disadvantage as compared with EEC members or associated countries. As a non-aligned country Yugoslavia's possibilities of a closer cooperation with the EEC are limited. The trade agreement with the EEC, signed in March 1970, under which Yugoslavia enjoys preferential treatment for a number of agricultural products, particularly high quality beef, expires end April 1973. The Yugoslav authorities expect that in the negotiations for renewal of the agreement Yugoslavia will be conceded some additional preferences for export of cotton, lower tariffs and reduced quantity restrictions mainly on farm products and the abolition of some protective clauses and modalities. Yugoslavia also wishes to expand the agreement to allow for an intensification of cooperation agreements between manufacturing enterprises and to promote joint operations in third markets. The ongoing negotiations seem to indicate that major changes in the relationship between Yugoslavia and the EEC will not occur in the near future.

12.24 Trade with less developed nations presents some problems of its own. First, this trade is often linked with economic aid and would imply that Yugoslavia, itself underdeveloped, would be passing on a part of the aid it receives. Second, its main exports, largely manufactured consumer goods and machinery and transport equipment have to compete with suppliers from industrialized countries which are still ahead in quality, design, technical

know how, and good-will. Moreover, as competition in international trade of capital goods is increasingly focussed on terms of financing the supplier is able to offer, Yugoslavia faces serious difficulties to match the terms of western competitors. On the other side, Yugoslavia's import possibilities from less developed countries are limited to certain raw materials and agricultural goods.

12.25 The Social Development Plan aims at a regional trade structure of 50 percent to the West, 35 percent to COMECON countries and 15 percent to less developed countries. The share to the East is about in line with Yugoslavia's long-term trade structure. It would quite realistically imply a slight increase from the presently achieved level. Trade with the West, however, is likely to take a higher share at the expense of trade with less developed countries, given Yugoslavia's intent to more closely cooperate with the West and the difficulties it faces in its trade relations with the developing world.

2. Structural Changes in Yugoslav Foreign Trade

Commodity Structure of Trade

12.26 Before World War II, agricultural and forestry products accounted for about 62 percent of total exports, and non-ferrous ores and metals for another 20 percent. On the import side, consumer goods and machinery and equipment dominated with a share of 65 percent; raw materials and intermediates accounted for 20 percent. The picture changed drastically in the postwar period. The rapid structural change was the result of the development strategy followed in the postwar period, which emphasized rapid industrialization as the chief method of development. The structural change of exports continued throughout the 1950's and 1960's. (See Tables 12.5 and 12.6.)

Table 12.5: STRUCTURE OF EXPORTS AND IMPORTS 1939-70
(in percent)

Year	Exports		Imports	
	Agriculture /a	Industry	Agriculture /a	Industry
1939	62	38	5	95
Average				
1947-51	25	75	4	96
1952-55	28	72	22	78
1956-60	23	77	16	84
1961-65	19	81	15	85
1966-70	16	84	10	90

/a Including forestry.

Source: Vladimir Pertot, Ekonomika Medunarodne Razmjene Jugoslavije, and Statisticki Godisnjak Jugoslavije.

Table 12.6: STRUCTURE OF EXPORTS AND IMPORTS BY SITC GROUPS 1939-70

(in percent)

SITC - Section	Food & live animals Beverages & tobacco Animal & vegetable Oil and fats (0+1) (+4)	Crude materials except fuels (2)	Mineral fuels (3)	Chemicals (5)	Manufactured goods classified by material (6)	Machinery & Transport equipment (7)	Miscellaneous manufactured articles (8)	Other (9)	Total (0-9)
				EXPORTS					
1939	46.5	34.5	0.2	3.0	15.5	0.1	0.2	-	100.0
1952 a/	34.6	31.8	1.4	4.8	25.8	0.7	1.0	0.1	100.0
1955 b/	33.0	27.6	1.2	4.8	26.6	3.3	2.8	0.1	100.0
1960 c/	32.9	14.5	3.1	3.6	22.8	16.3	6.8	0.1	100.0
1965 d/	26.4	10.7	1.4	5.1	22.9	21.7	11.7	0.1	100.0
1970 e/	19.3	9.6	0.7	6.0	29.5	21.6	13.2	0.1	100.0
				IMPORTS					
1939	5.1	15.1	6.6	7.9	40.7	20.0	3.6	0.04	100.0
1952 a/	26.3	13.2	7.8	4.5	15.0	31.7	1.4	0.0	100.0
1955 b/	29.8	16.2	9.0	6.8	12.5	23.8	1.8	0.1	100.0
1960 c/	15.4	13.5	5.5	8.8	19.1	34.4	3.1	0.2	100.0
1965 d/	15.1	15.3	5.3	9.7	22.0	29.0	3.6	0.02	100.0
1970 e/	7.6	11.7	4.9	9.8	27.2	33.5	5.4	0.0	100.0

a/ Average 1952-53
b/ Average 1954-56
c/ Average 1959-61
d/ Average 1964-66
e/ Average 1969-70

Source: Jugoslavije 1945-64, p. 206, and Statistics of Foreign Trade of the SFR Yugoslavia 1970 and 1971.

Trade in Agricultural Goods

12.27 Among agricultural exports, livestock more than doubled its share from 27 percent in 1952 to 57 percent in 1970 and is now the most important part of agricultural exports.

Table 12.7: STRUCTURE OF AGRICULTURAL EXPORTS
(in percent)

	Cereals	Fruit and Vegetables	Livestock	Fishery	Home made Products	Forestry Hunting
1951-53	45	4	27	1	8	15
1959-61	30	3	46	1	10	10
1964-66	16	3	63	1	10	7
1969-70	21	2	57	1	11	8

Sources: Vladimir Pertot, Vol. II loc. cit. Tables 38 to 47 and Statisticki Godisnjak Jugoslavije, 1971 and 1972, Table 113-7.

More than 50 percent of the exported livestock products is beef meat most of it in fresh, chilled or frozen form (54 percent of total meat exports). Processed meat ranks second among livestock exports and its share declined from 38 percent to 29 percent during the 1960's; this is mainly due to increased export possibilities of fresh meat, in particular beef, to Italy.

12.28 Yugoslavia's traditional agricultural exports, i.e., beef, maize and tobacco, have more or less maintained their level over the last five years, after a rapid increase of livestock exports between 1952 and 1965 (about 15 percent per annum). Exports of maize kept more or less their share in total agricultural exports despite rapid increases of livestock production, in particular pork. Changes in yields have caused heavy fluctuations of exports and even led to imports of maize in 1970, 1971 and most likely in 1972. The rapid development of livestock exports in the 1950's occurred despite heavy discrimination through the foreign exchange system.

12.29 Most important customers of agricultural exports were Common Market countries, foremost Italy and Germany; their share in agricultural exports increased from 40 percent to 56 percent between 1960 and 1970, mostly at the expense of EFTA and Eastern Bloc countries.

12.30 Agricultural imports increased significantly less than total imports, at 4.5 percent per annum during 1960 to 1970 as compared with 9.4 percent for total imports; their share in total imports decreased from 30 percent in 1955 to 8 percent in 1970. This was the only major sector where import substitution policy succeeded. Imports of goods which domestic agriculture was capable of producing were increasingly replaced by domestic production during the last decade with the exception of vegetable oil. On the other side, the

expansion of livestock production created new import needs mostly for protein concentrates; their share in total agricultural imports increased from 2.5 percent (or $5 million) in 1962 to about 10 percent (or $40 million) in 1970. Other relatively increasing import products were coffee, tea and citrus fruits; their increase followed the rise in per capita income and the pattern. The source of agricultural imports shifted during the 1960's from the U.S. (mainly for cereals) and the eastern countries to less developed countries where Yugoslavia in 1970 bought more than 50 percent of its agriculture imports.

Industrial Exports

12.31 Industrial exports expanded almost twice as fast as agricultural exports, at 13.5 percent per annum in constant prices during 1952 to 1970. Industrial exports grew most rapidly in the 1950's and the first half of the sixties. In the latter half of the 1960's though still increasing at 7 percent per annum in constant prices, export growth slowed down somewhat. Although the high export growth rates during the 1950's reflect partly the creation of new industries during the first plan period 1947 to 1952 and the low starting level, it was essentially export promotion policy through the multiple exchange rate system that explains the dynamic export development.

12.32 If Yugoslav industries are classified into traditional industries, (based largely on domestic natural resources), and new industries established mainly in the first plan period, the foreign exchange system prevailing till 1965 heavily favored exports of the new industries 1/. The four main traditional industries - non ferrous metals, non metallic minerals, wood and tobacco products - accounted for more than three quarters of total industrial exports in 1952 and only 28 percent in 1965. On the other hand the share of the new industries increased from 12 percent to over 45 percent in the same period. (Table 12.8.) After 1965, the extent of export promotion measures were reduced significantly. Export premia and tax rebates were largely abolished and the retention quota system, under which exporters were permitted to retain and freely use a proportion of their foreign exchange earnings, became the main instrument for export promotion. Though the retention quota increased with the share of total production exported and the increase of exports in the preceeding year, it provided less stimulation to those exporters who previously enjoyed tax rebates and premia. It eliminated largely the support to new industries after they had had time to establish themselves both in the domestic and world market. Only few branches, such as selected machinery and transport equipment industries including shipbuilding were stimulated by generally higher retention quotas, subsidized interest rates and special rediscount facilities for export financing. As a result industrial export growth slowed down significantly during the second half of the decade. Export growth of only a few branches (non-ferrous metals, iron and steel, food processing, rubber production and textiles and clothing) accelerated during 1965 to 1970 as compared to the earlier period.

1/ This classification of industries relies on a similar one made by Pertot. See V. Pertot, Vol. I loc. cit. pp 77 ff.

Table 12.8: STRUCTURE OF INDUSTRIAL EXPORTS BY BRANCHES *
(in percent)

	1952	1960	1965	1970
Domestic resource industries	84.0	49.6	38.5	38.9
Non-ferrous metals	28.0	12.4	11.1	15.9
Non-metallic minerals	4.0	3.2	3.2	2.9
Wood products	42.9	15.8	11.5	9.4
Pulp and paper	.4	1.3	2.0	2.5
Food processing	4.7	12.1	7.3	6.3
Tobacco manufacturing	4.0	4.8	3.4	1.9
Newly created industries	6.8	39.3	45.6	42.5
Petroleum	1.1	.9	1.7	.9
Iron and steel	2.8	3.8	2.5	3.2
Metal products	.4	16.3	18.1	13.6
Shipbuilding	-	8.0	9.5	10.0
Electrical equipment	.2	7.2	7.9	8.2
Chemicals	2.3	3.1	5.9	6.6
Other	9.2	11.1	15.9	18.6
Textiles and clothing	3.3	7.2	10.2	12.1
Leather and footwear	.7	3.3	5.4	5.9
Other	5.2	.6	.3	.6
Total Industry	100.0	100.0	100.0	100.0

* Exports in constant - 1969 prices
1952 = average 1951-53
1960 = average 1959-61
1965 = average 1964-66
1970 = average 1969-70

Source: V. Pertot, Vol. II, loc.cit., tables 38 to 47 and Statisticki Godisnjak Jugoslavije

Diversification

12.33 The policy of promoting new industries contributed significantly to broadening and diversifying Yugoslavia's export base. Though four branches accounted still for half of industrial exports in 1970, Yugoslavia's industrial export structure became increasingly diversified. Between 1961 and 1971 the number of exported items of manufactured goods 1/ more than doubled, from 737 to 1483. (Table 12.9.)

Table 12.9: NUMBER OF EXPORT ITEMS /a OF MANUFACTURES

SITC Category	Product	1961	1971
5	Chemicals	101	246
6	Manufactured goods classified by material	293	593
7	Machinery and Transport Equipment	196	372
8	Miscellaneous manufact.	147	272
Total	5 to 8	737	1483

/a Seven-digit items in the SITC - classification

Source: Statistics of Foreign Trade of the SFR Yugoslavia, 1961 and 1971.

12.34 The increasing diversification reflected a rapid expansion of highly processed manufactures, mainly at the expense of raw material exports and to a lesser degree of semi-manufactures and simply processed raw materials. (Table 12.10.)

1/ Defined as seven-digit items of SITC sections 5 to 8.

Table 12.10: STRUCTURE OF EXPORTS BY DEGREE OF MANUFACTURING
(in percent)

	Raw Materials	Simply processed raw materials and semi-manufactures	Highly processed manufactures
1939	55	39	6
1951-53	40	50	10
1954-56	36	45	17
1959-61	26	38	36
1964-66	14	35	51
1969-70	12	34	54

Source: Jugoslavije 1945-64 and Statistics of Foreign Trade of the SFR Yugoslavia.

The highly diversified export structure reflects essentially the broadly based industrialization strategy initiated in the first plan period. It was, however, also a deliberate policy, both of the government as well as individual enterprises, to reduce the risks involved in depending on few export products sold to a few countries. Smaller quantities exported of individual products usually connected with more diversification reduce the danger of protective reactions and marketing difficulties. Yugoslavia's export success in highly competitive Western markets seems to lend support to this hypothesis, "Capillary trade" as it is often referred to 1/ also increased the flexibility to adapt quickly to changes in the demand structure and thus to avoid big fluctuations in export earnings. The diversification strategy has enabled Yugoslavia also to exploit many export possibilities and in that way significantly contributed to its good export performance. Capillary trade, however, may also have its drawbacks; it may prevent the full exploitation of economies of scale in marketing and possibly production, if the domestic market is limited. It is, however, doubtful, whether Yugoslavia being geographically located between and economically outside of the big trading blocs in Europe could have established a permanent export position through export concentration. The industrialized countries have too often shown their readiness to protect their industries if massive competition from abroad endangers their existence.

12.35 The diversified export structure contributed significantly to a favorable price development. Since 1952 export prices increased at an average of about 2 percent per annum, comparing favorably with price developments for exports of less developed countries and even industrialized countries. As export prices rose faster than import prices, there was an improvement of the terms of trade of one half of one percent per year between 1952 and 1970.

1/ The origin of the term is often ascribed to Pertot.

This compares favorably with the declining trend of the average terms of trade for all less developed countries. It seems also, that with increasing diversification price fluctuations of exports decreased. While in the 1950s export prices moved in two cycles, there was a steady rise since 1959 with a one year interruption in 1968.

12.36 Main customers of industrial exports have been the EEC, EFTA and the Sino-Soviet countries. Their shares in the total vary, however, significantly by individual products. Chemical products including pharmaceuticals were largely exported to the Eastern Bloc mainly to the Soviet Union and Czechoslovakia. The Soviet bloc countries were the main buyers also for non-metallic minerals, bauxite and aluminium concentrates, iron and steel manufactures, electrical and non-electrical machinery, ships and clothing and footwear. In general, durable consumer goods and other highly sophisticated manufactured products were exported largely to the East and less developed countries, indicating that in these fields, where quality, design and selection play a major role, Yugoslav companies still have difficulties to compete in more competitive Western markets. It should be noticed however that over the last decade the exports of these products to OECD countries grew rapidly. Thus, the share of exports of electrical and non-electrical machinery to the EEC in the total Yugoslav exports of these categories increased from less than one percent in 1960 to 20 percent. The largest export shares to OECD countries in 1970 were in the categories leather and textile manufactures and furniture, the latter being sold mainly to the U.S. Particularly in the field of metal industries, a large part of export increase to the EEC since 1967 can be attributed to the rapidly growing practice of cooperation agreements concluded with enterprises in the Common Market, area under which Yugoslav enterprises manufacture parts for production lines of producers in the EEC. Both labor shortages in EEC countries and free industrial capacities in Yugoslavia have encouraged the expansion of cooperation agreements which benefit Yugoslav enterprises apart from providing them technical and financial assistance and marketing expertise through greater utilization of capacity.

Export Performance

12.37 Table 12.11 gives some indication of Yugoslavia's export performance during the last decade. Total commodity exports of Yugoslavia increased 1.5 percentage points faster than those of the European OECD countries. Only in four categories, food beverages and tobacco, wood manufacturing, furniture and non-electrical machinery was Yugoslavia's export growth below the OECD average while in the other 13 categories listed its performance was better. To exclude the impact of Yugoslavia's easier access to Eastern block markets on its export performance, a comparison is also made of the growth of Yugoslavia's exports to the OECD countries with that of exports of the European OECD countries into the same region. (Table 12.12.) Yugoslavia's total exports into the OECD region increased slightly slower than those in the European OECD countries. However, in the field of manufacturers, Yugoslav exports performed significantly better, particularly paper products, electrical and non-electrical machinery, textiles, and clothing and footwear.

Table 12.11: AVERAGE ANNUAL GROWTH RATES OF EXPORTS BY COMMODITY GROUP, 1960-70

(in percent)

	European OECD Countries Into World (1)	Yugoslavia Into World (2)	Difference Between Yugoslavia's and OECD Export Growth (3) = (2) - (1)
Food, beverages, tobacco	9.8	5.1	-4.7
Raw materials	1.4	6.0	4.6
Petroleum	7.5	14.6	7.1
Chemicals	12.2	15.5	3.3
Manufactures (SITC 6)	9.4	13.9	4.5
of which:			
Leather products	10.2	14.6	4.4
Wood products	10.0	6.8	-3.2
Paper products	14.2	26.0	11.8
Textiles	8.2	16.0	7.8
Non-metallic minerals	11.7	12.4	0.7
Iron and steel products	7.2	8.3	1.1
Non-ferrous metal products	11.6	16.9 a/	5.3
Machinery, Transport Equip.	12.0	16.2	4.2
of which:			
Non-electrical machinery	12.2	10.4	-1.8
Electrical machinery	13.7	17.7	4.0
Transport equipment	10.8	18.7	7.9
Miscellaneous Manufactures	13.7	18.7	5.0
of which:			
Furniture	18.4	12.5	-5.9
Clothing	15.8	30.0	14.2
Footwear	17.0	20.0	3.0
Total Exports	10.0	11.5	0.7

a/ 1970 over average of 1960 and 1961.

Source: OECD - Community Trade Statistics, Series B, Nos. 3 and 6, 1961.

Table 12.12: AVERAGE GROWTH RATES OF EXPORTS INTO OECD COUNTRIES BY COMMODITY GROUP, 1960-70

(in percent)

	European OECD Countries Into OECD (1)	Yugoslavia Into OECD (2)	Difference Between Yugoslavia's and European OECD's Export Growth Into OECD (3) = (2) - (1)
Food, beverages, tobacco	11.1	5.4	-5.7
Raw materials	8.2	7.4	-0.8
Petroleum	8.2	17.5	9.3
Chemicals	14.9	15.4	0.5
Manufactures (SITC 6)	11.9	18.3	6.4
of which:			
Leather products	10.3	20.0	9.7
Wood products	11.4	6.7	-4.7
Paper products	16.5	49.0	32.5
Textiles	10.6	19.4	8.8
Non-metallic minerals	13.1	14.5	1.4
Iron and steel products	10.0	14.7	4.7
Non-ferrous metal products	13.0	21.0	7.0
Machinery, Transport Equip.	13.0	27.0	14.0
of which:			
Non-electrical machinery	14.7	37.5	22.8
Electrical machinery	16.8	38.8	22.0
Transport equipment	13.6	21.5	7.9
Miscellaneous Manufactures	16.0	18.7	2.7
of which:			
Furniture	22.8	12.9	-9.9
Clothing	18.3	31.5	13.2
Footwear	22.5	31.0	8.5
Total Exports	12.8	12.2	-0.6

Source: OECD - Commodity Trade Statistics, Series B, Nos. 3 and 6, 1961 and 1970.

12.38 A major drawback of both comparisons in judging Yugoslavia's export performance is that they do not take into account that intra-EEC and intra-EFTA trade has been to a much larger extent free of trade barriers than trade with outsiders such as Yugoslavia. On the other hand, the comparisons make no adjustment for Yugoslavia's favorable regional trade structure with relative high export shares to fast growing countries such as Germany and Italy 1/. To eliminate the impact of Yugoslavia's regional trade structure its performance in individual markets has been analyzed. In Table 12.13 the growth of imports from Yugoslavia are compared with growth of total imports, for selected countries. It should be noted, however, that his method still includes a bias acting against Yugoslavia, since it does not take into account intra-bloc trade. The table shows that while Yugoslavia suffered a decline in its share of the market in less developed countries, it increased its share in the markets of the industrialized countries and particularly in the EFTA. Yugoslavia's less favorable export performance in the EEC market reflects partly the massive increase in protective duties of the EEC in 1968.

1/ The OECD Economic Survey of Yugoslavia 1971, follows a procedure which adjusts for the difference in regional trade structure. It shows then, Yugoslavia's loss of export markets during 1965-70 was almost 3 percentage points. The method, however, does not take into account the various trade barriers around the EEC and EFTA areas which impair significantly Yugoslavia's export chances.

Table 12.13: GROWTH OF TOTAL IMPORTS AND IMPORTS FROM YUGOSLAVIA IN MAIN FOREIGN MARKETS a/

Area and Country	Annual Growth rate 1965-70 of: (in percent)		
	Total Imports (1)	Imports from Yugoslavia (2)	Gain (+) and Loss (-) of Market Share (3) = (2) - (1)
World	10.2	9.0	-1.2
Less Developed Countries	8.3	6.3	-2.0
Industrialized Countries	12.0	15.4	+3.4
Industrial Europe of which:	11.9	16.4	+4.5
EEC	13.2	15.0	+1.8
Belgium - Luxemburg	12.7	7.0	-5.7
France	12.5	30.0	+17.5
Germany	14.2	15.6	+1.4
Italy	13.3	12.0	-1.3
Netherlands	12.4	22.0	+9.6
EFTA of which:	9.3	20.0	+10.7
Austria	12.9	12.3	-.6
Switzerland	12.7	24.0	+11.3
United Kingdom	7.2	22.0	+14.8

a/ Excluding Eastern bloc countries.

Sources: IBRD and IMF, Direction of Trade 1961-65 and 1966-70, and Statistics of Foreign Trade of the SFR Yugoslavia.

Industrial Imports

12.39 The rapid expansion of total imports was mainly due to increasing dependence of the economy on industrial imports, in particular raw materials and semi-manufactures. (Table 12.14.) Consumer goods imports, while in total of decreasing importance over the two decades, showed a significant structural change with food imports declining relatively except for the early 1960's and durable consumer goods, foremost household appliances, automobiles, textiles, clothing and shoes gaining significantly.

Table 12.14: STRUCTURE OF IMPORTS

	Structure (in percent)			
	1954	1960	1965	1971
Raw materials and semi-manufactures	52	57	62	64
Investment goods	22	29	20	21
Consumer goods	26	15	18	15
of which: food	(24)	(8)	(12)	(5)
textiles, clothing and footwear	(.1)	(2)	(3)	(2)
other durables	(2)	(4)	(4)	(6)

Source: Annex Table 3.8.

12.40 From two thirds to three quarters of imports of raw materials and investment goods are from convertible currency countries. In more detail, almost 80 percent of chemical imports and imports of machinery and transport equipment come from the OECD countries; for non-ferrous metals and textile yarn and fabrics, the OECD share is 74 and 73 percent respectively. It is only in the category of iron and steel and fuels that imports from non-convertible currency countries are of major significance.

12.41 The following indicators 1/ show in more detail the extent and development of the economy's import dependence during 1962 to 1970.

1/ Source: M. Seculic, "Osjetljivost Jugoslavenske privrede na pronijene uvoz nik cijena - Strukturna analiza". Edonomiski Pregled, Zagreb, No. 3-4, 1972 p. 137.

	1962	1968	1970
Share of imported intermediates in their total consumption (in percent)	12.0	13.6	16.4
Total import content /a of gross output (in percent)	11.0	11.4	13.4
Total import content /a of final (in percent)	18.3	18.8	21.3

/a Direct plus indirect imports.

All three indicators show that the import dependence increased moderately till 1968 but rapidly in 1969 and 1970. One reason for the increase in import dependence has been the growing importance in the industrial structure of branches with above average import content of output as well as increasing import dependence within these branches.

12.42 Tables 12.15 and 12.16 show the development of import dependence for individual industrial branches and the total economy in greater detail. They confirm the trend of moderately rising import dependence during 1962-68 and its rapid increase after 1968, particularly pronounced in the field of intermediate imports. The total import content of all branches with only a few exceptions increased significantly faster after 1968. As a result the relative importance of high import content industries increased. In 1962, the import content of production exceeded 20 percent for 5 industrial branches, and these accounted for less than one fifth of value of industrial output. In 1970, eleven industrial branches had an import content exceeding 20 percent, and they accounted for about two thirds of the total industrial production. There has also been a rise in the import content of certain components of final demand. In terms of final demand sectors, investments showed the highest import content in 1970 and particularly investments in industry. Also exports show a high and sharply increasing import content after 1968, while the import content of personal and public consumption remained stable at a relatively low level.

Table 12.15: TOTAL IMPORT CONTENT (DIRECT AND INDIRECT) BY INDUSTRIAL BRANCHES AND ANNUAL GROWTH

	Rank According to Import Content in 1970	Import Content as Percentage of Production 1962	1968	1970	Annual Growth (percent) 1962-68	Growth Rate of Import Content (percent) 1968-70
	I. High import content industries (<20% in 1970):					
(1)	Petroleum	17.2	34.1	39.6 a/	12.1	7.8
(2)	Rubber	32.8	31.0	36.1	-.9	7.8
(3)	Shipbuilding	37.4	30.9	35.5	-3.2	7.2
(4)	Non-ferrous metallurgy	14.8	26.5	34.4	10.2	13.9
(5)	Chemicals	22.7	29.7	33.2	4.7	5.7
(6)	Textiles	27.0	29.1	29.5	4.2	.6
(7)	Electrical industry	19.6	22.3	27.9	2.2	11.9
(8)	Iron and steel	18.7	23.2	26.9	3.7	7.7
(9)	Leather and footwear	22.9	24.0	26.3	.8	4.7
(10)	Metal industry	16.9	18.0	23.5	1.0	14.3
(11)	Paper industry	7.6	16.0	21.6	14.1	16.2
	II. Medium import content industries (20% - 13.4% b/ in 1970):					
(12)	Coal and Coke	14.0	15.2	18.5	1.4	10.3
(13)	Wood manufacturing	5.9	12.0	15.9	12.6	15.1
(14)	Printing and Publishing	7.2	10.5	14.3	6.5	16.7
(15)	Food manufacturing	9.8	13.2	14.1	5.1	3.3
	III. Low import content industries (< 13.4% b/ in 1970):					
(16)	Non-metallic minerals	9.2	12.3	12.5	5.0	.8
(17)	Tobacco manufacturing	5.8	7.8	11.9	5.1	23.4
(18)	Building materials	8.0	7.8	8.4	-.4	3.7
(19)	Electrical energy	5.8	5.6	5.8	-.6	1.8
	Total Economy	11.0	11.4	13.4	.6	8.4

a/ Estimated
b/ Average import content of total production in 1970.

Source: M. Seculic, Osjetljivost Jugoslavenske privrede na pronijene vuoz mik cijena - strukturna analiza. Ekonomiski Pregled, Zagreb, No. 3-4 1972, p.137.

Table 12.16: IMPORT CONTENT (DIRECT AND INDIRECT) OF FINAL DEMAND (percent of total category)

	1962	1966	1968	1970
Investment	26.5	24.7	26.0	28.1
Investment in Industry	57.8	59.1	63.0	68.9
Consumption	15.1	16.2	15.4	16.1
Exports	14.5	15.1	16.8	21.7

Source: M. Seculic, "Osjetljivost Jugoslavenske privrede na pronijene vuoz mik cijena - strukturna analiza". Ekonomiski Pregled, Zagreb, No. 3-4 1972 p. 137.

12.43 These trends towards, increasing import dependence in the structure of production and the structure of final demand were encouraged by a number of factors. First, though a fast increase of imports in particular of investment goods and raw materials, is to be expected with rapid industrialization, the foreign exchange and trade system and the overvalued exchange rate, both tended to lower prices for imports and thus introduced an additional import encouragement. Second, the policy of integrating the Yugoslav economy into the world market and the concomittant liberalization put a strong pressure on enterprises to improve competitive efficiency, to replace obsolescent machinery and introduce modern technology. The result was a high pressure on imports, which further increased when the economy entered a boom period in 1969-70 with investments increasing at more than 10 percent per year in real terms. Thirdly, the restrictions on foreign borrowing were significantly relaxed after the 1965 Reform. At the same time the government embarked on a restrictive antiinflationary policy. With monetary policy carrying the main burden, domestic credit conditions became very tight. Enterprises facing increasingly tight credit conditions domestically resorted to imports financed by financial and suppliers credits from abroad. Finally, the foreign trade regime, not only proved inefficient in preventing the rapid import rise, it, on the contrary, provided a strong incentive for importing. The retention quota, i.e., the proportion of foreign exchange earnings left at the free disposal of enterprises has encouraged them to develop import activities above and beyond their needs for production and investment. Moreover, they started importing goods that had no connection with their production. Those imports could be sold on the domestic market with significant profit margins 1/.

1/ There has also been reportedly some export and re-import activity to circumvent price controls which do not apply to import goods. Moreover, a good deal of import increase in 1970 and 1971 can be explained by stockpiling in the wave of devaluation rumors in 1970 and 1971.

12.44 To what extent the increasing import dependency of the Yugoslav economy is a structural phenomenon or only of temporary nature is difficult to say. Some factors mentioned above were clearly a short-term character. Following the two devaluations in 1971 imports rose by only 5 percent in 1972 while production continued to increase at almost the same rate as the years before. This indicates that the explosion of imports in 1970 (35 percent) and 1971 (13 percent) was to a large extent due to devaluation expectations and that in 1972, when stocks were declining, the import dependency of the economy was significantly reduced.

12.45 There remains, however, a structural problem of an increasing import dependence since 1961, partly reinforced by the bias toward importing inherent in the foreign exchange system. When in the late 1950's, the emphasis shifted to the development of import substituting industries, in particular the manufacture of electrical equipment, textiles and clothing chemicals and metal products, Yugoslavia experienced, as many other countries, an increasing rather than decreasing dependence on imports. The import substitution industries were industries with relatively high import coefficients. Their faster development would have raised the overall import dependence of the economy by itself. Moreover, the import coefficients of these and most other industries rose over the 1960's as well. While this is partly due to the increasing insistence on modernization and international competitiveness, there was also a lack of coordination between primary production and manufacturing. The heavy promotion of manufacturing was accompanied by the neglect of the development of raw material production. Their prices were kept low and the foreign exchange and trade system discriminated against them. As a result, between 1961 and 1971 production of coal and coke increased annually at 1.6 percent, of iron and steel at 7.2 percent and of non-ferrous metals at 6.5 percent while manufacturing industries such as chemicals, electrical equipment and rubber products expanded annually at 17 percent, 13 percent and 11 percent respectively.

12.46 The disproportions in industrial development have clearly contributed to the serious structural problem for the balance of payment, making it the major constraint to fast economic growth. The new development plan in recognizing this gives more emphasis to developing the domestic resource base 1/. While it is certainly a step in the right direction it remains to be seen how fast and to what extent it would solve the balance of payments problem. Yugoslavia's recent efforts to negotiate larger longer term credits both from the East and West suggest that the government still sees the need for large capital inflow for some time to come.

1/ See Chapter XIV.

C. Development of Services [1/]

Overall Development

12.47 Perhaps the most remarkable change in the structure of foreign exchange earnings over the two decades was the increasing importance of invisibles since the early 1960's. (See Tables 12.17 and 12.18 and Charts XV and XVI.) A tourism boom in Western Europe in the early 1960's accompanied by a shift of tourism from traditional Mediterranean countries such as Spain and Italy to relatively low-priced Yugoslavia boosted the receipts from tourism. The rapid growth of trade caused the rise in transportation receipts. Since 1965, workers' remittances showed the most rapid development of all invisible items, and were in 1972 the most important single item. The importance of earnings from tourism and workers' remittances goes well beyond their quantitative aspects, since they consist almost exclusively of convertible foreign exchange.

Table 12.17: STRUCTURE OF FOREIGN EXCHANGE EARNINGS 1954-72

	1954	1960	1965	1971	1972 [/a]
Exports of commodities	86	85	63	53	51
Invisibles	14	15	37	47	49
of which:					
Transportation	7	8	18	12	11
Tourism	2	2	7	10	11
Workers' remittances	-	-	3	18	18
Others	5	5	9	7	9
TOTAL	100	100	100	100	100

/a Preliminary.

1/ See Chapters XIV and XV.

Table 12.18: FOREIGN EXCHANGE EARNINGS FROM INVISIBLES 1954-70

(Million US dollars)

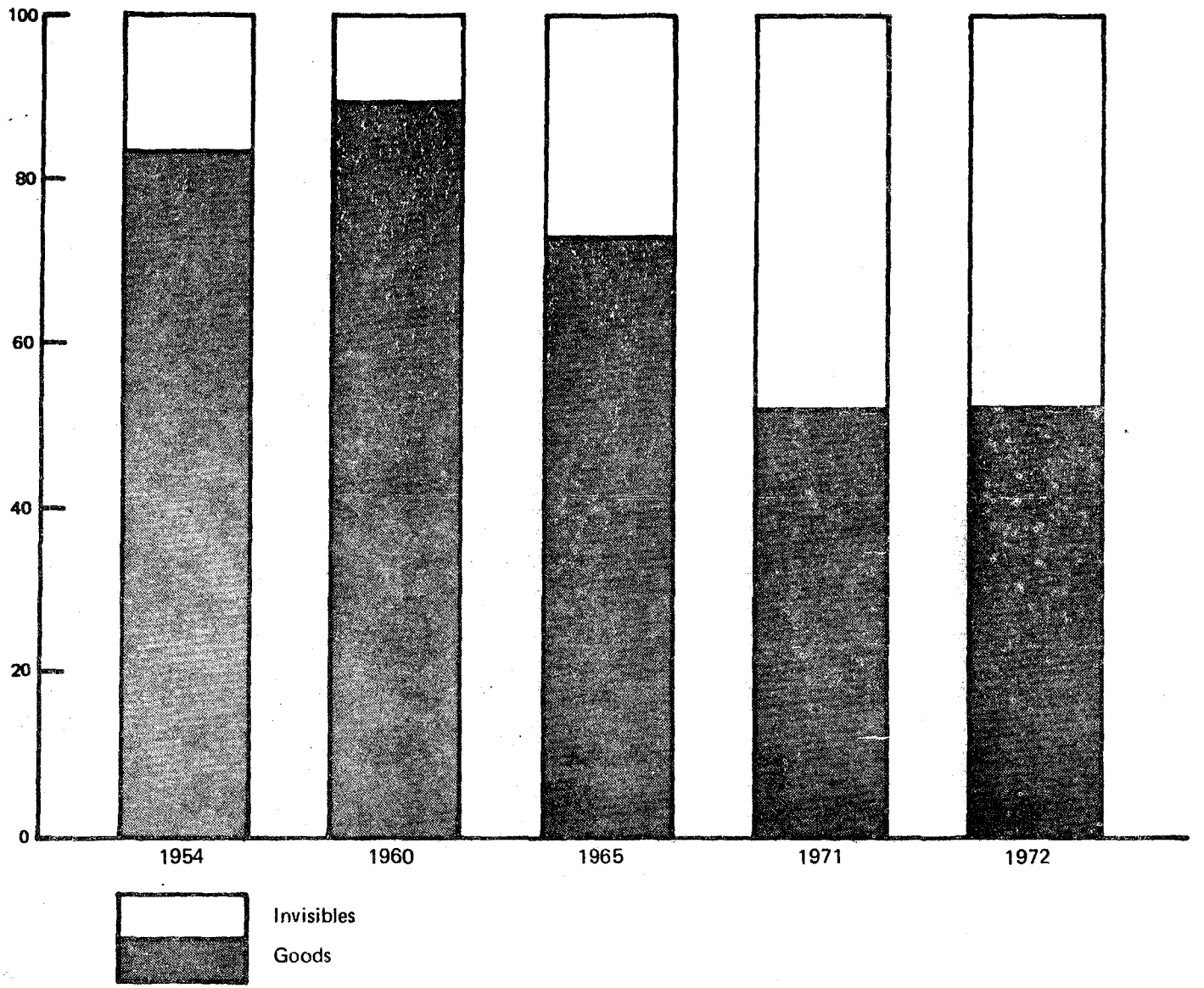
	1954	1960	1965	1971	1972 /a
Transportation	31	78	194	424	470
Tourism	5	15	81	355	450
Workers' remittances	-	-	32	630	780
Other	14	43	98	226	377
TOTAL	50	136	405	1,635	2,077

/a Preliminary

Source: National Bank of Yugoslavia.

Chart XV

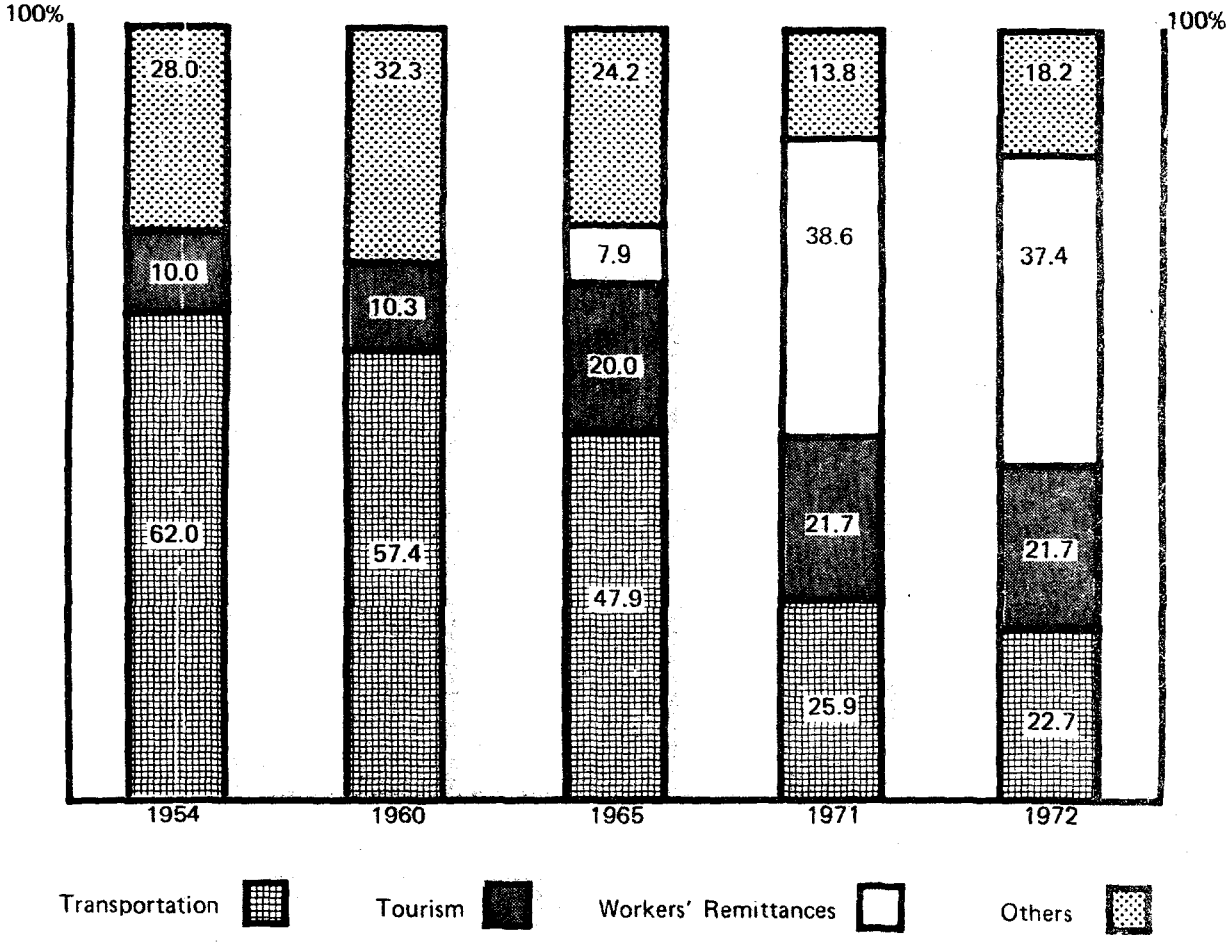
FOREIGN EXCHANGE EARNINGS
(PERCENTAGES)



World Bank — 7722

Chart XVI

FOREIGN EXCHANGE EARNINGS FROM INVISIBLES (PERCENTAGES)



World Bank – 7511

Transportation

12.48 Income from transportation has developed largely in line with merchandise trade. In 1972 total receipts amounted to $470 million accounting for 11 percent of total foreign exchange earnings. About 80 percent of transportation receipts consisted of convertible currencies. Their future development is most likely to be in line with the overall development of exports of goods and services.

Tourism

12.49 Foreign exchange earnings from tourism became a substantial item in the balance of payment only after 1960, when tourism was recognized as an economic sector that could contribute significantly to economic development. The following table summarizes some of the principal indicators of Yugoslavia's tourist development in the 1960's 1/.

1/ Only foreign tourism is being considered here unless otherwise stated.

Table 12.19: TOURISM DEVELOPMENT 1960-71, SUMMARY INDICATORS

	1960	1965	1968	1971 a/	Average Annual Rate of Growth (in percent) 1960-65	1965-68	1968-71 b/	1960/61-71 c/
Total Tourist Arrivals (in 000s)	1157	8316	23206	29392	48	41	13	38
Total Toruist Nights (in 000s)	3510	11240	17210	25849	26	15	15	20
of which (in percent):								
Western Europe	88	82	81	89		15	18	20
Eastern Europe	7	14	16	7		20	-11	26
North America	3	2	2	3		8	26	19
Other	2	2	1	1		5	15	11
Average Length of Stay (no. of nights)	4.0	4.2	4.4	4.9				
Western Europe	4.2	4.5	4.7	5.3				
Eastern Europe	4.4	3.6	4.1	3.9				
North America	2.7	2.5	2.5	2.3				
Other	3.6	2.9	2.9	2.7				
Tourist Nights by Republic (in percent)								
Croatia	71	73	75	76		16	15	21
Slovenia	14	13	11	10		11	10	17
Serbia	9	6	6	5		12	6	13
Sub-total Developed Regions	94	92	92	91		13	14	19
Montenegro	3	5	6	7		17	23	36
Bosnia-Herzegovina	2	2	1	1		12	5	14
Macedonia	1	1	1	1		8	15	17
Sub-total Less Developed Regions	6	8	8	9		16	19	29
Average Annual Occupancy Rate d/ (in percent)	40	36	32	34 a/				
Foreign exchange earnings ($ million)	14	81	189	360	42	33	24	34

a/ 1970
b/ 1968-70
c/ Calculated as a ten year period.
d/ For hotels and similar type of accommodation, including domestic tourism.

Source: Federal Institute of Statistics

12.50 Yugoslavia receives the third largest number of tourists from Western Europe among the Mediterranean and Adriatic countries. The number of tourist arrivals in Yugoslavia increased between 1960 and 1971 at an average annual rate of about 38 percent. Total foreign exchange earnings increased at an average annual rate of 34 percent; their proportion to merchandise exports rose tenfold from about 2 to 20 percent over the decade. The composition of tourists has shifted somewhat since the mid 1960's as the proportion of Western Europeans increased from 82 percent to 89 percent between 1965 and 1971 while the share of Eastern Europeans has declined from 14 percent to 7 percent of total tourists nights. The dominant tourist generating country was the Federal Republic of Germany, followed by Italy, Austria and the United Kingdom.

12.51 A major problem of tourism development has been both its severe seasonality and the concentration on the coast. About 57 percent of tourist nights fall into the peak season July and August and another 28 percent into the adjoining months June and September. Thus 85 percent of tourist nights are concentrated in only 4 months of the year. As a result the average annual occupancy rate of around 34 percent 1/ was extremely low. If Yugoslavia were to achieve a somewhat higher occupancy rate, this would permit an increase in tourist nights per year with the present capacity. It would also raise the profitability of hotel investment which presently seriously limits the construction of new hotels. This would, however, require a successful promotional effort in spreading the peak demand over a longer period, admittedly a difficult undertaking given the climatic and market constraints. There have been efforts to attract international congresses, seminars, etc. during the low season. There are also plans to develop winter tourism particularly in the less developed regions. This may also help to distribute tourism more evenly over the whole of Yugoslavia. It would be desirable to see the less developed regions, which presently participate only with less than 10 percent in total tourist earnings, enlarge their share. The heavy concentration in the coastal areas of Croatia — Croatia accounts for more than three-quarters of total tourist nights — may also set limits to a continuation of past expansion because of environmental reasons. There is need for expansion of infrastructure, transportation facilities as well as water supply and sewerage infrastructure, if tourism is to continue to grow as in the past. With decentralization the responsibility for local infrastructure has been transferred largely to the communes and therefore intercommunal or even regional projects face significant administrative and financing difficulties.

Workers' Remittances

12.52 Remittances from Yugoslavs working temporarily abroad increased from about $30 million in 1965 to an estimated $800 million in 1972, surpassing even the most optimistic expectations. In 1972, they accounted for 18 percent

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1/ Bed occupancy rate in hotels, motels, and inns, including domestic tourism.

of total and 25 percent of convertible foreign exchange earnings. The growth of remittances was the result of increasing migration of workers abroad 1/. It also appears that there has been an increase in the remittance rate - the proportion of their incomes the workers remit back, and this has been an important factor for the increase in the remittance flow. Assuming that the migrants average annual income increased in line with average annual earnings in the manufacturing sector in Germany, it would appear that the average remittance rate in 1970-72 was about 40 percent higher than in 1965-67 2/. The reasons for the increase in the remittance rate are complex and may be shortly summarized here. First, there is reason to assume that there is a close positive correlation between the remittance rate and the rate of income growth of workers abroad. Second, expectations of a dinar devaluation has probably induced migrants to hold back some of their savings during the pre-1971 period which after the devaluations were repatriated to Yugoslavia. Third, there may have been an increasing flow of remittances stemming from accumulated savings in the past of those migrants returning home. This factor may become particularly important in the future, as the number of migrants returning home increases. Finally, there may also have been offsetting influences tending to reduce the remittance rate. As migrants stay longer abroad, they tend to adopt foreign consumption standards; there is also a tendency that their families may join them abroad. It is difficult to say in our current state of knowledge and given the information available which of these factors had the most important or a significant influence at all on the past development of remittance flows. However, all evidence suggests that workers' remittances will for some time to come continue to grow and remain an extremely import factor in the balance of payments. 3/

1/ For a detailed analysis of external migration, its causes as well as benefits and costs to the Yugoslav economy, see Chapter III.

2/ This estimate is based on data included in an internal study of the IBRD by Ian Hume. "Projection of Workers' Remittances to Turkey and Yugoslavia 1972-80". January 24, 1973.

3/ In 1973 the remittances have continued to increase rapidly and are expected to reach $1,250 million, or 41 percent above the level of 1972.

XIII. CAPITAL FLOWS AND EXTERNAL DEBT

A. Capital Flows

Evolution and Structure of Capital Flows

13.1 The expulsion from the Cominform and severance of economic relations with Eastern Europe was followed by a massive aid program from the USA under which more than $2 billion 1/ was provided during 1949-61 - equivalent to an average of $155 million per year. About three-quarters of this amount was in the form of grants or grant-like contributions. Capital flows from the United States declined to a total of $580 million during 1962-70 or an average of about $65 million a year, of which only 13 percent was in the form of grants or grant-like contributions. Western European countries were only providing small amounts during the 1950's; however, they became increasingly more important as suppliers of long-term capital during the 1960's.

13.2 Since 1965, gross inflow of medium- and long-term capital almost tripled from $330 million in 1965 to an estimated $970 million in 1972, equivalent to an average annual growth of 17 percent. However, due to the even more rapid growth of amortization payments - from $165 million in 1965 to $630 million in 1972, or at 21 percent per year - the net inflow of medium- and long-term capital increased only from $163 million to $340 million during the period, averaging about $250 million a year. About two-thirds of this were medium-term suppliers and financial credits. The share of long-term Government loans, accounting for 41 percent of the net inflow during the first half of the 1960's, decreased to 16 percent during 1967-71. IBRD loans have been the main source of long-term capital during this period, accounting for 37 percent of long-term official capital. Credits from Eastern countries have also become more important. They accounted for 14 percent of total net inflow during 1967-71 as compared with a net outflow in the mid-1960's (see Table 13.1). To some extent this inflow has been offset by Yugoslav export credits, which averaged about $50 million annually during 1967-71.

13.3 There have been significant changes in the structure of loan capital (see Table 13.1). Capital from private sources, largely suppliers' and financial credits was relatively important in the second half of the 1950's, with a share of 96 percent of total net loan capital inflow in 1960. Its importance then declined to a share of 40 percent in 1965/66. In the subsequent years up to 1970, private capital again became the main source. By the late 1960's the term structure of foreign borrowing had worsened significantly and the debt service became increasingly burdensome, due to the shift from long-term official capital to medium-term suppliers' and financial credits. The government rescheudled some debt in 1968 and eventually followed a more active debt management policy to regulate the amounts and improve the terms of capital inflow. Following the standby agreement with the

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1/ About $700 million of this was military assistance.

International Monetary Fund in July 1971 Yugoslavia limited external medium-term and short-term borrowing. The outstanding short-term credits at the end of 1972 were by much lower than a year earlier and the growth in 1971 and 1972 of medium-term debt guaranteed by business banks slowed down significantly. There was no new short-term foreign borrowing in 1972. In addition, to improve the structure of the outstanding debt in 1970 Yugoslavia approached a number of countries to reschedule or refinance existing debts and to extend long-term credits. The United States agreed to reschedule $58.6 million debt payments falling due in 1971 and 1972. Italy, Germany, France, Japan, Belgium and the Netherlands, have agreed to extend financial credits of $75 million, $142 million, $120 million, $30 million and $5 million respectively 1/. The terms of these new loans and of the rescheduling are more favorable than the average terms of the outstanding external debt during 1972-74. Apart from this amount totalling $277 million for the period 1971-75, the Yugoslav authorities hope to receive some further credits from major creditors in the near future.

1/ Dollar equivalents at exchange rates prevailing December 31, 1972.

Table 13.1: STRUCTURE OF MEDIUM- AND LONG-TERM CAPITAL (NET) 1955-72

(in percent)

	1955	1960	1965/66	1967/68	1969/70	1971/72*
Official Capital	14	4	61	9	24	41 1/
Eastern Europe	-	-3	-3	7	22	10 1/
Other Bilateral	-57	9	49	-6	-8	21 1/
USA	(-43)	(14)	(48)	(4)	(-12)	(7) 1/
Other	(-14)	(-5)	(1)	(-10)	(4)	(14) 1/
International	71	-2	15	8	10	9
of which World Bank	(71)	(-2)	(15)	(8)	(10)	(9)
Private Capital	86	96	39	91	76	59 1/
Total net inflow	100	100	100	100	100	100

* Preliminary

1/ Estimated on the basis of data for 1971

Source: Annex Table 3.12

13.4 In late 1972 Yugoslavia also negotiated a long-term credit of $540 million equivalent from the Soviet Union for financing improts of investment goods during 1973-75. Furthermore, the agreement foresees a continuation of financing the investment of good imports after 1975 of $450 million. These credits are expected to be used mainly to finance projects in the coal, oil, electric power, ferrous and non-ferrous metal industries. The debt service burden of these credits will be fairly low due to the soft terms they carry, i.e. 2 percent interest per annum and 13 years' maturity. Moreover, repayments are expected to be made in the form of raw materials from projects financed by these credits and of Yugoslav machinery and equipment.

Long-term Private Capital

13.5 Since a continuous net capital inflow will be needed in the foreseeable future to maintain high growth rates, the Government has tried tapping other sources of long-term finance. It has succeeded in placing several private issues in Western capital markets. It is also exploring a public bond issue of $20 million in the US capital market. Since 1967, the Government has also tried to encourage private foreign investment through special legislation 1/. However, the response of foreign investors has so far been disappointing in terms of its impact on the balance of payments. By end 1972, about 68 joint venture agreements had been signed between local and foreign enterprises committing the latter to invest a total of around $100 million or about $20 million a year. Among the main reasons for the reluctance of foreign private firms to invest on a larger scale in Yugoslavia has been the rather vague and restrictive regulations of such matters as majority share of capital, management control and profit and capital transfer. There is also a lack of understanding of the economic and social conditions in Yugoslavia on the part of private foreign firms which makes them apprehensive to place risk capital in a socialist country. There is also at times a basic conflict of interests. While partners from the West intend to build a base in Yugoslavia for gaining easier access to eastern markets, Yugoslavia's interest in joint ventures is focussed on increasing exports to Western markets. In the light of this development the conditions for foreign partners in joint ventures with Yugoslav enterprises have recently been further improved. The Constitution now includes a provision which protects foreign partners against any unfavorable change in regulations regarding joint ventures after conclusion of contract; the regulation by which the foreign partner had to re-invest 20 percent of his profits has been abolished; the portion of foreign exchange available for transfer of profits has been increased to 33 percent of the enterprise's total foreign exchange earnings. With increasing communication and familiarity with conditions and the recent change in regulations, the Yugoslav authorities expect the flow of joint venture captial to increase, particularly from the United States, following the enactment of a law in 1972 under which the US Government will be able to extend guarantees for private investments in Yugoslavia.

1/ Also see Chapter V.

B. External Debt

Evolution and Structure

13.6 Yugoslavia's total foreign debt almost quadrupled in the eight-year period from the beginning of 1964 to the end of 1971 from $700 million to $2,700 million on a disbursed basis. This represented an average annual increase of 18 percent. Total debt including undisbursed over this period rose slightly less from $1,114 million (end 1963) to $3,700 million in 1971. In relation to GDP (in constant 1966 prices) foreign debt rose over the period from 14 to 29 percent for disbursed, and from 22 to 42 percent for debt including undisbursed.

13.7 The most significant changes in Yugoslavia's external debt were: (a) a shift from long-term public loans to medium-term suppliers' credits as the major source of lending after 1965; (b) a sharp rise in non-guaranteed suppliers' credits since 1967. The latter increased from $124 million in 1967 to about $800 million in 1971. The increase in non-guaranteed suppliers' credits was facilitated by decentralization measures under Yugoslavia's 1965 Economic Reform which transferred the authority to contract and guarantee foreign credits from the state to banks and enterprises. This authority, however, was restricted by a requirement that foreign borrowing not exceed, on the average, three times the foreign exchange holdings of the borrower. The debt management system after the 1965 decentralization up to 1971 was rather inefficient, both because it offered effective control neither over amounts nor on terms of new debt contracted. New regulations were introduced in 1971 and 1972. They are discussed below.

13.8 Table 13.2 reflects the changing structure of outstanding disbursed debt. Loans from governments amounted to $337 million and accounted for about 50 percent of the total in 1963 and declined to 27 percent in 1971. At the same time suppliers' and bank credits became the most important source with a rising share from 32 to 62 percent. The IBRD share increased to 16 percent in the mid-1960's and declined thereafter to 10 percent of the total. A remarkable fact emerging from the Table is that there was little change in the distribution between non-convertible and convertible debt, with the latter accounting from about 90 percent both in 1963 and in 1971.

Table 13.2: STRUCTURE OF FOREIGN DEBT /a
(percent)

	1963	1965	1967	1971
Loans from Governments	49	48	43	27
Convertible	(39)	(43)	(37)	(18)
Non-Convertible	(10)	(5)	(6)	(9)
Suppliers' and Bank Credits	32	30	41	62
Convertible	n.a.	(30)	(37)	(60)
Non-Convertible	n.a.	(-)	(4)	(2)
IBRD	12	16	13	10
Others	7	6	3	1
TOTAL	100	100	100	100

/a On disbursement basis.

Source: I.B.R.D., Economic and Social Data Division.

13.9 In the category loans from governments, the share of disbursed debt due to Eastern Bloc countries increased from 12 to 32 percent between 1965 and 1971 1/. Czechoslovakia became the main creditor among Eastern Bloc countries with $104 million debt outstanding in 1971 or 14 percent of debt due to governments, replacing the USSR (which used to be the main Eastern creditor in the early 1960's) with $80 million or 11 percent and Poland with $28 million or 4 percent in 1971. Major creditors from the convertible currency area in this category in 1971 were the US with $311 million or 43 percent of total debt due to governments, followed by Italy with $98 million or 13 percent and the Federal Republic of Germany with $78 million or 11 percent. This ranking did not change between 1963 and 1971, although the shares varied somewhat.

13.10 Within the category of suppliers' and private bank credits, debt due to non-convertible currency area was of minor importance ($58 million or 3 percent of this category in 1971). Major creditors were the Federal Republic of Germany with $413 million or 25 percent, US with $372 million or 22 percent, Switzerland with $204 million or 12 percent, Italy with $145 million or 9 percent, the UK with $140 million or 8 percent and France with $118 million or 7 percent.

1/ For the debt outstanding including undisbursed, the share due to Eastern countries is considerably higher, 32 percent in 1965 and 47 percent in 1970, due to a proportionately larger amount of undisbursed debt.

Terms of Borrowing

13.11 The average terms on Yugoslavia's total foreign debt became significantly harder during recent years. Table 13.3, based on information as reported to the World Bank, quite clearly understates this trend as it includes only public or publicly-guaranteed debt. It is, therefore, of limited use in analyzing the development of terms on total borrowing, in particular, since non-guaranteed debt became increasingly important since 1967 accounting for 50 percent of the total in 1971. Though the data in the Table fail to indicate a clear trend over the period 1963-70, there was, nevertheless, a trend towards hardening of terms on public debt in recent years: interest rates increased and maturities decreased, while, on the other hand, the average grace period increased. The combined indicator, the grant element 1/ declined from 27 percent in 1966 to 17 percent in 1970. The exceptionally soft average terms in 1967 were mainly due to a $160-million credit from the USSR and a $40-million credit from Czechoslovakia with interest rates of about 2.5 percent and a maturity of more than 12 years. A large part of the explanation for the hardening of terms may be found in the rising interest rate of loans from Western governments and international organizations and a shortening of the average maturity of the former 2/.

1/ See footnote b/ in Table 13.3.

2/ OECD calculations, as shown in the "Terms Matrix" (OECD, Terms Matrix 1967 and 1968, Paris 1970 and Terms Matrix 1969, Paris 1971), indicate a lower grant element for total borrowing averaging only 14 percent in 1968 and 13 percent in 1969 as compared with 22 and 24 percent, respectively, shown in Table 2. The lower OECD figures for the grant element reflect the harder terms of private borrowing. For "official development assistance" the average grant element was 37 percent in 1967 declining to 31 percent in 1969.

Table 13.3: AVERAGE TERMS OF FOREIGN LOANS, 1963-70

	1963	1964	1965	1966	1967	1968	1969	1970	Average 1963-70
Interest rate (percent)	5.4	5.1	3.8	4.8	2.7	6.3	5.8	7.1	4.9
Governments	4.5	4.3	3.2	4.5	2.3	5.6	5.5	4.1	3.5
International Organizations	5.5	5.5	6.2	a/	6.0	6.3	6.5	7.0	6.2
Suppliers	5.9	5.5	5.5	5.7	6.0	6.1	6.0	5.7	5.6
Private Banks	5.2	5.8	6.0	a/	a/	6.5	5.8	6.5	6.2
Grace Period (years)	2.5	3.1	3.0	2.4	2.9	5.2	2.8	3.9	3.1
Governments	2.2	2.3	3.2	2.5	2.9	1.2	1.6	2.7	2.7
International Organizations	4.0	5.2	1.8	a/	3.9	5.2	5.3	5.0	4.8
Suppliers	1.6	2.6	2.2	2.0	2.0	1.8	2.2	2.9	2.2
Private Banks	3.3	5.5	3.4	a/	a/	5.4	5.5	4.3	5.1
Maturity (years)	14.2	14.4	15.3	12.8	18.0	14.7	15.2	14.9	15.1
Governments	8.8	16.7	16.9	13.8	18.5	4.0	13.5	6.8	16.2
International Organizations	22.2	25.2	14.2	a/	17.1	22.4	25.3	21.2	22.4
Suppliers	11.5	10.0	11.1	9.8	7.0	10.6	8.9	11.2	10.5
Private Banks	9.9	8.5	11.3	a/	a/	8.4	8.5	6.4	8.7
Grant Element of Loans b/ (percent)	25.0	28.0	35.0	27.0	45.0	22.0	24.0	17.0	30.0
Governments	23.0	33.0	41.0	29.0	48.0	10.0	22.0	22.0	38.0
International Organizations	31.0	33.0	20.0	a/	25.0	26.0	26.0	21.0	27.0
Suppliers	19.0	20.0	21.0	18.0	14.0	17.0	17.0	21.0	20.0
Private Banks	23.0	21.0	20.0	a/	a/	17.0	21.0	14.0	19.0

a/ No debt commitments.
b/ The grant element is the difference between the nominal value of the loan and the discounted value of its service payments discounted at a rate of that reflects the opportunity costs of capital. The discount rate used in this table is 10 percent.
Source: IBRD, Economic and Social Data Division

13.12 The structure of Yugoslavia's outstanding debt from the standpoint of the time profile of total amortization obligations became more favorable between 1964 and 1967 but unfavorable thereafter (Table 13.4). While at the end of 1964, 53 percent of the outstanding debt had to be amortized within the following 3 years, this share declined to 44 percent in 1967 and rose again to 52 percent at end-1970.

Table 13.4: STRUCTURE OF AMORTIZATION PAYMENTS ON OUTSTANDING DEBT

	End 1964	End 1967	End 1970
Amortization of following 2 years as % of debt outstanding	38	32	37
Amortization of following 3 years as % of debt outstanding	53	44	52

Source: I.B.R.D., Economic and Social Data Division.

The changing amortization structure can be partly explained by the increasing importance of private non-guaranteed borrowing in recent years. Table 13.5 indicates the relatively unfavorable amortization structure of private debt in 1970. A significantly larger burden on the short-term debt servicing capacity is imposed by private (mostly suppliers') credits. Long-term maturities of IBRD and governmental loans were only partly able to compensate for the short maturities of private credits.

Table 13.5: STRUCTURE OF AMORTIZATION PAYMENTS IN 1970
(in percent)

	Public Debt	Loans from Governments	International Organizations	Private Debt
Amortization in 1971-72 as % of debt outstanding at end 1970	31	31	10	45
Amortization in 1971-73 as % of debt outstanding at end 1970	42	43	15	61
Amortization in 1971-74 as % of debt outstanding at end 1970	55	54	22	73
Amortization in 1971-75 as % of debt outstanding at end 1970	63	64	29	82
Amortization in 1971-76 as % of debt outstanding at end 1970	71	72	36	87

Source: I.B.R.D. Economic and Social Data Division.

Service Payments

13.13 Service payments, as reported to IBRD, more than quadrupled since 1963, reaching almost $630 million in 1971. Interest payments increased from $25 million in 1963 to about $105 million in 1971; amortization payments rose from $104 million to $520 million over the same period. Of the total debt service in 1971, $600 million or about 95 percent was due in convertible currency. This compares with a share of convertible currency debt in total debt outstanding of 90 percent on disbursement and 83 percent on commitment basis. The rapidly-rising debt service has caused the increase of almost all debt indicators, as shown in Table 13.6 since 1968. This indicates the significantly increased burden of foreign indebtedness on the economy. The debt service ratio 1/ on total debt outstanding increased between 1967 and 1971 from 12 percent to 18 percent; debt service payments as percentage of gross domestic savings more than doubled between 1967 and 1971; and the debt outstanding as proportion of GDP also almost doubled between 1966 and 1971. As the debt service is due largely in convertible currency the burden on the economy goes

1/ Debt service payments as percentage of exports of goods and services, including factor income.

well beyond what the above quantitative indicators suggest. Thus, the debt service ratio in convertible currency 1/ is significantly higher. It rose from 17 percent in 1966 to about 23 percent in 1971.

Table 13.6: SELECTED DEBT INDICATORS
(in percentages)

	1966	1967	1968	1969	1970	1971
Debt service payments/debt outstanding /a	20.6	19.2	16.4	18.6	22.8	23.1
Amortization payments/debt outstanding /a	16.2	12.6	12.6	14.0	17.9	19.3
Debt service payments/exports of goods & services including factor income	13.2	12.3	13.2	14.2	16.2	18.0
Debt outstanding /a /GDP at constant 1966 market prices	13.0	15.6	17.2	18.2	19.8	24.2
Debt service payments/GDS at current market prices	8.3	8.3	9.0	10.3	13.9	17.6

/a Disbursed only.

Debt Management

13.14 The projections below 2/ show clearly that the debt situation will continue to remain serious and that the Government has to continue to give attention to external debt management. The rapid increase in the external debt burden in recent years was partly the result of liberal regulations concerning foreign commercial borrowing after the Economic Reforms of 1965. The Government has placed increasing emphasis on regulating the growth and structure of external borrowing following the emergence of the external debt service problem. In July 1971, the National Bank instituted new reporting and registration procedures to help regulate the growth of external debt. Enterprises and banks must notify the National Bank of Yugoslavia before borrowing abroad and register with it the debt incurred. The National Bank may refuse to register a loan undertaken on unfavorable terms or in excess of the estimated borrowing limit of the unit concerned. Banks are authorized to guarantee only those external loans that have been registered. Under the regulations governing external borrowing until April 1972, enterprises and

1/ Debt service payments in convertible currency over exports of goods and services including factor income in convertible foreign exchange.

2/ See Chapter XIV and Appendix III "A Long-Term Projection Model for Yugoslavia."

banks were free to borrow abroad only within limits determined by their estimated capacity to repay in foreign exchange. In general, the borrowing limits of enterprises depended on the exchange available to them in the form of retention quotas and depreciation allowances in foreign exchange. Banks were allowed to incur or guarantee external loans to a limit dependent on their "foreign exchange credit fund", consisting of their purchases of retention quotas from enterprises and earnings from their assets denominated in foreign currencies. In addition, a macro-economic limit on aggregate external borrowing was determined each year, jointly by the Federal government and the National Bank of Yugoslavia, according to the estimated requirements for servicing existing debt and covering the foreign exchange gap. The limit was set at $900 million in 1971 and kept unchanged for 1972. Of this, $100 million was retained for foreign loans to be authorized by the Government, and the rest allocated among the authorized banks according to their foreign exchange credit fund.

New Regulations of Foreign Borrowing

13.15 On April 28, 1972 new regulations were enacted for regulating external borrowing. The new regulations replace the previous system of limits on borrowing set for enterprises and banks on the basis of their estimated capacity to repay in foreign exchange with one of variable dinar deposits which would make external loans, particularly with relatively short-term maturity, costly and less attractive. The abolition of former quantitative limitations does not imply that no global limit exists any more. As mentioned any credit arrangement with abroad (commercial or financial) has to have prior approval of the National Bank of Yugoslavia and be registered with the National Bank when concluded. The National Bank of Yugoslavia may at any time and without giving any reasons refuse to give the approval to any credit arrangement with abroad 1/. The dinar deposits are non-interest bearing and have to be deposited with the National Bank before an external loan can be registered. The deposits are not repaid until the external loan has been fully repaid. They vary in size with purpose, maturity and location of the user of the credit.

13.16 For commercial credits financing the import of raw materials and semi-finished products, 66 percent of the contract value has to be deposited with the National Bank at registration time. The remaining 34 percent has to be deposited 30 days before each maturity. Moreover, the importer must have the right to buy foreign exchange (under the import regime) and his rights are blocked at registration for the full value of contract. If the credit is to be repaid out of own foreign exchange funds (retention quota), the amount covering the full contract value is blocked. When machinery and equipment is imported on credit basis, the deposits are 20 percent for credits of up to 3 years maturity, and 10 percent if the borrower is from an underdeveloped region. For credits with a maturity of 3 to 5 years, the deposits

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1/ At the end of 1972, the National Bank refused under this provision to approve credit arrangements with repayments within the first 12 months.

are 10 percent and 1 percent respectively and for maturities of over 5 years, the deposit is uniformly 1 percent 1/. In addition to the above deposits, the foreign exchange account of the importer or the rights to buy foreign exchange under the import regime are being blocked up to the amount of the deposit. If a bank guarantee is required to cover obligations undertaken under commercial credit arrangements an additional deposit of 5 percent has to be transferred to the National Bank of Yugoslavia before issuing the guarantee and remains also deposited with the National Bank during the whole period of the validity of guarantee without any interest. For financial credits, the dinar deposits were set in July 1972 at 40 percent for credits with a maturity of less than 2 years, 30 percent for maturities of 5 to 7.5 years, 5 percent for maturities of 7.5 to 10 years and 1 percent for maturities of 10 years or more. In late 1972, dinar deposits were temporarily raised to 75 percent for the short-term maturities.

13.17 The effectiveness of the new regulations can be judged only with time and when more detailed data on recent external borrowing is available. It is, however, reported that there was a significant decline in short-term borrowing. Credits with less than 1 year maturity reportedly disappeared completely after April 1972. Though the new system abandoned the quantitative limit on external borrowing, the new dinar deposit and registration requirements provide the authorities with more effective instruments to regulate both amount and terms of new foreign borrowing. It also appears that the Yugoslav authorities are determined to fully utilize the new instruments to prevent a deterioration of the external debt situation. Thus, for 1973 an increase of dinar deposits for short-term and medium-term financial credits is considered. Moreover, the National Bank plans to coordinate foreign borrowing through forming a consortium of Yugoslav banks. Contracting credits outside the limits set by the consortium would be imposed with high dinar deposits thus possibly amounting to prohibiting borrowing outside the consortium.

1/ There are some exemptions from these deposit requirements concerning, in particular, credit obligations for account of the Federal Government or the National Bank of Yugoslavia, for projects financed by international financial organizations, for shipbuilding for exports and credit obligations for joint ventures.

XIV. DEVELOPMENT PROBLEMS AND PROSPECTS

Introduction

14.1 The analysis of the development experience and problems of the Yugoslav economy that has been presented in this report gives ground for a favorable assessment of future economic performance. The success with which Yugoslavia has combined rapid economic growth and fundamental institutional changes over a long period of time, gives evidence of the basic soundness of the line of economic development and of the country's ability to face and to find reasonably effective solutions to the seemingly intractable economic problems - domestic and external - that continue to persist. The endowment of natural and human resources, together with the pragmatic and dynamic approach brought to bear on economic problems and issues, the readiness to consider and undertake institutional changes, and the general commitment to an open market-oriented economy are other bases for confidence about development prospects.

14.2 The major factors likely to influence growth are (a) the efficiency of the decentralized system of decision-making based on consensus among the republics in formulating, adopting and implementing general economic policy and in effectively coordinating regional investment programs; (b) success in controlling inflationary pressures, implying the development of an environment of financial responsibility in which monetary policy can be more effective, and implementation of incomes policy to restrict the growth of personal incomes, and the development of a more flexible fiscal policy; (c) improvement in the tight balance of payments situation, depending partly on the attainment of domestic stability as well as on the rate of growth in Western European countries, particularly Italy and Germany, which absorb more than a quarter of Yugoslav exports and are a major source of tourism earnings and workers' remittances; (d) improvement in resource allocation, and maintenance of the rate of aggregate savings.

Institutional Change

14.3 The trend towards decentralization and greater self-management is likely to continue. The legislative framework required for the implementation of the constitutional amendments of 1971 is still being created and the implications of these amendments have not yet been fully elaborated. The amendments have made out of date the basis of certain institutions e.g. the Federal Assembly and further constitutional changes are being formulated. The constitution of 1963 has been amended to such an extent that it is felt that instead of new amendments a new constitution is needed to consolidate the developments of the last decade. A draft constitution has been prepared and is being discussed. The continuation of institutional change and its necessarily experimental character may be expected to absorb energy and attention. However, on the basis of past experience, it is unlikely to impede economic and social progress significantly in the short run. In the long run it is likely to further economic development, since the whole

process aims at greater efficiency of the Yugoslav production structure with increased market orientation and better integration with the international economy.

14.4 The crucial problem that has appeared in this process of institutional development, and which has not yet been solved fully, is how to secure a proper balance between decentralization and self-management on the one hand and the essential requirements of coordination of economic, and particularly, investment decisions and macro-economic management necessary at the Federal level on the other. As has been indicated in this report the Yugoslavs have experimented with a number of institutional constraints to achieve such a balance and with some success. The recent innovation of social and self-management agreements between involved parties and the state which are legally binding appears to have begun to work and the formalization of consultation and agreement among republics and provinces on all matters of common interest has also yielded decisions on a number of controversial questions. While much yet remains to be achieved, particularly in terms of the speed with which decisions are reached and implemented, the trend appears to be towards smoother and more effective coordination.

Employment

14.5 As a result of a relatively slow growth rate of population and labor force, the dimensions of the employment problem in Yugoslavia are different from that in other developing countries with surplus labor in agriculture. Also, Yugoslavia has been relatively successful in expanding non-agricultural employment, though migration of workers abroad has been important since 1965 in alleviating the pressure for such employment. The total resident population is likely to increase at about 0.8 percent per year to about 22.5 million in 1985. Assuming that the participation rate remains unchanged at the level for 1971 the labor force would increase at the same rate as population. This would imply an average increase in the labor force of about 70,000 per year 1/ during 1971-85. If the social sector employment grows at the trend rate of 2.9 percent annually, an average of about 140,000 new jobs would be created in the social (primarily non-agricultural) sector during this period. If net external migration averages, say 20-25,000 per year during the next decade, then by the early 1980's, these developments would have more than absorbed what current estimates suggest to be the country's pool of underemployed (about one million in 1971) plus the expected increments to the labor force. Even if it were assumed that the average growth rate of social sector employment were to be only 2 percent per annum, i.e. about two-thirds of the trend rate, the number of new jobs created would exceed the projected increase in the labor force, and the main implication would be that the existing underemployment would not be fully absorbed by the 1980's.

1/ If the participation rate rises so that the labor force increases at 1 percent per annum, the average annual increment in the labor force would be about 88,000.

14.6 It would appear, therefore, that there is some prospect of Yugoslavia being transformed into a labor scarce full-employment economy in the 1980's. This prognosis, however, may be academic in view of the following considerations:

(i) Even achieving the above employment goals, it would still leave about 38 percent of the domestic labor force in agriculture.

(ii) There would be about one million Yugoslav workers still employed abroad, i.e. about 11-12 percent of the labor force.

(iii) The achievement of "full employment" in Yugoslavia does not rest on the achievement of simple global arithmetic goals, but on the achievement also of a suitable regional balance of new jobs and available workseekers.

In 1971 Yugoslavia was creating about twice as many jobs in the social sector as there were net increases in the labor force (about 110,000 new jobs annually, against a growth in labor force of around 50,000 a year). However, while most of the new jobs created were in the developed regions a relatively higher proportion of the underemployed and those seeking work in the social sector were in the less-developed republics and autonomous provinces.

14.7 External migration of workers abroad has played a very important role in Yugoslavia's success in reducing underemployment in the last few years. For reasons indicated earlier in the report external migration is unlikely to play a similar role in the future 1/.

The Dual Economy

14.8 In Yugoslavia the dualism, characteristic of developing economies, between the traditional and the modern sector broadly coincides with the distinction between the private and the social sectors. The private sector has played essentially a passive role in the development process mainly as a reserve for labor and supplier of a part of the needs of the social sector for agricultural commodities 2/, and its relative importance has tended to decline. Since the bulk of the underemployment in Yugoslavia is in private sector agriculture, the prospect of reduction and perhaps elimination of the existing labor surplus in the 1980's would imply both an improvement in the economic situation of the peasant farms as well as a decline in the number of people dependent of them. On the employment assumptions of para 14.5, about 65-70 percent of the labor force would be employed in the social sector by 1985 as against about 50 percent today. The dualistic nature of the economy is therefore likely to persist for some time to come, but would tend to become less important.

1/ See Chapter III.

2/ The bulk of the requirement for marketed agricultural production has been met by social sector agriculture. See Chapter VI.

Economic Growth and Structural Change

14.9 The growth rate of GDP that is likely to be attained would depend on the success in tackling the major problems that have prevented sustained rapid growth in recent years, and have slowed down the trend rate of growth of GDP to around 5 percent since 1965, namely inflationary pressures and balance of payments difficulties. An average growth rate of about 7.5 percent per year is the official target, considered as necessary for the achievement of basic social and economic objectives within an acceptable time period 1/. It is, however, recognized by the Yugoslav planners that a rate of growth of 7-8 percent per year would not be feasible if recent measures for domestic stabilization are not successful. In that situation a growth rate of between 5-6 percent per year is regarded as the minimum acceptable. These targets may be compared with the average growth of GDP of 6 percent per year achieved during 1953-71, and of 6.5 percent per year during 1953-65. On the basis of the analysis of the preceding chapters the mission believes that a growth rate of GDP of around 6-7 percent could be achieved in the medium- and long-terms. Given the fairly low rate of population growth, this would imply a fairly rapid increase of per capita GDP, from around $700 in 1971 to a level around $1,450 (in 1971 prices) in 1985 2/.

14.10 The pattern of structural change is unlikely to be different from past trends and from that found in cross-country investigations. The share of industry in output and employment may be expected to increase mainly at the expense of agriculture. With high levels of incomes and consumption the importance of tertiary activities may be expected to increase. Here, however, it may again be pointed out that the increase in non-agricultural employment in Yugoslavia has, to a much greater extent than other development countries, occurred in industry rather than in "spongy" service industries 3/.

14.11 Industry may be expected to continue to be the leading growth sector, given the dynamism of the industrial enterprises, the outward orientation in industrial development and the emphasis placed in national policy objectives on modernizing and increasing the efficiency of Yugoslav industry, partly by import of technology through joint ventures with Western firms. A major factor determining the rate of growth of the industrial sector would be the availability of funds for investments. This implies both an improvement in the savings performance of enterprises and in the intermediation of financial resources. Much will depend on a successful implementation of incomes policy which would leave more room for investment financing out of

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1/ This was the target growth rate in the Social Development Plan for 1966-70 as well as for the current plan (1971-75).

2/ The 1985 per capita GDP corresponding to a growth of 7.5 percent per year and of 6 percent per year would be about $1,600 and $1,350 respectively.

3/ See Chapter III, para 3.46.

enterprises' own resources. It would also allow the Federal government to relax somewhat monetary policy and credit restrictions without exacerbating inflationary pressures. A second important determinant of industrial growth would be the growth of export markets since domestic markets may be expected to grow rapidly with rising incomes. The recent increase in the number of joint ventures with foreign firms, the encouraging results for Yugoslavia of the system of generalized preferences for developing countries adopted by the EEC, and the active exploitation of market possibilities in the East Bloc and in developing countries, all appear to augur well for the future. However, foreign markets for particular industries (e.g. textiles) may be difficult to extend. Weaknesses in industrial planning and coordination which result in fragmentation and duplication of capacity and the existence of substantial idle capacity in some industries and regions have also tended to be an important constraint, on the progress of the industrial sector. The availability of skilled labor so far has not been a significant problem for Yugoslav industry. Regional and occupational imbalances are, however, a possibility particularly considering the practical elimination of the labor surplus in the more developed Republics e.g. Slovenia and Croatia, partly because of migration of workers abroad.

Savings and Resource Allocation

14.12 The high levels of past average and marginal savings rates seems to imply that the saving potential is quite high. Though there has been some erosion of the gross domestic saving rate since the Economic Reforms, the ratio of gross national savings to GNP has remained more or less stable at a very high level (averaging 28 percent of GNP during 1969-71). There is little reason to believe that this picture would change drastically in the medium-term, particularly since there has been a shift in economic policies designed to keep the growth rate of private and social consumption somewhat lower than the growth of output, and efforts have also been undertaken to increase the rate of enterprise savings out of their net income through incomes policy 1/. While it is important that the aggregate savings rate be stabilized in order that savings are not a constraint on rapid growth, it is even more important that the resources are intermediated efficiently to appropriate sectors and regions. Econometric projections using a Chenery-Strout gap model indicate that a stable gross domestic savings rate of around 26 percent of GDP (i.e. slightly above the level of 1971) is consistent with a growth rate of GDP of 7.5 percent per year 2/. The analysis, however, also indicates that if the savings rate is eroded gradually to around 20 percent, a GDP growth rate of even 6.5 percent is likely to be unfeasible in terms of the implied deficits in the current balance of payments and the levels of total external capital disbursements needed.

1/ An explicit objective of the 1965 Reform and the 1966-70 Social Development Plan was to raise the ratio of aggregate consumption to GDP. The current Social Development Plan aims at stabilizing and even slightly reducing this ratio.

2/ See Appendix III, "The Projection Model", discussion of the Base Run.

14.13 Improvements in resource allocation resulting in an acceleration of the growth of GDP given the rate of investment or alternatively implying that a given rate of growth may be achieved with a lower rate of investment are an important issue for policy. The distortions in resource allocation introduced by inflation, the low real interest rate, and the weakness in financial discipline, the effects of price controls on relative attractiveness of particular industries, as well as the bias towards capital intensity in the institutional framework have been pointed out 1/. Measures to tackle some of these problems are being undertaken and some progress is likely to be achieved. To the extent that this occurs the rate of growth may be closer to the official objective.

The Balance of Payments

14.14 The balance of payments situation is likely to continue to be an important factor influencing the rate of growth. There are a number of reasons for the mission's generally favorable prognosis of the long-run balance of payments prospects. We foresee a continued fairly rapid growth of export earnings, and a high rate of increase in tourism receipts and workers' remittances. The explosive growth of imports in the past few years is expected to be contained to more sustainable levels. Consequently, while the trade deficit is anticipated to grow the current account balance is expected to stabilize at quite acceptable levels.

Merchandise Exports

14.15 Merchandise exports may be expected to grow rapidly in line with past trends. Over the last two decades, Yugoslavia has successfully built up a strong export base that is founded on a wide variety of industries with well-established channels into Western and other markets. Industry's close association with leading Western firms through cooperation agreements, including licensing and marketing contracts, has assured its enterprises access to modern technologies, know-how and marketing. Yugoslav exports enjoy a favorable commodity structure with a relative large share of high demand elasticity products such as beef, wine and certain fruits and vegetables among agricultural products copper, lead, zinc among minerals and a wide range of engineering manufactures. Moreover, a large portion of its exports are sold in fast growing markets in the West, and the prospects for increasing exports to Eastern markets are good. Rapidly-rising domestic wages and prices may constitute a major threat to fast expanding exports. However, the flexible exchange rate approach followed in recent years is likely to continue to compensate the disadvantage Yugoslav exporters may have through higher inflation rates domestically than abroad.

14.16 The trend growth rates of merchandise exports by major export categories are shown in Table 14.1. It is evident that there has been in general a slowdown in export growth rates during 1965-71 in line with the

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1/ See Chapter IX and Chapter III, para 3.48.

slowdown in economic growth in that period. On the basis of these trends, combined with informal discussion and judgments about expansion of production, export market conditions, high and low projected growth rates for each export category are also shown 1/.

Table 14.1: EXPORT GROWTH RATES: PAST TRENDS AND FUTURE ASSUMPTIONS

	Trend Growth Rates /a		Projections			
			Low		High	
	1959-71	1965-71	1972-76	1977-88	1972-76	1977-88
Ferrous & Non-Ferrous Metals			11.4	11.6		
Ferrous	6.5	8.5	7.0	7.0	7.0	7.0
Non-Ferrous	12.2	15.2	12.0	12.0	14.0	12.0
Metal Products			12.4	10.6		
Metal Products	8.9	1.7	9.0	9.0	12.0	10.0
Ships	10.9	9.0	16.0	12.0	20.0	16.0
Electrical Equipment	12.1	7.4	15.0	11.0	18.0	14.0
Chemicals	20.7	9.1	12.0	8.0	12.0	8.0
Wood Products	3.4	1.9	6.0	6.0	8.0	8.0
Textiles			8.4	7.0		
Textiles	15.6	8.1	6.0	6.0	10.0	8.0
Leather & Rubber	17.4	12.0	12.0	8.0	12.0	8.0
Food Products	1.9	0.9	2.0	2.0	2.0	2.0
Other Goods	2.3	-2.2	2.0	2.0	2.0	2.0

/a In constant prices based on least squares, trend lines fitted to the data, using the expression $y = a (1 + r)^t$.

Tourism

14.17 Future prospects of tourism earnings depend essentially on the solution of internal constraints on the financing of hotel and infrastructure investments. External demand for tourism to Yugoslavia is not a bottleneck. The enactment of incentive legislation has been slow, and without new incentives and a quick solution to problems of domestic financing, not more than 40,000 beds seems likely to be added to present capacities between 1973 and 1976. Apart from increases in accommodation capacity future development of foreign exchange earnings from tourism depend, firstly, on Yugoslavia's

1/ Also see Appendix III on Projection Model.

success in increasing the average occupancy rate through reducing the seasonality, expanding the peak season over a large time period, and secondly on successful promotion of entertainment facilities etc. to increase average daily expenditure per tourist. If one would assume optimistically that encouragement of winter tourism would succeed in raising the average occupancy rate by 8 percentage points between 1972 and 1977, and if one furthermore expects an increase in the average daily expenditure of 10 percent per year - slightly below the annual growth rate during 1965-71 - foreign exchange earnings from tourism could rise at 20 percent per year. If one assumes, perhaps more realistically, a rise in the occupancy rate at only 3 percent per year to 39 percent in 1977 and an increase of the average daily expenditure by 5 percent per year from $14 to $19 per day in 1977, the annual growth of tourism earnings would be 14 percent per year. Thus the projections are very sensitive to assumptions concerning the occupancy rate and average daily expenditure.

Workers' Remittances

14.18 An accurate forecast of the volume of future workers' remittances in future years is not possible because of the complexity of the factors affecting them. However, it seems possible to predict within the scope of a fairly broad set of assumptions reasonable upper and lower expected limits. On this basis the predictions offer a fairly optimistic outlook for remittances as a major (possibly still the major) source of foreign exchange into the 1980's. Calculations based on relatively conservative assumptions regarding the behavior of factors affecting remittances suggest that the annual flow of remittances in 1980 are very unlikely to be much less than about $1.5 billion as a very low minimum even if no further migration were to occur. Nominal wage increases abroad of 8 percent per annum and slightly rising savings rates would be sufficient to sustain this figure. On the other hand, if the number of migrants abroad were to grow by 50,000 a year, this effect together with that of the wage increase will, according to our calculations, imply a remittance flow of about $2.5 million in 1980 (i.e., an increase of 15 percent per year). The actual development may be expected to be in this range.

14.19 Possibly the key factor in these speculations is the question of the rates of future migration. If for some reason which, at the present time of writing, would have to be quite unexpected, there was to be a large scale repatriation of Yugoslavs from Western Europe, then certainly the foundations for the above calculations would not hold. If this were to occur, however, it seems likely that many workers would bring with them at least some portion of their unremitted savings which, by the evidence of recent sample surveys, are equal to about twice the amount remitted each year. The foreign exchange effect of such a repatriation, therefore, could well be significantly greater than the normal remittance effect. To this extent, therefore, these considerations add yet further weight to the view that this part of the foreign exchange account is not likely to yield either to instability nor to a diminished importance through the current decade.

Imports

14.20 During the last decade, Yugoslavia became increasingly dependent on imports due to factors analyzed in Chapter XII. In summary, they include: Yugoslavia's drive toward efficiency, modernization and international competitiveness; its liberalization of the foreign exchange and trade regime and external borrowing; the priority given to manufacturing and processing, neglecting the development of raw material production thus creating an imbalanced production structure with increasing dependence on raw material imports; inflationary developments in the domestic market; tight domestic monetary policies encouraging enterprises to import on credit instead of buying on the domestic market; and finally a bias in the foreign exchange regime inducing enterprises to use their retention quota for unnecessary imports to be sold profitably in the domestic market. As a result the import elasticity increased from an average of about 1.7 during 1950-67 to 2.1 during 1967-71. The average import elasticity in recent years is too high for Yugoslavia to be able to sustain its official high target growth rate despite the favorable growth of foreign exchange earnings, because the levels of disbursements of external capital that would be implied do not appear feasible. Some decrease in the import dependency can be expected with efficient implementation of stabilization and incomes policy, and the increase in the domestic content of investment and exports with the recent emphasis on the development of raw material and semi-finished goods industries. However, it is unlikely that the import elasticity will decrease much below its long-run level.

Long-Run Projections and Their Implications

14.21 The inter-relationship and the consistency of the long-term growth prospects and employment, savings and balance of payments developments discussed above was examined with the help of an econometric projection model 1/. The analysis covered a range of alternative growth rates, a high and a low projection of export earnings growth, and the implications of a stable and declining savings rate. It confirmed that with a gross domestic savings rate slightly higher than recent years, a favorable export performance and an import elasticity significantly lower than in recent years, a GDP growth of 7.5 percent per year would be feasible, considering the implied levels of external capital disbursements and debt service ratios.

14.22 The projection exercise rests on certain assumptions about the composition of future gross capital inflows to Yugoslavia, based on recent trends and judgments. Official capital inflows are assumed to be around $300-400 million per year with maturity varying from 3 to 25 years 2/, and interest rates from 2-7.25 percent per year 3/. The remaining inflow is assumed to consist of financial and suppliers' credits on the following terms.

1/ For a detailed discussion of the structure of the model its assumptions and its implications see Appendix III.

2/ For the US Commodity Credit Corporation and the IBRD loans respectively.

3/ For the USSR and the IBRD loans respectively.

Type	Percent of Total	Terms: Maturity (years)	Terms: Grace (years)	Terms: Interest (%)
Non-Convertible	10.0	5	1	6.0
Convertible				
Short-Term	13.5	2	1	6.0
Medium-Term	66.6	5	1	6.0
Long-Term	9.9	12	1	6.0

The mix of suppliers' credits in the future is based on an analysis of past trends as well as likely future prospects based on discussions with officials of the Government of Yugoslavia.

14.23 The basic run of the model assumes a 7.5 percent growth rate for GDP, based on the growth assumptions of the recent development plan. This growth rate, plus an optimistic assumption for exports of goods and services results in the projections summarized in Table 14.2 below.

Table 14.2: SELECTED RESULTS OF BASE RUN
(constant prices)

	Average 1965-71	Actual 1971	Projected 1971-76	Projected 1971-80	Projected 1981-88
Growth Rates /a					
GDP	5.2	7.7	7.5	7.5	7.5
Investment	5.3	4.7	8.5	8.3	7.7
Consumption	6.9	10.1	7.0	7.3	7.1
Imports GNFS	13.3	12.1	10.3	10.5	9.6
Exports GNFS	8.0	9.5	11.4	12.5	10.7
Values of			1976	1980	1988
S/y /b (percent)	28.1	25.2	27.0	26.4	28.8
Marginal savings rate	.097	.030	.264	.247	.346
ICOR	6.3	3.9	4.0	4.1	4.2
Import elasticity	2.8	1.6	1.5	1.4	1.2
RG/Y /c (percent)	3.0	6.7	6.5	7.8	6.6

/a Past growth rates are least-squares trends.
/b Average savings rate, based on gross domestic savings.
/c Resource gap as a share of GDP.

14.24 The growth rate of 7.5 percent for GDP implies a slightly faster growth rate for investment, and as a result the incremental capital output ratio tends to rise slightly during the projection period, from 3.8 in 1972 to 4.1 by 1980, and 4.2 by 1988. While exports of goods and non-factor services grow at between 10-11 percent per annum, imports grow even faster causing a widening of the resource gap. The resource gap as a percent of GDP tends to rise from 5.2 percent in 1972 to 7.8 percent in 1980, but then declines gradually to 6.6 percent by 1988. The increased capital inflow necessary to cover the widening resource gap, permits the level of gross domestic savings to remain at about 26-27 percent of GDP during the period, despite the higher levels of investment required. Although the gap between imports and exports grows wider over time, its impact on the current account is largely offset by factor income flows (see Table 14.3). The deficit on current account is largely affected by other factor payments and transfers the chief items among these being interest on the external debt and transfers. As the growth of the resource gap slows down after 1980, the balance on current account eventually turns to a surplus by 1988.

Table 14.3: BALANCE OF PAYMENTS, CURRENT ACCOUNT: BASE RUN PROJECTIONS (current US$)

	1971	1976	1980	1988
Exports	2,835	5,791	9,882	29,292
Imports	3,743	7,251	12,538	34,461
Resource Gap	-908	-1,461	-2,656	-5,169
Workers' Remittances	650	1,412	2,535	5,944
Net Current Transfers	64	110	173	429
Net Investment Income	-26	-15	-24	46
Interest on Debt	-104	-190	-299	-554
Balance on Current Account	-324	-143	-270	697

14.25 Large inflows from foreign borrowings are still required despite the small current account deficit (Table 14.4). This is largely due to the heavy amortization payments due on existing debt, as well as the projected repayments on new obligations. By 1980, disbursements from foreign loans are projected to rise from about $900 million in 1971 to $1.8 billion, while amortization payments to rise from $.7 billion to $1.4 billion. While direct foreign investment levels off at $150 million, net export credits extended by Yugoslavia continue to grow as a result of an assumed growth of 12 percent per year in their gross disbursements. As workers' remittances largely offset the resource gap, future external borrowings are needed mainly to cover the payments of interest and amortization on the external debt.

Table 14.4: BALANCE OF PAYMENTS, CAPITAL ACCOUNT: BASE RUN
(current US$)

	1971	1976	1980	1988
Direct Foreign Investment	20	130	150	150
Net Export Credits	-16	-111	-111	-276
Loan Disbursement	857	1,283	1,849	2,754
Debt Amortization	504	-1,023	-1,381	-2,667
Reserve Change (- = increase)	49	-161	-261	-658

Even with the high amounts of external borrowings, debt service payments remain relatively small in relation to total foreign exchange earnings. The debt service ratio in fact declines from 20.2 percent of foreign earnings in 1972, to 13.3 percent in 1980, and 9.0 percent in 1988 (see Table 14.5).

Table 14.5: DEBT SERVICE RATIOS CONVERTIBLE AND NON-CONVERTIBLE AREAS: BASE RUN

	1972	1976	1980	1988
Debt Service Ratio: (percent)				
Convertible	25.2	19.7	15.8	11.1
Non-Convertible	4.6	8.0	6.5	3.6
Total	20.2	16.5	13.3	9.0

Alternative Runs

14.26 These results for the balance of payments projections are conditioned by somewhat optimistic assumptions about the growth of exports and workers' remittances. Alternative (more pessimistic) hypotheses for these two items produce markedly different results. In Variant A, workers' remittances are assumed to grow at a slower rate, and in Variant B, both workers' remittances and exports of goods grow at slower rates. Workers' remittances are assumed to grow at 13 percent per annum for the 1972-79 period, as opposed to 16 percent in the base run, and then decline to a growth rate of 7 percent by 1985, as compared to 10 percent in the base run. Exports of goods are assumed to grow at the lower ranges given in Table 12.1, which means an average growth rate of 8-9 percent for total exports, as compared with 10-11 percent in the base run. All other assumptions are held the same as the base run.

Table 14.6: BALANCE OF PAYMENTS SENSITIVITY RESULTS: ALTERNATIVE RUNS

	1976			1980		
	Base	A	B	Base	A	B
Resource Gap	-1461	-1461	-2110	-2656	-2656	-4590
Balance on Current Acct.	-143	-293	-999	-270	-821	-3080
Total Disbursements	1283	1477	2453	1849	2752	6662
Debt Service Ratio	16.5	17.5	23.8	13.3	17.2	38.4

14.27 A lower growth rate for workers' remittances (Variant A) has a major but not catastrophic effect on the balance of payments. In Variant B, however, the effects are much more marked. With both low export commodity growth rates and lower remittances, the deficit on current account jumps to $1.0 billion by 1976 and $3.1 billion by 1980 and the debt service ratio reaches 38 percent by 1980. This is an untenable position, not only because of the high debt service ratio, but also because of the implied level of disbursement of external capital of $6.7 billion a year. This amounts to 90 percent of projected fixed investment in that year and about 50 percent of total imports. Thus it seems clear, then, that the 7.5 percent growth rate assumption is incompatible with an assumed growth rate of exports of only 8-9 percent per annum.

14.28 To illustrate what would be a more feasible level of growth, given the more pessimistic assumptions about workers' remittances and exports, alternative rates of growth of GDP were analyzed. In Variant C, a 6.0 percent growth rate of GDP, when combined with the low workers' remittances - low export assumption produced a result similar to the Base Run. The balance on current account remains low, and in fact shows a small surplus by 1980. Total disbursements in that year would be about $1.0 billion, and the debt service ratio is 11 percent. It is evident that if the export assumptions of the Base Run prove too optimistic, a reduction in the growth rate will be necessitated by the inability to either borrow or absorb the large capital inflows necessary to sustain 7.5 percent growth. A reduction in the average growth rate of exports of goods and services of 1 percent appears to necessitate about a 1-percent reduction in the growth of GDP.

14.29 The validity of these projections depends upon the ability of Yugoslavia to maintain a fairly high, by world standards, savings rate. The model projects average gross domestic savings rate of about 27 percent for 1972-80. This is somewhat higher than the recent past which has seen a tendency for the gross domestic savings rate to decline. After reaching a peak of about 32 percent (calculated in constant prices) in 1966, the domestic savings rate has fallen to 25.2 percent in 1971. The average for the 1955-71 period is 27.4 percent, or close to the average for the projected period 1972-80.

14.30 The implications of a lower savings rate are illustrated in Variant D of the Base Run (Table 14.7). In this run, a savings gap approach was used in the projection exercise. A marginal savings rate of 20 percent was used

as an exogenous estimate of a lower savings performance, while all other assumptions of the Base Run were maintained. This has the effect of causing the average saving rate to fall from 24.8 percent in 1971 to 22.7 percent in 1980.

Table 14.7: SELECTED RESULTS OF VARIANT D
(lower savings performance)

	Actual	Projects		
	1971	1976	1980	1988
GDP - growth rate	7.7	7.5	7.5	7.5
S/Y	25.2	23.6	22.7	21.5
MSR	3.0	20.0	20.0	20.0
Import Elasticity	1.6	1.5	1.3	1.3
ICOR	3.9	4.0	4.1	4.1
Current Account Balance	-324	-916	-1722	-5594
Total Disbursement	857	2574	5048	17978

The lower savings performance with the same overall growth rate is compensated for by a higher level of imports. The balance on current account shows a $1.7 billion deficit in 1980 as compared to $300 million in the Base Run, and total external capital disbursements are $3.2 billion higher. Clearly, this is an unfeasible situation. Thus it is evident that even with an optimistic growth of exports and workers' remittances there must be an improvement in, or at least no deterioration of, saving performance in the future, if a 7.5 percent growth rate of GDP is to be sustained.

14.31 In conclusion, the projection exercise essentially demonstrates that while a rapid growth rate is attainable it depends upon a continuation of high export earnings and the stabilization, and perhaps slight reversal of the trend towards lower gross domestic savings. Considering the uncertainty regarding export earnings in the future, in particular the rather uncertain nature of workers' remittances, and the institutional problems concerned with savings mobilization, it appears quite possible that the target GDP growth rate 7.5 percent per year will not be attained. However, the lower limit of GDP growth of about 6 percent per year set out in the current Social Development Plan appears to be attainable even under pessimistic assumption of the growth of export earnings and workers' remittances.

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