PROGRAM PERFORMANCE AUDIT REPORT

YUGOSLAVIA

STRUCTURAL ADJUSTMENT LOAN
(LOAN 2326-YU)

September 29, 1987
LIST OF COMMON ABBREVIATIONS

EDF - Export Development Fund
LTPES - Long-Term Program for Economic Stabilization
SAL - Structural Adjustment Loan
UBB - Udružena Beogradska Banka
YBA - Yugoslav Banking Association
YBIEC - Yugoslavia Bank for International Economic Corporation (YUBMES)

CURRENCY EQUIVALENT

1982 Average - US$1 = 50.28 dinars
1983 Average - US$1 = 92.84 dinars
1984 Average - US$1 = 152.82 dinars
1985 Average - US$1 = 270.16 dinars
1986 Average - US$1 = 379.22 dinars
December 1986 - US$1 = 453.10 dinars
March 1987 - US$1 = 532.48 dinars
September 29, 1987

MEMORANDUM TO THE EXECUTIVE DIRECTORS AND THE PRESIDENT

SUBJECT: Project Performance Audit Report on Yugoslavia - Structural Adjustment Loan (Loan 2326-YU)

Attached, for information, is a copy of a report entitled "Project Performance Audit Report on Yugoslavia - Structural Adjustment Loan (Loan 2326-YU)" prepared by the Operations Evaluation Department.
PROGRAM PERFORMANCE AUDIT REPORT

YUGOSLAVIA

STRUCTURAL ADJUSTMENT LOAN
(LOAN 2326-YU)

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PROGRAM PERFORMANCE AUDIT REPORT

YUGOSLAVIA

STRUCTURAL ADJUSTMENT LOAN
(LOAN 2326-YU)

PREFACE

This is a performance audit of the Bank's structural adjustment loan (SAL) provided to Yugoslavia for the amount of US$275 million. The loan (Loan No. 2326-YU) was approved on June 28, 1983, was signed on July 7, 1983 and was fully disbursed in July 1985. The loan was made to the Udruzena Beogradska Banka with the guarantee of the Yugoslav Government.

The Program Performance Audit Report (PPAR) consists of a Program Performance Audit Memorandum (PPAM) prepared by the Operations Evaluation Department and a Project Completion report (PCR) prepared by the Bank's operational staff. The PPAM is based on a review of the President's Report, the Loan Agreement, the summary of Board discussion, the project files, economic and sector reports and special studies, and interviews with Bank staff. An OED mission visited Yugoslavia in October-November 1986 to interview Government officials and to receive additional information. The kind cooperation and assistance of the authorities is gratefully acknowledged.

The PCR provides a satisfactory review of the policy content of the loan, the various conditions which were agreed upon by the Bank and the Yugoslav Government, and the extent of compliance. The PPAM focuses on the factors which influenced the design and content of the policy package, the procedures for processing the loan within the Bank, and provides a brief description of the political and institutional structure of the country which influenced implementation. It also provides additional information on the performance of the mechanism for resource transfer which involved the establishment of an Export Development Fund by the borrowing agency.

Comments received from the Federal Secretariat of Finance and Udruzena Beogradska Banka on an early draft of this report are reproduced as Attachments I and II to this report. These comments have been taken into account in the PPAM.
PROGRAM PERFORMANCE AUDIT REPORT

YUGOSLAVIA

STRUCTURAL ADJUSTMENT LOAN
(LOAN 2326-YU)

BASIC DATA SHEET

LOAN STATUS
(Amounts in US$ million)

| Loan 2326-YU | 275.0 | 275.0 | - | 11.5 | 396.7 /a |

CUMULATIVE LOAN DISBURSEMENT

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<td>(iii) (ii) as % of (i)</td>
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OTHER LOAN DATA

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/a Includes 133.1 exchange adjustment.
/b Includes total staff weeks devoted to SAL based on the Time Recording System.
PROGRAM PERFORMANCE AUDIT REPORT

YUGOSLAVIA

STRUCTURAL ADJUSTMENT LOAN

(LOAN 2326-YU)

EVALUATION SUMMARY

Introduction

In the period following World War II through the mid-1970s, Yugoslavia experienced a remarkable economic expansion. Accompanied by a sharp decline in the rate of growth of population, per capita income more than tripled, absolute poverty was eradicated and a predominantly agrarian society was transformed into a modern diversified economy. These developments took place within, and were influenced by, the unique political and institutional framework which was undergoing continuous evolution. (PPAM, paras. 1 and 2).

A socialist economy, Yugoslavia in 1965 abandoned rigid central planning and the orientation shifted toward decentralization of domestic economic decision-making with greater integration into the world economy. Self-managed enterprises and the banks which they controlled became the primary decision makers and many responsibilities of the federal government were transferred to the six independent republics and two autonomous provinces which comprise the Socialist Federal Republic of Yugoslavia (SFRY). A new constitution adopted in 1974 increased the extent of decentralization. The republican structure has long historic roots reflecting cultural, religious and social differences among the populations in the various regions of the country. Moreover, the republics are characterized by significant variations in economic characteristics, the area of the more developed north having per capita income levels substantially above those prevailing in the less developed south (PPAM, paras. 1-4).

The Economic Crisis and the Preparation of the SAL

During the 1970s, Yugoslavia experienced sharp cyclical fluctuations in economic activity. At the end of the decade, it was confronted by serious domestic financial and external imbalances and there was growing realization that a major reorientation of macroeconomic policies was required to deal with the situation deriving from the changed external environment and internal stresses; critical reforms were needed to correct the distorted set of incentives facing economic agents. A comprehensive stabilization program was initiated in 1979 which, after May 1980, was supported by an IMF-standby agreement. Some improvement in the external balance was subsequently achieved but the adjustment process was made more
complex by adverse developments in international capital markets during 1982
and emerging liquidity problems in major Yugoslav banks (PPAM, paras. 8-10;
PCR, paras. 4-7).

At the end of 1982, an attempt was made to put together an
international financial rescue package, the IMF helping to coordinate the
efforts of the private commercial banks while several OECD countries
assembled official commodity, export and financial credits. To round out a
package expected to amount to about US$6 billion, the desirability of Bank
participation was indicated. In December 1982, after consultation with the
Bank, the Yugoslav Government formally requested that consideration be given
to the preparation of a SAL (PPAM, paras. 10-14).

Earlier during 1981, the Yugoslav Government had organized a high
level body of policy makers and academics, a Commission on Economic
Stabilization, to formulate an adequate stabilization program and to frame an
appropriate medium term development program which would entail significant
policy reforms. At the same time the Bank had intensified its own economic
work program in the country, preparing a major economic study, and a close
working relationship was developed with the members of the Commission. The
Bank's report, providing a comprehensive analysis of macroeconomic
developments and of the structural imbalances, represented a merging of views
on the major elements underlying the crisis. The Commission in 1982 issued a
series of working papers and presented its conclusions in the Long-Term
Program for Economic Stabilization (LTPES) issued in 1983 (PPAM, paras.
11-13).

In the early stages of review of the Government's request, some
consideration was given to a more limited sectoral adjustment program, given
a perceived ambivalent attitude in the Board regarding the content of SALs.
However, in an apparent attempt to provide support to the Stabilization
Commission which was proposing major structural reforms, as well as to
impress upon the participants in the rescue package the seriousness of the
Yugoslav effort, a broad based SAL program was drafted, embracing critical
macroeconomic aspects as well as sectoral issues. Given the economic work
already completed by the Bank and the on-going dialogue with the
Stabilization Commission in Yugoslavia, the Bank was able to proceed rapidly
in the processing of the loan for US$275 million which was presented to the
Board in June 1983. (PPAM, paras. 15-20).

As outlined in the Letter of Development Policy submitted by the
Federal Secretary of Finance, the action program under the SAL focussed on
three principal areas: (a) investment planning and resource allocation; (b)
foreign exchange allocation and external trade policies; and (c) price
policies and enterprise decision-making. The actions defined in each area
ranged from the formulation of specific policy measures to the preparation of
studies or reports which could serve to determine the future orientation of
work. The loan would be tranched, US$175 million becoming available on the
date of effectiveness and the balance to be made available subject to the
Bank being satisfied, after an exchange of views with the Government, with
the progress being made in the execution of the program; it was expected that
this would occur three to four months after effectiveness (PPAM, paras. 22-29; PCR, Annex I).

In the preparation stage, the Bank did not focus on the mechanism for resource transfer which in most other SALs had financed a defined set of imported commodities. The Government had indicated that at least some part of the resources would be used to set up on a revolving basis an Export Development Fund (EDF) to provide short-term foreign currency financing for the imported input requirements of exporting enterprises; similar mechanisms were to be established to utilize some of the bilateral suppliers' credits being made available within the financial rescue package. At the concluding meeting of the Bank's appraisal mission, the Government indicated its decision to use the entire proceeds of the SAL for an EDF (PPAM, paras. 31 and 32).

Implementation Experience

Macroeconomic Performance. The external balance in 1983 continued to show some improvement, largely due to a decrease in imports as well as some increase in exports to convertible currency areas. Domestic demand fell, particularly investment, and total GDP declined slightly; nevertheless inflation continued unabated. In 1984 economic performance was essentially unchanged; the short-term stabilization efforts appeared to have eased the external imbalance but output remained stagnant and inflation accelerated. In 1985, some of the constraints on domestic demand were eased and there was a revival in domestic activity; however, the current account surplus with the convertible currency areas was reduced and the inflation rate continued unchecked. The growth rate of the economy in 1986 was the highest in several years but it was accompanied by accelerated inflation and a deterioration in the external balance. At the beginning of 1987, the country once again faced serious external and internal imbalances (PPAM, paras. 33-35).

Operations of the EDF. In accordance with the institutional characteristics of the banking system and of Yugoslavia's operations with the Bank, the Yugoslav Banking Association chose the Udrezena Beogradska Banka (UBB), one of two associated banks in the Republic of Serbia, to operate the EDF and it became the borrower with the guarantee of the Federal Government.

After an initial period of low level of applications, the pace of commitments accelerated rapidly and the Bank's funds were fully disbursed in two years, by August 1985. By the end of October 1986, total approvals amounted to US$660 million, roughly two and one-half times the original funding. Assuming an import content of one-third, EDF funds resulted in some US$2 billion in exports. It is not possible to determine the extent of "additional" exports but interviews with a sample of EDF clients indicated that their trade was, at the least, facilitated by the existence of the fund, given the complexity of the administrative regulations governing imports and foreign exchange allocation at the time and the untied nature of Bank finance. In spite of efforts made to achieve country-wide distribution, some 60% of the funds were used by enterprises in the Republic of Serbia which accounts for some 20% of exports to the convertible currency areas. The
performance of EDF compares favorably with that of the various funds set up under bilateral official suppliers' credits. None were fully utilized and almost one-third of the total resources available was cancelled by the end of 1985; a major factor in the lower rate of utilization was the tied nature of these credits.

In the course of 1986, EDF experienced a decline in demand for its funds and began to accumulate unutilized balances. EDF funds, available at a spread above the Bank's lending rate, were no longer competitive with commercial bank short-term credits (in foreign exchange) based on LIBOR. In addition, it appears that the prevailing allocation system was making available adequate foreign exchange to established exporters; to the extent that these enterprises required credit for the dinars to purchase that exchange, prevailing domestic interest rates were also favorable. However, at the beginning of 1987, there was a recovery in demand for EDF funds; it appears likely that increases in domestic interest rates, the persistent foreign exchange shortage and the untied nature of the resources all encouraged renewed use of the Fund.

EDF now faces a serious problem due to the recent weakening of the US dollar. Under the currency pool arrangements for disbursing Bank loans, the dollar value of UBB's obligations to the Bank in January 1987 was about 45% above the nominal value. As a consequence, UBB's interest and loan repayments at that time were about 45% more in dollar terms than originally expected (PPAM, paras. 37-46).

Compliance with SAL Conditionality. The SAL contained 24 monitorable conditions, including the establishment of the EDF. The review in mid-1986, in connection with the preparation of the PCR, indicated that six conditions had been implemented more or less as originally defined, 11 partially met and the remainder largely not implemented (PCR, paras. 13-33 and Table 2). Details are given below.

Assessing the Impact of the SAL and Main Lessons Learned

The Adjustment Process. In its broadest sense, the SAL has failed to achieve its objectives. The recent poor macroeconomic performance reflects in great part the regression which has occurred as regards the commitment to achieve a more open and market-oriented economy; the regression underlies the limited adherence of the Yugoslav authorities with the action program. While the short-term stabilization efforts and import controls reduced for a time external deficits, inadequate progress in achieving the necessary structural reforms leaves the country once more facing serious internal and external imbalances.

Lack of progress in moving towards positive real lending rates and in establishing an adequately functioning foreign exchange market, as well as the persistence of import controls, remain the principal concerns. The permissive monetary management leading to record inflation, the limited success in imposing financial discipline, has reduced the possibility of taking corrective actions in the first two areas at the present time (PPAM, paras. 47-50).
Nevertheless, significant institutional changes supported by the SAL have begun to take root, albeit at a slower pace than expected. A key element is the growing acceptance of a project evaluation methodology focusing on economic rates of return. When properly applied in investment decisions, the methodology can help avoid the selection of uneconomic projects. The recent law on social planning is designed to promote an inter-republican approach to investment in several infrastructure fields to avoid duplication of facilities.

To develop financial discipline, additional measures have been taken to strengthen bankruptcy laws, to restrain banks from maintaining support to bankrupt firms, and to establish accounting standards to ensure realistic evaluations of the financial positions of enterprises. These reforms represent important constraints on the behavior of enterprises as well as the banks.

Important advances had also been made in the area of price liberalization but changes continue to occur. The 1987 economic program contained measures reflecting a more positive attitude towards use of the price mechanism to achieve allocative efficiency than prevailing in previous legislation. However, in February 1987, measures were taken to limit price increases as well as wage increases.

As regards sectoral issues, in some instances (e.g. agriculture, energy and transport) the monitorable conditions largely pursued policy matters which had emerged in the implementation of ongoing projects or in the preparation of projects in the pipeline; compliance was generally satisfactory and related conditions were incorporated into the respective projects. However, in the case of the industrial sector, the Bank had had limited exposure and the studies to be undertaken within the action program were essentially designed to deepen its knowledge of different manufacturing activities with a view towards possible project financing. It proved possible to organize only one (for textiles) of the five or six study groups expected and that with considerable delay. Many factors contributed to this result, including the reluctance of firms to submit to review by external groups and the complex institutional characteristics of the subsectoral organizations (PPAM, paras. 50-57).

Main Lessons Learned. With hindsight, the content of the Yugoslav SAL, the 24 monitorable conditions, was overly ambitious and unnecessarily complex. The issues on which attention was focused covered not only the principal macroeconomic areas but also a number of sectoral problems which might have been more effectively dealt with separately. It included a number of conditions which had limited operational content while, in several other instances, the Bank had not been adequately prepared in formulating the provisions and difficulties were encountered in implementation (PPAM, para. 72).

Nevertheless, the question may be raised whether, even if the quality of the product delivered by the Bank had been improved, would it have been any more effective in achieving the desired results. There is little
doubt that at the end of 1982 the need for major reforms was recognized and advocated by many individuals within the technical circles of the Government and the academic community. Unfortunately, however, the Yugoslav authorities involved in elaborating the SAL program with the Bank, as well as the Bank staff, underestimated the political difficulties in implementing the main elements of the reforms proposed (PPAM, paras. 69 and 70).

Each of the administrations which has been in office since the SAL was initiated has also recognized the need for basic economic policy changes. To elaborate and implement the necessary measures requires a set of political compromises; all macroeconomic reforms involve some element of compromise among the various domestic political forces. The Yugoslav situation is unique because of the extent to which these political aspects have been institutionalized. As a consequence, it can be expected that the pace of reforms which are needed to improve economic performance will be slow and the record has been one of irregular progress. By their nature these compromises can only be reached through highly visible and open transactions among the parties concerned. It is not unreasonable to ask whether the process has been helped or hindered by the appearance of external intervention.

SAL programs seek to provide solutions to medium term development problems and are complementary to stabilization programs, for example those supported by the IMF. One characteristic of this SAL was that the resources made available, at least for the first of what was considered to be a series of operations, were deemed necessary to fill out a large financial assistance package designed to meet immediate needs. Had this pressure to complete the operation quickly not existed, and had some other lending form been available to effect the resource transfer, the complexity of the political situation might have been explored in more detail and a more realistic assessment could have been made of the prospects (PPAM, paras. 78-80).

The adjustment process in Yugoslavia has not ended and it is likely that the pace will continue to be at a speed slower than originally expected. Moreover, it now appears likely that there will be need for additional resource transfers to the country in the immediate future, an area in which the Bank could provide additional support. With hindsight, Yugoslavia at the time was not an appropriate candidate for a SAL; while the need for adjustment was widely accepted the process was likely to require considerable time for implementation given the political complexity. Is there a basis for considering non-project lending to Yugoslavia in the future? The lessons from this experience suggest that, at the least, it would have to be substantially front-loaded (PPAM, para. 82).

Other lessons relate to the possible inclusion of sectoral conditions in a SAL. Where there has been previous accumulation of knowledge through earlier projects, links between SAL conditionality and on-going operations can be beneficial. On the other hand, it does not appear desirable for the Bank to use SALs as a means of promoting projects where it has not already accumulated a substantial background of work (PPAM, paras. 75-77).
Impact of the EDF. During this period, the EDF has fulfilled its objectives. After some decline in demand for its funds in the course of 1986, the rate of loan approvals increased again at the beginning of 1987, reflecting essentially the impact of a number of the policy adjustments made at that time. However, it is likely that the demand for these resources will be volatile. There remain problems in competing with commercial credit which is available at more favorable rates. EDF is lending long-term resources (from the Bank) for short-term purposes; at the time of establishment, long term rates in international markets were lower than those for short term and that situation, not the normal pattern, has now been reversed. A return to more normal conditions in the foreign exchange and domestic credit markets in Yugoslavia could lead once again to a shift away from the fund. Consideration should therefore be given to other uses for unutilized balances, including the possibility of fixed asset financing (PPAM, paras. 83-86).

The changes in currency parities, most recently the weakening of the dollar, affect all of the Bank's borrowers and the Bank has been reviewing its procedures to determine if there are ways it can assist its clients, as well as to increase its efforts at familiarizing borrowers with the workings of the system and measures to minimize risks. It is also important that governments themselves review the situation, particularly in cases such as Yugoslavia where borrowers are many different institutions or banks (PPAM, para. 61).

The use of the EDF as the mechanism for resource transfer was rather unique in a SAL and gave the operation project content, since the Bank in a number of countries has directly supported such institutions with "free-standing" projects. Some of the lessons relevant to this type of operation are summarized in the PPAM, paras. 87-90. The experience in this instance also indicates the importance of focussing on the mechanism of resource transfer as early as possible in the preparation of a SAL (PPAM, para. 91).
During the 1960s and 1970s, Yugoslavia experienced an impressive record of economic development, the rate of GNP growth in the latter decade averaging about 7 percent. At the same time there was a significant reduction in the population growth rate from 1.7 percent in 1950 to 0.9 percent at the end of the 1970s; as a consequence, real per capita incomes more than tripled between the mid-1950s and the beginning of the 1980s and absolute poverty was eradicated. From a predominately agrarian society, Yugoslavia was transformed into a modern diversified economy, the share of agriculture in GDP declining from 36 to 14 percent between the mid-1950s and the end of the 1970s.

The political and institutional structures of the country are rather unique and the changes and modifications introduced during the years of rapid growth played important roles in generating that growth as well as in the subsequent period of crises and stagnation. A socialist economy, Yugoslavia in 1965 abandoned rigid central planning and the orientation shifted toward decentralization of domestic economic decision-making with greater integration into the world economy. An increasing role was assigned to market forces in determining prices and resource allocation. Self-managed enterprises and the banks which they controlled became the primary decision makers and many responsibilities of the federal government were transferred to the six independent republics which (along with two autonomous provinces) comprise the Socialist Federal Republic of Yugoslavia (SFRY). The set of instruments used at micro levels became part of a system of macroeconomic management enabling the participation of all economic agents in the formulation of major economic policies.

In 1974, a new constitution was adopted which greatly increased the scope of the workers' self-management system in the formulation and implementation of economic policy. Moreover, steps were taken for further devolution of powers to the regional bodies within the republican framework.

The republican structure has long historic roots reflecting cultural, religious and social differences among the populations in the various regions of the country. At the same time, the republics are characterized by rather sharp variations in economic characteristics, particularly per capita income levels; for example, the ratio between per capita GNP in the Republic of Slovenia, the most developed region bordering on Italy and Austria, to that of Kosovo, the least developed autonomous province in the south, was estimated at six to one in the 1970s. These regions are equally represented in the federal legislative system.
5. In line with the general expansion of Bank lending in the years since the late 1960s, Yugoslavia’s borrowing from the Bank, which cumulatively had amounted to US$377 million at the end of FY69, increased rapidly; in the four-year period from FY70 to FY73, a total of US$374 million was lent, virtually the same as in the previous two decades. During the subsequent four-year period, FY74 to FY77, Bank operations amounted to over US$200 million per annum and during the period FY78 through FY82 the average reached about US$335 million per annum. As a consequence, the country became one of the largest clients of the Bank, representing slightly less than five percent of the total portfolio throughout this period.

6. In view of the unique economic and political decision-making structure of the country, and particularly the disparities in incomes among the republics, the Bank focussed much of its lending, as well as its economic and sector work, on channelling resources to the less developed regions which lie predominantly in the southern part of the country. For example, in the second half of the 1970s about two-thirds of lending was targeted to that area. At the same time, in several sectors, notably transport and power generation, the regional objective was combined with institutional development and sectoral coordination objectives, seeking an inter-republican approach to investment in those fields to benefit from economies of scale and to avoid duplication of investment in necessary facilities.

7. Bank economic and sector work dealt largely with analyzing the implications of the particular set of political and economic institutions. While these analyses pointed up the need for modifications in macroeconomic policy, the limited authority of the Federal Government in the economic area tended to reduce the possibilities for a systematic macroeconomic policy dialogue particularly after the 1974 constitutional changes. Two major studies were prepared by the Bank in the 1970s dealing with the self-management system of enterprise control and the republican nature of the political system;1/ these studies were given wide distribution, designed to promote within the international community a better understanding of how the systems functioned. These efforts were closely linked to the lending program which sought to develop through a number of projects financing arrangements with external official and private financial institutions, and, in more general terms, to increase Yugoslavia’s access to international capital markets. Considerable success was achieved in this respect.

II. THE ECONOMIC CRISIS AND THE PREPARATION OF THE SAL

A. The Emergence of the Macroeconomic Imbalances

8. The decade of the 1970s was characterized by sharp cyclical variations in economic performance. The previous period of expansion and of basic structural transformation had occurred in the context of high world economies. 

economic growth; the movement towards opening the Yugoslav economy had permitted it to take advantage of that development.\(^2\)/ With the loss of dynamism in the external environment following the first oil price shock at the end of 1973, structural imbalances which had emerged during the period of growth but which had not impinged on that growth began to have adverse impact on the performance of the economy. At the same time internal adjustments were required to accommodate the changes which had occurred in the world economy. An adjustment strategy was proposed in the 1976-1980 economic plan but it was not until the end of the decade that the course of economic events began to indicate the need for a substantial reorientation of macroeconomic policies. Major reforms were needed to correct the distorted set of incentives facing economic agents (see PCR, paras. 4-7). Pervasive price controls, fixed interest rates (largely negative in real terms) for both borrowers and lenders, lack of financial discipline among the self-managed enterprises and the banks they controlled, a highly protected domestic industry, and foreign exchange controls all imposed severe constraints on the proper functioning of product, capital and currency markets.

9. In 1979, an overheated domestic economy with domestic inflationary tendencies exacerbated by the second oil price shock, an earthquake affecting tourism receipts and poor agricultural conditions led to a current account deficit of US$3.7 billion, around 6 percent of GDP. A comprehensive stabilization program was initiated, supported after May 1980 by an IMF stand-by agreement; this resulted in a reduced external deficit in 1980 and a further reduction in 1981, the latter attributable to both an expansion in exports and reduction in imports. However, in 1982, export volume declined but the deficit was again reduced mainly through a very sharp curtailment of imports which had an adverse impact on output and employment.

10. Attempts at formulating adjustment efforts were complicated by adverse developments in the international capital market in 1982 and, at the same time, some Yugoslav banks also faced serious liquidity crises. These events led to sharply higher interest payments on the outstanding debt, as well as difficulties in obtaining both roll-overs of maturing loans (particularly short-term) and new credits needed to meet the country's liquidity needs. With the aid of the IMF, meetings were held with the major creditor banks to arrange continuing financial assistance while, simultaneously, a number of OECD countries assembled an aid package of commodity, export and financial credits to be made available in 1983 and 1984. As noted in the President's Report for the SAL,\(^3\)/ representatives of the OECD countries and the commercial banks indicated that a World Bank contribution would be a

\(^2\)/ Thus, the share of exports of goods and services in GDP rose from 7.3% in 1960 to 19.3% in 1970 while the share of Yugoslavia in the total exports of non-oil developing countries rose from 2.1% to 3.5% in the same period, reflecting a fourfold increase in the value of the country's exports.

desirable element in the major financial programs being organized which were expected to total in excess of US$6 billion.

11. The macroeconomic difficulties which had begun to emerge in the late 1970s had led the Bank to increase its attention to these issues, a tendency which was in line with the general policy being pursued at the time to devote more of the Bank's staff resources to such work. A report dealing with export performance and policies was issued in 1980 and in June 1981 a major economic mission visited Yugoslavia. The report of this mission, entitled Yugoslavia: Adjustment Policies and Development Perspectives (Report No. 3954-YU), was issued in November 1982; a draft had been discussed with the Government in June 1982.

12. The work of this mission coincided with the strong efforts being undertaken by the Yugoslav Government to analyze the origins of its economic difficulties, to formulate an adequate stabilization program and to frame an appropriate medium term development program. A high-level body of Yugoslav policy makers and academics, known as the Commission on Economic Stabilization, was formed in the second half of 1981 and during 1982 it issued a series of working papers. The Bank's economic staff maintained close working relationship with members of the Commission in the development of its work and the Bank's report was able to reflect a merging of views on major elements underlying the crisis.

13. The 1982 economic report thus provided a comprehensive analysis of macroeconomic developments, in particular the structural imbalances in the external sector reflecting inadequate encouragement to export activity, an excessive rate of investment characterized by serious misallocation of resources, and the deep-rooted lack of financial discipline among enterprises and the banking system, also contributing to the poor resource allocation. In addition, it provided indications of the basic distortions in sectoral structures.

14. In December 1982, the Yugoslav Government formally requested the Bank to consider a structural adjustment loan and urged that, in the context of the international financial assistance program then being assembled, every effort be made to finalize the loan before the end of the Bank's fiscal year. Given the extent of the knowledge which the Bank had accumulated on the economic crisis, a preappraisal mission was quickly mobilized in January-February 1983 to develop the main principles of the adjustment program to be supported and an appraisal mission was in the field in March to work out in more detail the program.

B. Designing the SAL

15. Prior to the 1982-83 crisis, consideration had been given within the Bank to the possibility of developing such a loan (or a series of loans) for Yugoslavia. It was recognized from the outset that the nature of the country's political and economic institutions which were seen as integral to the problems in turn made it extremely difficult to generate the consensus and commitment which were essential to the design of such a program. The
extensive work which the Bank had undertaken in 1979 and 1980 with regard to export performance suggested at the time that a limited or sectoral approach to non-project lending might be readily acceptable. At the time, the Government had not indicated interest in non-project lending and, with a relatively strong project pipeline, this was not pursued.

16. At the end of 1982, after consultations with the Bank, the Government formally requested a SAL; at the same time, the participants in the official and private financial packages indicated their desire to obtain a contribution from the Bank. It was possible, as noted above, to move quickly to set out the major issues which would be dealt with in the context of the SAL program. Following the analysis of the 1982 economic report, three main areas emerged both from the point of view of meeting stabilization needs, as well as for promoting medium-term development efforts. These were: (a) investment planning and resource allocation; (b) foreign exchange allocation and external trade policies; and (c) price policies and enterprise decision making. These were, moreover, the major policy areas which the Stabilization Commission had itself focused on and where its own conclusions, formalized in the Long-Term Program for Economic Stabilization (LTPES) issued in the second half of 1983, provided a framework as to content and timing of the policy reforms. Given the economic analysis which it had undertaken, the Bank could also provide important details to assist in implementation in selected areas.

17. At an early stage of discussion of possible assistance from the Bank, the question of a limited sectoral approach was again raised, given that much of the suggested program might be elaborated within such a framework. In part this consideration was motivated by what appeared to be at the time an ambivalent attitude of the Bank's Board to the concept and scope of SALs. Although more than 15 SALs had been approved by the end of 1982, on the occasion of each Board approval there had been considerable discussion on the diversity of the content covering such matters as the scope of policy reforms, the degree of conditionality and timing. Within the Bank efforts had been made to establish criteria for these types of operations but, given the very nature of the issues to be dealt with, these tended to be general and subject to varied interpretation.4/

18. After some discussion and consultation with the Yugoslav authorities, the decision was made to proceed with elaborating a SAL program. In part this appears to have been motivated by the desire to lend support to the far-reaching effort being undertaken by the Stabilization Commission which was involved in proposing major structural reforms in the country and to strengthen its hands in the domestic decision-making. In addition, it appeared useful to highlight the reform program to the other participants in the international financial package. There was, moreover, the possibility of

4/ Some of these problems are explored in the recent report of the OED entitled Structural Adjustment Lending - A First Review of Experience, Report No. 6409, dated September 29, 1986, particularly Chapter 1.
developing a much stronger and longer lasting policy dialogue between the Bank and the Yugoslav authorities, particularly since the SAL process was generally expected to involve a series of loans. Moreover, in an environment of limited experience with SAL lending and the uncertainty as to precise scope, a broad approach to the design of the Yugoslav SAL was adopted, embracing sectoral problems as well as macroeconomic areas.

19. The action program as regards macroeconomic areas to be included in the first SAL operation could be based upon the initiatives of the Stabilization Commission, including the measures already taken in such matters as curtailment of investment and more rational investment decision-making, interest rate policy, exchange rate valuation and export promotion. Further measures were proposed by the Bank and accepted by Yugoslav authorities in these areas in the light of the recommendations of the 1982 economic report, as well as of the 1980 export promotion study.

20. As regards sectoral problems, in a number of sectors, such as transport, agriculture and energy, Bank project work had already identified key issues and appropriate measures or studies were underway in the context of ongoing operations or in the preparation of projects in the pipeline; these were considered to be complementary to the measures being proposed at the macro-economic level. Thus, the specific components contained in the SAL largely reinforced the understandings already reached in the ongoing project work.

21. On the other hand, in the case of the industrial sector which, by its size, had to be considered a priority, there had been limited involvement of the Bank, mainly for DFC-related lending to medium and small-scale industries in the less developed republics and provinces. Since interest rate policy was of concern in those instances, there had been some attempts to deal with the Government's overall approach to lending rates. While industrial development problems had been analyzed in broad sectoral terms in earlier Bank economic reports, the structural characteristics of the sector, particularly of large-scale industries, had not been examined in detail. As a consequence there was interest in using the opportunity provided by the SAL to explore some of those issues and to deepen the Bank's knowledge of the characteristics of Yugoslav industry. In this case, therefore, the need to build up the Bank's knowledge led to the elaboration of a new program of studies for inclusion under the SAL. The specific elements of these studies were presented to the Government on the grounds of their relevance to the issue and to the medium term development needs of the country, given the importance of industrial activities in the economy, and of the possibility of identifying and preparing future projects for Bank lending.

C. Main Elements in the Action Program

22. The main elements of the action program agreed upon were outlined in the Letter of Development Policy (LDP) submitted to the Bank by the Federal Secretary of Finance, reproduced as an annex to the PCR. The letter spelled out the measures which had already been taken as well as those proposed within the specified time frame. As noted in para. 16, three areas
were highlighted: (a) investment planning and resource allocation; (b) foreign exchange allocation and external trade policies; and (c) price policies and enterprise decision-making.

23. Actions were defined in each of these areas, ranging from the formulation of specific policies to the preparation of studies or reports which could serve to determine the future orientation of work. The loan was tranched, US$175 million becoming available on the date of effectiveness. The second tranche, the remaining US$100 million, was to be made available subject to the Bank being satisfied, after an exchange of views with the Government, with the progress being made in the execution of the program; this was expected to take place about October 1983.

24. Policy actions in the area of resource allocation included an agreement to reach positive real interest rates for lending intermediated funds within two, three or five years depending upon sectoral priorities through gradual increases in minimum nominal lending rates. As a further means for improving resource allocation, it was agreed that a Social Compact on Uniform Investment Criteria would be formulated with the participation of the key institutions involved in investment decision-making. These criteria would be based on economic rates of return principles developed by the Bank in its methodology for project evaluation.

25. As regards price policies, the Government indicated its intention over the medium term to increase the proportion of commodities whose prices would not be subject to control or review by the Federal Price Agency. In the case of certain energy related items, it was agreed to formulate a long-term policy to achieve parity with economic prices over a period of four to six years.

26. Measures to strengthen the legal framework for enforcing financial discipline within enterprises and the banking system were also set forth with action to be taken in the course of 1983. In addition, the Government was to initiate a program to limit payments from common reserve funds which had been used to cover the operating losses of enterprises.

27. As regards the operation of the foreign exchange market, note was taken of the commitment made to maintain a competitive exchange rate as part of the IMF standby. A study of the existing foreign exchange allocation system, with a view towards eventual liberalization, was to be undertaken and discussed with the Bank and the Fund in late 1983.

28. A number of other studies in the area of foreign exchange and external trade were also spelled out. The topics included export marketing, export incentives and export credit facilities; the studies were to lead to the formulation of action programs in the course of 1984. In the case of import controls, the Government indicated its intention to develop by September 1983 a program for phased import liberalization parallel to the liberalization of the foreign exchange market, to be implemented in the course of 1984 and 1985. In this connection, a study of effective protection, tracing the effects of trade and payments restrictions on domestic prices, was to be undertaken for completion by April 1985.
29. Sectoral conditions, aside from price policies noted above, centered on investment reduction and the undertaking of studies of subsectoral structures and/or efficiency. In the agricultural sector, a study of primary production was formulated drawing largely on the on-going project work (see PCR, para. 30). It was also agreed to undertake studies for restructuring selected industrial subsectors parallel with studies on energy conservation at enterprise levels; details of this work were to be worked out in subsequent discussions with the Bank. It was contemplated that a proposed technical assistance Bank loan would be used to finance the latter group of studies.

30. Finally, as an input to the economic dialogue between the Bank and the Yugoslav Government, a report would be prepared for discussion with the Bank (first on a semi-annual basis, subsequently on a quarterly basis) showing in particular sectoral allocation of investment expenditure, reflecting the revisions in the 1981-85 Plan which had been introduced in mid-1982, and analyzing the priority nature of individual large projects. In the particular case of energy, a program of priority investment projects for the period 1983-85 (the core investment program) would be defined.

D. The Mechanism for Resource Transfer

31. In the preparation stage, the Bank did not focus on the mechanism of resource transfer, preferring to leave the decision on this matter to the Yugoslav authorities. Some early indication was given by the Government that at least part of the proceeds of a first SAL would be used to constitute a revolving export development fund (EDF) to finance through short-term lending the foreign exchange needs of exporters, and thus to ensure their access to necessary imported inputs during a period of curtailment of import privileges. The establishment of a number of such funds with similar characteristics was being contemplated at the time which would use the bilateral official (suppliers') credits being offered under the international rescue package. It was considered, however, that a Bank-supported EDF with untied procurement would provide particular advantages. The proposal of the Government to use all of the proceeds of the Bank loan for the establishment of an EDF was presented to the appraisal mission at the wrap-up meeting it had with Government officials prior to its departure. In order to work out the details, it was necessary to send a special post-appraisal mission.

32. The creation of this type of fund within the context of a SAL operation is rather unique, in effect giving project content to a non-project loan. Resource transfer in most SALs has been accomplished through financing a pre-defined set of imports in order to achieve the objective of quick disbursement. On the other hand, the Bank has supported the creation or expansion of EDFs in a number of countries through direct lending for that purpose. The speed at which the funds had been disbursed in those cases was generally at a much slower pace than under direct import financing, being dependent upon the level of demand from eligible exporters (thus in part upon the criteria for eligibility) and the operational efficiency of the mechanism established for processing and approving applications. In helping to draft the operating procedures for the fund, Bank staff sought to draw upon the experiences of similar projects in this field.
III. IMPLEMENTATION EXPERIENCE

A. Macro-Economic Performance

33. The SAL was approved by the Board on June 28, 1983, was signed shortly afterward and became effective on August 24, 1983. The measures which had been introduced in the latter part of 1982 and during 1983, in compliance with the LTPES, the IMF stand-by's and subsequently the SAL itself, led to some improvement in the macro-economic situation during 1983. The trade deficit was further reduced, largely through a reduction in imports leading to a surplus on current account. While total exports declined, exports to convertible currency countries rose sharply. Measures to restrain domestic demand, particularly curtailment of investment, led to a small decline in total GDP. At the same time, however, inflationary tendencies were not reduced, and the rates of increase of the retail price and cost-of-living indices were slightly above that recorded for 1982. Economic performance in 1984 showed little change. A small expansion in exports, again largely to the convertible currency areas, helped increase the surplus on current account. Thus the efforts at short-term stabilization appeared to have eased the external imbalance but output remained stagnant while inflation accelerated.

34. In 1985, the measures which had been taken to restrain domestic demand were loosened and there was some rise in domestic activity, largely due to a rise in consumption, which was accompanied by a further increase in the rate of inflation. While the current account surplus was increased, this reflected a rise in exports to the non-convertible currency areas as the balance with the convertible currency countries deteriorated slightly because of a rise in imports from those countries. Total output rose 3.7% in 1986, the largest rise since 1979, reflecting not only a continued increase in consumption but also an expansion in investment for the first time in several years. However, this was accompanied by a further deterioration in the macro-economic imbalances as inflation accelerated and there was a widening of the trade deficit.5/

35. The situation at the beginning of 1987 presented numerous difficulties. Concern with the rise in inflation and the deteriorating trend in economic activities in the second half of 1986 prompted the authorities to introduce a number of measures in late 1986 and early 1987.6/


6/ The views of the Government on the situation at the beginning of 1987 are also contained in its comments, Attachment I. Further details on the measures adopted at the time are contained in Report No. 6353-YU, op. cit, paras. 3.135-3.141.
B. **Compliance with SAL Conditionality**

36. The compliance of the Yugoslav authorities with the conditions of the SAL is reviewed in detail in the PCR (paras. 13 through 30). Twenty-four monitorable conditions have been identified, including the establishment of the Export Development Fund. It is concluded that six of the conditions have been met more or less as originally defined, while 11 have been only partially met, with substantial time delays in most of these instances. Some conditions were not met at the time of preparation of the PCR (June 1986) although certain measures recently introduced by the authorities (at the end of 1986 and early 1987) could be considered as complying with these earlier commitments, particularly in the area of energy pricing. A fuller discussion of compliance is undertaken in the next section which attempts to assess the impact of the SAL.

C. **The Operations of the EDF**

37. As noted earlier, the Yugoslav SAL was unique in that the resources to be transferred were to be used to establish a revolving export development fund rather than to be disbursed against imports. This type of mechanism was chosen by the Yugoslav authorities as a means to ensure that exporters would be able to get relatively quick access to foreign currencies for their necessary imports in the context of the extreme shortage of foreign exchange at the time. The advantage in using Bank funds was the untied nature of the resources provided by the Bank since most of the official suppliers' credits were tied to the sources of finance.

38. Because of the decentralized nature of the banking system, management of the various credit lines, both bilateral and multinational, was allocated among the principal regional banks by decisions of the council of the Yugoslav Banking Association (YBA). The Udruzena Beogradaka Banka (UBB), one of the two associated banks in the Republic of Serbia, was chosen to execute the Bank loan and, in conformity with the prevailing federal-republic relationships, it became the borrower with the guarantee of the Federal Government. However, at the insistence of the Bank, various procedures were established to ensure to the maximum extent possible that enterprises throughout the country would have ready access to the resources.

39. A special unit of UBB to manage the fund was created in August 1983 and its operations began at a rather slow pace, given the time required for setting up procedures and a slow build up in demand, given the time required

7/ The Government, in its comments on the PPAM, has indicated a number of areas where it believes that progress has been made and also notes the tendencies in international economic conditions which have affected implementation; see Attachment I.

8/ A brief description of this system is provided in a Project Performance Audit Memorandum, Yugoslavia - First Industrial Credit Project (Loans 1012/1013-YU), Report No. 5119, dated June 11, 1984.
to familiarize potential borrowers with the nature of the fund. In subsequent supervision missions, Bank staff assisted in streamlining the procedures in an effort to speed up approvals. Bank funds were fully disbursed in August 1985, some one year after the date expected in the President's report. However, that expectation was clearly unrealistic in view of the need to create a completely new system. Given the characteristics of a revolving fund, the total value of the loans approved by EDF at the end of October 1986 amounted to almost US$660 million, more than twice the value of the original Bank loan. On the assumption of an import content of about one-third, the fund has therefore financed about US$2 billion in exports. While it is not possible to determine the extent of "additional" exports provided by this mechanism, interviews with users of the fund indicated that, at the least, their exports were facilitated through quick access to the foreign exchange, particularly due to the untied nature of the Bank's resources and the complexity of the administrative regulations which, at the time, limited access to foreign exchange.

40. Following the start-up period through the end of 1983, EDF approvals rose rapidly, averaging some US$20 million per month in 1984 and somewhat less than that during 1985 (see Table 1). At the beginning of 1986, the new foreign exchange control regulations, as originally elaborated, did not permit this type of revolving fund and these had to be amended; as a consequence no approvals were made in the period January through March of that year.

Table 1: EXPORT DEVELOPMENT FUND SUMMARY OF APPROVALS

<table>
<thead>
<tr>
<th>Amount (US$ millions)</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Through December 1983</td>
<td>63.3</td>
</tr>
<tr>
<td>January - June 1984</td>
<td>151.0</td>
</tr>
<tr>
<td>July - December 1984</td>
<td>114.9</td>
</tr>
<tr>
<td>January - June 1985</td>
<td>127.6</td>
</tr>
<tr>
<td>July - December 1985</td>
<td>96.0</td>
</tr>
<tr>
<td>January - June 1986</td>
<td>57.0</td>
</tr>
<tr>
<td>July - October 1986</td>
<td>50.0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>659.8</strong></td>
</tr>
</tbody>
</table>

/a Including recycled funds.

Source: EDF Unit, UBB

9/ See PCR, para. 31. It is also noted that the original estimate of the speed of disbursement was unrealistic.
The prevailing institutional structure, as noted earlier, largely dictated the decision to assign the EDF, as well as the bilateral official suppliers credit lines, to individual republican banks whose clientele tend to be located in the respective regions. But it was not intended to restrict the use of any of these funds to existing clients of the participating banks. The Government and the banking system make strong efforts to publicize widely the availability of all of these resources and measures were also taken to encourage inter-bank relationships to increase such use. Nevertheless, at the end of October 1986, some 60 percent of the EDF funds were used by enterprises in Serbia (see Table 2 and PCR, para. 32); exports of enterprises in that republic represent about 20 percent of total sales to the convertible currency areas.

Table 2: EXPORT DEVELOPMENT FUND
REGIONAL PATTERN OF APPROVALS /a
(at end October 1986)

<table>
<thead>
<tr>
<th>Region</th>
<th>Amount (US$ millions)</th>
<th>% of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Serbia</td>
<td>393.9</td>
<td>59.7</td>
</tr>
<tr>
<td>Croatia</td>
<td>53.6</td>
<td>8.1</td>
</tr>
<tr>
<td>Bosnia and Herzegovina</td>
<td>66.5</td>
<td>10.1</td>
</tr>
<tr>
<td>Macedonia</td>
<td>73.3</td>
<td>11.1</td>
</tr>
<tr>
<td>Slovenia</td>
<td>34.7</td>
<td>5.3</td>
</tr>
<tr>
<td>Montenegro</td>
<td>4.2</td>
<td>0.6</td>
</tr>
<tr>
<td>Vojvodina (province)</td>
<td>21.4</td>
<td>3.3</td>
</tr>
<tr>
<td>Kosovo (province)</td>
<td>12.2</td>
<td>1.9</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>659.8</strong></td>
<td><strong>100.0</strong></td>
</tr>
</tbody>
</table>

/a Including recycled funds.

Source: EDF Unit, UBB

On balance, the fund can be considered as having achieved considerable success. None of the bilateral suppliers' credits provided during 1983 and 1984 was fully utilized (see Table 3) and one-third of the total available was actually cancelled. Exporters who were interviewed, who theoretically could have used either the EDF or one of the bilateral credits, indicated that prices for goods financed under the latter systems tended to be higher than under the EDF.10/

10/ The Stopanska Banka Skopje which managed a Canadian credit not included in the group in Table 3 cancelled Can$45 million of a total of Can$50 million and reported that price differentials for the eligible products were cited by its clients as the major factor in discouraging them from using that fund.
Table 3: DISBURSEMENT OF TRADE-RELATED SUPPLIERS' CREDITS UNDER BERNE ACCORD
(in thousands of US$)/a

<table>
<thead>
<tr>
<th>Creditor Country</th>
<th>Granted</th>
<th>Disbursed Until December 31, 1985</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>54,386</td>
<td>51,352</td>
</tr>
<tr>
<td>Belgium</td>
<td>2,017</td>
<td>2,006</td>
</tr>
<tr>
<td>Denmark</td>
<td>3,680</td>
<td>2,203</td>
</tr>
<tr>
<td>Fed. Republic of Germany</td>
<td>95,972</td>
<td>72,345</td>
</tr>
<tr>
<td>France</td>
<td>45,998</td>
<td>37,456</td>
</tr>
<tr>
<td>Italy</td>
<td>198,402</td>
<td>55,952</td>
</tr>
<tr>
<td>Japan</td>
<td>1,002</td>
<td>1,000</td>
</tr>
<tr>
<td>Netherlands</td>
<td>9,996</td>
<td>7,718</td>
</tr>
<tr>
<td>Norway</td>
<td>15,765</td>
<td>8,746</td>
</tr>
<tr>
<td>Sweden</td>
<td>15,424</td>
<td>4,818</td>
</tr>
<tr>
<td>Spain</td>
<td>222</td>
<td>77</td>
</tr>
<tr>
<td>Switzerland</td>
<td>38,815</td>
<td>32,758</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>4,450</td>
<td>815</td>
</tr>
<tr>
<td>USA</td>
<td>259,527</td>
<td>216,104</td>
</tr>
<tr>
<td><strong>TOTALS</strong></td>
<td>745,656</td>
<td>493,350</td>
</tr>
</tbody>
</table>

/a Statistical exchange rates ($1 = 185.70 din, $1 = 2.93 DM) are used in calculating dollar amounts of non-dollar credits.

Source: National Bank of Yugoslavia

43. At the current time, however, EDF is encountering sharp fluctuations in demand for its funds. At the end of October 1986 it had un-utilized balances of about US$50 million and the demands for its resources had dropped to about US$12 to US$15 million per month (see Table 1 above). Two factors appear to underlie that situation. In the first place the lending rate for EDF funds has not been competitive with other short-term credit lines which are now available to finance imports. EDF is charging to the final user two percentage points above the Bank's lending rate in accordance with the loan agreement. In other words, at the present time the subloans under the EDF carry an interest rate to the final borrower of approximately 10 percent. Foreign commercial banks have made available short-term credit lines to finance imports at LIBOR plus from .5 to 1.5 percentage points, i.e. a total cost currently of about 6.5 to 7 percent.

44. Secondly, the prevailing system of foreign exchange allocation appears to have provided adequate access to such resources for established exporters. To the extent that they needed to borrow local currency to purchase that exchange, domestic lending rates were much more favorable and
the borrowers could avoid foreign exchange rate risks. Nevertheless, it appears that EDF remains an important source of foreign exchange for new exporters or those who expect to increase substantially their exports in the future.

45. At the beginning of 1987, however, there was a recovery in the demand for EDF funds and approvals have been averaging some US$30 million per month. While it is not possible to analyze at this time all of the factors involved in this development, it appears to reflect a number of policy changes introduced at the beginning of the year. In the first place, domestic interest rates were increased sharply, reducing the spread in favor of borrowing local funds at the same time that the constraints in the foreign exchange market continued to limit the availability of foreign currencies. Moreover, enterprises who need to import equipment for their operations are being encouraged to make use of existing credit lines to finance part of their foreign exchange requirements. In 1986 EDF, with Bank approval, revised its lending regulations to permit financing of imported machinery by exporting firms (see PCR, para. 31) and there appears to have been some increased use of this facility. Finally, EDF funds which are not tied remain attractive to potential borrowers.

46. Perhaps the most serious problem facing the EDF is the impact of the recent weakening in the US dollar in view of the currency pooling arrangements for disbursing Bank loans. The nominal value of disbursements at the time they were made was US$275 million. With the currency relationships prevailing at the beginning of 1987, the dollar value of UBB's obligation (the borrowers liability to the Bank) was some 45 percent higher than the nominal value. As a consequence, the interest payment which fell due in January 1987 was some 45 percent higher than expected and the first repayment due at the same time was also 45 percent higher than expected ($16.7 million as compared to $11.5 million). With the further changes in currency relationships, UBB's obligation to the Bank at the end of May 1987 was 50 percent higher than the nominal value of the balance of the loan, $396.7 million as compared to $263.5 million.

IV. ASSESSING THE IMPACT OF THE SAL

A. Main Elements of Adjustment

47. The difficulties in assessing the impact of a structural adjustment program have been set out in the first OED overview of these operations. It is clearly not appropriate to attempt to establish a one-to-one relationship

11/ See the comments on the draft PPAM submitted by UBB which appear as Attachment II to this document.

12/ See also the comments of the Government, Attachment I, and of UBB, Attachment II.
with macro-economic performance in either the short or long-term. Nor, given
the influence of exogenous factors as well as an imperfect knowledge of eco-

nomic relationships, would it be appropriate to suggest that substantial eco-

nomic development with both equity and growth require an inflexible adherence
to a pre-defined program. Moreover, by definition these programs are ex-
pected to have impact in the medium-term and generally to involve more than
one operation so that definitive assessments may only be undertaken after
some lapse of time.

48. The PCR has concluded that there has been limited adherence of
Yugoslav authorities with the action program agreed to under the SAL (para.
36). Moreover, it observes that the recent poor macro-economic performance
reflects in great part the regression which has occurred as regards the
commitment to achieve a more open and market oriented economy. Failure to
pursue that objective is at the heart of the limited adherence to the SAL
program; preparation of a second SAL has been delayed, as discussions between
the Government and the Bank continue in relation to the scope of a possible
further operation.

49. The main policy concerns center on the lack of more rapid progress
in moving towards positive real lending rates and in establishing an ade-

quately functioning foreign exchange market. It is recognized that, at the
present time, the failure to exercise proper demand management, in particular
a permissive monetary management which has led to record inflation, has
reduced the possibility of taking corrective action in those two areas. In
the broadest sense, therefore, the SAL has not achieved its fundamental
objectives. The short-term stabilization efforts and import controls were
successful in reducing the external imbalances through 1984 which encouraged
the Yugoslav authorities to shift subsequently to growth-oriented policies
(see PCR, para. 11). Because of the inadequate progress in achieving the
necessary structural reforms, however, the country now finds itself once more
facing serious internal and external imbalances.

50. Nevertheless, some significant institutional changes supported by
this SAL have begun to take root, albeit slower than expected. One key
element is the progress which has been achieved in increased acceptance by
institutions responsible for investment decisions of a social compact on the
evaluation of projects, with its methodology focussing on economic rates of
return. While use of the precise methodology has not been ratified by all
participants, particularly the institutions at republican government levels,
the banking system under the leadership of the YBA has now agreed to its
application in 1987; a number of these banks have already been using and

13/ See also the comments of the Government, Attachment I, concerning a
number of areas when progress has been made.
applying the methodology.\textsuperscript{14} If properly applied in investment decisions, the methodology can help avoid the selection of uneconomic projects.

51. A second major element is the progress made in developing financial discipline. Enterprise self-management is one of the most important principles in the Yugoslav social and political system, having evolved over the last 35 years. It can be expected that modifications will require patience and careful monitoring. While bankruptcy laws have long existed and have recently been strengthened, it remains the case that few banks have been willing to force such action on enterprises which are in turn their shareholders (see PCR, paras. 27-29). Nevertheless, regulations have been enacted which make clear the responsibilities of the banks for curtailing financial support to what are essentially bankrupt and unsustainable enterprises.

52. Moreover, accounting standards are now being established which require enterprises to make more realistic estimates of costs such as depreciation, thus limiting the capacity to record profitable operations (hence, to generate profits for distribution) when in fact there are losses. Along with other recent laws on income distribution, these measures introduce important constraints on the behavior of enterprises designed to develop financial discipline.

53. As regards other elements of reform, the process of regional decentralization has led to situations where important economies of scale in many infrastructure areas have been ignored, in fact to actual duplication of investment. The recent law on social planning is designed to promote an inter-republican approach to investment in such fields as electric power, transport and gas distribution. A first attempt at elaborating a long-term integrated development plan for electric power generation, with investment decisions to reflect an optimal program, did not meet that objective and a revised draft is now being prepared by the energy agencies.

54. The PCR (prepared in June 1986) has noted that, overall, perhaps the most significant advances had been recorded in the area of price liberalization although some retrogression had occurred in early 1986 (PCR, para. 25). There have been several more recent developments in this particular area and it is likely that further changes will occur in the next few months. The 1987 economic program announced at the end of 1986 contained measures with the intention to provide a more liberal price policy than prevailing in previous legislation; a substantial reduction in the number of items whose prices are subject to review by the Federal Price Agency reflected a more positive attitude towards use of the price mechanism to

\textsuperscript{14} In particular, banks which have participated in industrial credit lines provided by the Bank, primarily in the less developed regions, are required to use this methodology in appraising loan requests from final borrowers; these have been mainly small and medium sized industries. Other banks had also become familiar with the procedures which they were applying for their own internal reviews.
achieve allocative efficiency. In February 1987, measures were introduced to limit increases in prices of individual items to the general inflation rate; at the same time, increases in nominal wages were limited to the gains in productivity and/or "real material possibilities".\textsuperscript{15}

55. As regards the sectoral issues, it was noted earlier that, in most instances (i.e., agriculture, energy and transport), the monitorable conditions largely pursued policy matters which had emerged in the implementation of on-going projects or in the preparation of projects in the pipeline. The SAL conditions thus permitted a more intensive follow-up by the Bank based on the accumulated experience and the working relationships which had already been developed.

56. In the case of industry, where there had been little prior exposure, one of the principal objectives was to develop a project pipeline in this sector and the action program called for undertaking a number of subsectoral studies to that end. Limited success has been recorded in achieving that objective. Some of the reluctance of the different industry groups to participate in these studies may have stemmed from their concern over the possible implications on their operations of recommendations which might emerge from the analyses in areas such as restructuring (PCR, para. 16). At the same time, however, it must be recognized that many other factors contributed to this situation. In the first place, there was (and continues to be) great reluctance on the part of enterprises to incur additional debts in foreign exchange. This pertained not only to loans for productive purposes but also to loans to finance studies needed for preparing projects which is required under present Yugoslav practice. Secondly, many enterprises had already begun to analyze measures required to improve their efficiency. In this connection, the institutional structure with which the Bank had to deal, industrial chambers organized by subsectors, was complex, each involving a highly heterogeneous membership. It was possible to obtain agreement for only one sub-sector as compared to the five or six that were expected.

57. Finally, it also appears that in some of the institutions and enterprises involved there were negative feelings regarding the origin of the effort, the fact that the initiative had not come from the Yugoslav side but rather from the Bank and that compliance was an element of conditionality attached to the SAL. On the other hand, many of these groups did welcome the technical inputs which the Bank was prepared to provide.

B. The Impact of the EDF

58. The review of the operations of the EDF presented above indicates that overall it has achieved its objectives. The main problems now being faced by EDF are its uncompetitive interest rate to sub-borrowers and the exchange losses imposed on borrowers by the recent currency realignments.

\textsuperscript{15} See the comments of the Government, Attachment I.
The first problem raises questions for the Bank as to the design of such funds; the second raises questions for the Yugoslav government as the guarantor regarding the ways it can help the borrowing enterprise deal with those risks; it should also be noted that following the recent sharp movement in currency parities the Bank is reviewing the system with a view to helping countries deal with this problem.

59. On the interest rate issue, the fundamental problem is the use of resources generated from a borrower's long-term obligation for short-term lending operations. In the early 1980s, when many of the EDF operations supported by the Bank were initiated, interest rates for the type of short-term lending for which the EDF is designed generally tended to be higher than the rates paid for the longer term credit lines such as those provided by the Bank which financed those funds. In that situation, the main concern was to ensure that the sub-borrowers did not receive a subsidy and that the EDF rates were at least as high as comparable rates for trading operations in international markets. That situation was rather abnormal and the current pattern, with long-term rates exceeding short-term rates, is a more usual one. As a consequence, EDF had large unutilized balances in foreign exchange; even if the UBB had placed these resources in highly liquid interest-earning assets (i.e. in the London Inter-Bank market), the return it would earn would have been less than the cost of funds borrowed from the Bank which at present is around 8%.

60. The sharp recovery in demand for EDF resources at the beginning of 1987, reflecting mainly policy changes at the time (see para. 45), has reduced the need for seeking other solutions for the present. Nevertheless, it appears likely that, as more normal conditions are established in domestic credit and foreign exchange markets, EDF will once again have difficulties in competing with conventional commercial credit lines. One alternative to make use of unutilized balances would be to set aside some of the funds for longer-term lending to export-oriented industries for purposes such as rehabilitation, modernization or de-bottlenecking; a number of the Bank-supported EDF projects contain such fixed-asset financing components. Interest rates charged for those loans could be set at levels consistent with current market conditions for longer-term lending and could at least cover UBB's cost of the funds involved.

61. The workings of the currency pool arrangements for Bank disbursements raise questions beyond the scope of this audit. As noted, the Bank is currently reviewing its practices to determine the ways in which it can help its borrowers to deal with this problem. There is, moreover, increasing recognition that in the past the Bank may not have sufficiently alerted its clients to the full implications of the system and that further steps need to be taken in the future to ensure that borrowers understand better the nature of the risks and advantages it offers. At the same time, however, it is important that governments themselves undertake an analysis of the situation so that they can also take appropriate actions.16/ This is particularly the

16/ See the comments of the Government and of UBB, Attachments I and II.
case with Yugoslavia where all of the Bank's loans are currently made directly to enterprises or banks with the guarantee of the Federal Government. While from the point of view of the entire economy, losses and gains from the operation of the system may in the long run balance out, these would, in the absence of any countervailing policy, be randomly distributed.17/

C. Social Issues

62. Common to other SAL operations prepared at the time, explicit attention to social issues was not given in the preparation of the Yugoslav SAL. It was recognized that the adjustment process would be a painful one, that total product was unlikely to rise more than one percent for a number of years and that as a consequence there would be little if any increase in average per capita incomes over this period. At the same time, the LTPES supported by the SAL stressed the longer term growth potential of the economy and attempted to allay fears of more fundamental deterioration in living standards. Moreover, Yugoslav governments have consistently argued that their political and social system is geared towards more equitable distribution of the benefits of economic growth as well as of the costs of adjustment; as noted in the introduction, absolute poverty is considered to have been eliminated by the 1970s.

63. While there are substantial differences in urban and rural incomes, the major imbalance arises from the regional differences, between the more developed republics of the north and the less developed of the south. It is not clear what impact the LTPES measures could have on that distribution. There is evidence that the policies which were adopted during the 1960s and early 1970s, ostensibly designed to improve the regional pattern of incomes, had little impact on the situation, although the relative deterioration which had characterized the earlier post-war period was halted.18/

D. Relations with the IMF

64. Extensive exchange of information and regular consultation between the Bank and the IMF characterized the preparation of both the standby programs beginning in 1980 and the SAL, as well as of the work involved for the inter-governmental and commercial bank meetings which led to the international financial package of 1984. For example, Bank staff members participated in the IMF review missions for both the first and second years of the standby

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17/ In some countries where an enterprise may be the borrower for the Bank's loan, there may be an agreement between the government and the borrowing agency which assigns to the former all of the risks associated with the currency pool.

arrangement while an IMF staff member participated in the Bank's 1981 economic mission. This close collaboration continued during the period of implementation of the SAL during which time Bank staff participated in a number of IMF missions, particularly to review the foreign exchange allocation system.

65. The policies and actions indicated in the Government's 1983 LDP which was the basis for the SAL were considered fully consistent and complementary with the policy actions monitored by the IMF under its standby arrangements which had originally been formulated in 1980. The main areas of common interest between the Bank and the Fund included interest rate policy, foreign exchange allocation, external debt monitoring and price policy. The Fund concentrated mainly on the immediate need to resolve capital liquidity problems through actions related to demand management, exchange rate policy and external finance. The Bank's concern focussed on the medium-term framework for growth being developed through the work of the Stabilization Commission (see PCR, paras. 8 and 9).

E. Relationship of SAL to the Lending Program

66. As noted in para. 5, through the 1970s and the early 1980s, Yugoslavia had been among the most important clients for the Bank, with annual lending averaging more than US$300 million in the latter years of that period. The approval of the SAL at the end of FY83 resulted in a lending level for that year in excess of US$500 million. The total of approved loans in FY84 was only slightly less (US$451 million) but a fertilizer sector loan (US$90 million) was subsequently withdrawn when the Yugoslav authorities were unable to complete the necessary arrangements to permit signing.

67. Recent Bank lending to Yugoslavia has been sharply reduced; while the FY85 level of approvals was US$292 million, that included one loan (US$35 million) which was also subsequently withdrawn. Lending activities in FY86 and FY87 amount to one operation in each year, for US$121 million and US$90 million respectively; the first loan, approved in June 1986, was signed at the end of February 1987, while the second was approved in March 1987.

68. To a great extent, this situation reflects the sharp cutback in gross domestic investment in recent years and, in particular, the reluctance of Yugoslav enterprises, including the banking system, to take on additional foreign liabilities under present circumstances. Most of these entities are experiencing serious difficulties because of the impact of the devaluations on the servicing of their current foreign debts. Moreover, the Government has adopted various regulations to control the growth of foreign borrowing and difficulties for the borrowing agencies to operate within these restrictions largely explain the failure to sign the two approved loans noted in the previous paragraphs which were subsequently withdrawn. While preparation of a second SAL is proceeding, the Bank has indicated willingness to continue to consider a moderate level of project lending but, at the present time, few proposals appear ready for further processing.
V. MAIN LESSONS LEARNED

A. The Design of the SAL

69. This audit has focussed on the process of developing the SAL design and of decision making within the Bank. A number of these findings had emerged in the course of implementation of this loan as well as during the implementation of other SALS; to some extent they have already been reflected in the efforts made to improve the design, as well as implementation procedures, of subsequent SALS. The question may be raised whether, even if the quality of the product delivered by the Bank had been improved, would it have been any more effective in achieving the desired results.

70. There is little doubt that at the end of 1982 the need for major reform was recognized and advocated by many individuals within the technical circles of the Yugoslav Government and the academic community. Unfortunately, however, the Yugoslav authorities involved in elaborating the SAL program with the Bank, as well as the Bank staff, underestimated the political difficulties in implementing the main elements of the macro-economic reforms proposed and the problems affecting the implementation of several elements of the sectoral conditions.19/

71. As has been pointed out in the recent OED Review, there have been a number of countries where the Bank has broached the possibility of a SAL but no agreements could be reached due to political issues such as the high visibility of the macro-economic conditionality. Nevertheless, policy reforms were accomplished in many instances through more limited sectoral approaches or where conditionality was "frontloaded" in more carefully designed SAL operations.20/

72. The content of the Yugoslav SAL, the 24 monitorable conditions, was overly ambitious and unnecessarily complex. The issues on which attention was focussed covered not only the principal macro-economic areas earlier identified21/ but also a number of sectoral problems which might have been more effectively dealt with separately. The SAL included a number of conditions which had limited operational content while, in several other instances, the Bank had not been adequately prepared in formulating the provisions and difficulties were encountered in their implementation.

19/ The Government has indicated its disagreement with this statement; see Attachment I.

20/ Report No. 6409, op. cit., para. 8.41. "Front-loading" refers to the adoption of the agreed upon major policy reforms prior to the approval of the SAL.

21/ See above, para. 16; these included investment planning and resource allocation, foreign exchange allocation and external trade policies, and price policies and enterprise decision-making.
Similar observations have been made about earlier SALs in the respective audits which have been reflected in the recent OED review.

73. There was significant variation in what may be termed the operational content of the monitorable conditions. For example, three reports were prepared by the Government and submitted to the Bank which dealt with the level and structure of investment in the country. However, neither the extent to which these were reviewed by the Bank staff, nor what action could have been taken by the Bank on the basis of any review, is clear. Reducing the level of investment was essential at the time and the direct and indirect measures taken by the Yugoslav authorities were largely successful in achieving that objective. Nevertheless, some investments which, under a more rational decision-making process, may not have been considered economically justified, continued to be implemented due to prior commitments, financial and otherwise.

74. The Bank's concern with both strengthening the investment decision making process and establishing an adequate monitoring system was clearly appropriate. The former purpose was properly served by the efforts devoted to formulating and implementing the Social Compact on the Economic Evaluation of Projects; the Bank's contribution was outstanding and was welcomed by the Yugoslav authorities. As regards a monitoring system, given the decentralized nature of investment decisions with control being exercised primarily at the republican level, preparing these reports at the federal level would be meaningful if the federal authorities had the power to intervene in implementation. By focusing on this aspect, the expectation was to generate reforms which would make that possible. However, in the ensuing political process, no changes were introduced and the main measures for the federal government to influence both the magnitude and structure of investment remain largely of a macro-economic nature.

75. The experience with the sectoral efforts is particularly interesting, shedding light on the pre-conditions for achieving the desired objectives in these areas. The project work which had been done previously in the agricultural, energy and transport sectors had led to broad understanding within the Bank of key issues facing those productive activities and to the development of working relationships with the corresponding national institutions. This enabled the Bank to focus quickly on the core problems and to

22/ As noted earlier, this methodology had been applied in appraising subprojects financed under various industrial credit lines provided by the Bank and officials of the participating institutions had been trained in its application. In addition, in connection with the efforts at seeking wider use of the methodology, EDI assisted in revising the manual and in training other government officials.

23/ The Government has indicated its disagreement this statement; see Attachment I.
take advantage of the momentum provided by the presence of the Stabilization
Commission to pursue appropriate measures in a constructive manner.\(^{24}\)
Links between SALs and on-going projects can thus be particularly beneficial.

76. On the other hand, there had only been limited exposure of the Bank
to the industrial sector, especially to the institution involved, and, in
this instance, insufficient appreciation of the uniqueness of the Yugoslav-
environment. It proved difficult to achieve meaningful dialogues with the
Yugoslav counterparts on the basis of instructions from the top. This would
suggest that it is not desirable for the Bank to use SAL operations as a
means of promoting projects where it has not already accumulated a
substantial background of work (see above, para. 21).\(^{25}\)

77. The experience with the one subsector study which was undertaken
(for the textile industry) underscores this point. A report dealing with the
modernization and rehabilitation needs of that industry was submitted to the
Bank at the end of 1986 and is now being reviewed for possible action.
During the initial contacts with the various subsector-related associations
which took place shortly after the signing of the SAL, the proposal for a
study was not well received. However, after a period of substantive
interchange with the Bank, those groups became familiar with both the
technical and financial inputs which could be available to develop a sound
investment program to meet their needs. A study team was then organized and
arrangements made to pursue the work, mobilizing various resources for its
financing, including a contribution from the industry itself; it should be
noted that the problem of financing such studies had been cited as a barrier
to implementation of a number of the other studies included in the action
program which were not undertaken.

78. At the same time it has to be emphasized that, in the larger sense of
structural adjustment, the deficiencies in the design which are noted
above are minor. The major question which must be asked is the extent of the
commitment of the Government to fundamental reform. That there is need for
basic economic policy changes had been recognized by the authorities in each of
the different administrations which has been in office since the SAL was
initiated. To elaborate and implement the necessary measures requires a set
of political compromises. In fact, all macro-economic reforms require some
element of compromise among the various domestic political forces. The
Yugoslav situation is unique because of the extent to which these political

\(^{24}\) For example, in the energy sector, the Bank was able for the first time
to deal with the problem country-wide; one result was the preparation of
a major study, Yugoslavia: Constraints and Prospects for Restructuring
the Energy Sector, issued in 1985.

\(^{25}\) The Government has indicated its disagreement with this paragraph; see
Attachment I.
aspects have been institutionalized. As a consequence, it can be expected that the pace of the reforms which are needed to improve economic performance will be slow.26/

79. The record has been one of rather irregular progress in achieving reform. By their nature these compromises can only be reached through highly visible and open transactions among the parties concerned. It is not unreasonable to ask whether that process has been helped or hindered by the appearance of external intervention. If, on hindsight, there is general agreement that the political difficulties facing the Yugoslav SAL were severely underestimated, it must be recognized that, in cases where this approach is proposed, these aspects must be more thoroughly analyzed in preparing SALs and the possibility that the effect may be counterproductive, not only as regards the operation at hand but perhaps more importantly future relations, must be a consideration in reviewing alternative scenarios.

80. By definition a SAL program is devoted to seeking solutions to medium-term development problems and can be considered complementary to stabilization programs, for example those supported by the IMF. One characteristic of this Yugoslav SAL was that the resources made available, at least for the first of what was considered to be a series of operations, were deemed necessary to fill out a large financial assistance package designed to meet immediate needs. Had this pressure to complete the operation quickly not existed, and had some other lending form been available to effect the resource transfer, the complexity of the political situation might have been explored in more detail and a more realistic assessment could have been made of the prospects.

81. At times the quality of the "dialogue" which took place on the SAL during implementation appears to have deteriorated and could not be characterized as "constructive", with officials in both the Bank and the Government demonstrating great frustration in reviewing the progress made or not made in meeting the many commitments under the loan. The concern is not the degree of discomfort experienced by the two parties but rather the extent to which time and effort was spent on admittedly secondary issues (such as those in the trade and industry areas), detracting from the efforts needed to deal with those issues which were clearly of highest priority primarily in the macro-economic areas (see para. 72). In addition, given the longer term benefits which accrue to the Yugoslav economy from Bank assistance, both financial and technical, which is frankly recognized by those officials, there is a danger that prospects for a more positive future dialogue may have been reduced.27/

26/ See the comments of the Government on content and design of SALs, Attachment I.

27/ The Government has indicated its disagreement with the content of this paragraph; see Attachment I.
82. It is clear that the adjustment process in Yugoslavia has not ended and it is likely that the pace of reform will continue to be at a speed considerably slower than originally expected. Moreover, it now appears likely that there will be need for additional resource transfers to Yugoslavia in the immediate future. The Bank could play a role in helping to provide further support. With hindsight, Yugoslavia was not at the time an appropriate candidate for a SAL; while the need for reform was widely accepted, the process was likely to require considerable time for implementation given the political complexity. Is there now a basis for considering non-project lending to Yugoslavia in the future? The lesson from this experience suggests that, at the least, it would have to be substantially front-loaded. 28/

8. The Operations of the EDF

83. The resource transfer mechanism selected for the Yugoslav SAL, the EDF, has lent itself to a separate evaluation since this type of project has been supported by the Bank in a number of countries in "free standing" form. In the analysis, however, the uniqueness of the Yugoslav banking structure must be taken into account in deriving generalizations for wider application. The major structural problem now facing UBB, the need to deal with the impact of the currency pool disbursement procedure which has increased by 40% the nominal dollar value of its liability to the Bank, has already been discussed (see para. 61).

84. As regards the basic design of the EDF, the original concept was to establish a permanent lending facility 29/ which would be able to continue even after it began repaying the Bank loan. To that end, an incentive scheme was developed to encourage users to surrender foreign exchange over and above that required to service their subloans. However, with the change in the foreign exchange allocation system at the beginning of 1986, the scheme was no longer permitted. While operative, it led to the mobilization of US$25 million.

85. The demand for EDF funds remains highly volatile. Under current conditions of foreign exchange allocation, the fund apparently remains a useful source of currencies for new exporters or for those planning to expand substantially these sales who might otherwise have difficulty in getting access to the full amount of imported inputs they may require. For this facility, borrowers are currently paying a high price, especially considering the riskiness of some new export ventures. Given the objective of the Government to move towards a more open foreign exchange market, it is likely that the number of such clients will be reduced. EDF will, as a consequence,

28/ See the comments of the Government on this paragraph, Attachment I. Discussions between the Bank and the Government continue in relation to the scope of a possible SAL II operation.

29/ According to the President's Report, "...possibly, to become over time the nucleus of a foreign exchange market...", see Report No. P-3606-YU, op. cit., para. 80.
only be able to survive as a source of short-term working capital if it is able to compete with the other short-term credit lines available. This would involve at present a substantial cut in its lending rate to levels below its own cost of funds. As suggested earlier, there is also the possibility of shifting some of the resources to fixed asset financing implying a reduction in the revolving fund character of its operations but at the same time permitting it to charge interest rates closer to its own borrowing rate. EDF is already providing some financing of imported equipment as a result of changes introduced in its lending regulations at a time (1986) when the demand for funds for imported inputs had declined (see para. 60).

86. The possibility of changes in the interest rate structure had been recognized in a policy paper dealing with EDF lending prepared by the Bank and presented to the Board in September 1983.30/ In that paper it was noted that the need for short-term financing funds such as EDF, which are based on long-term borrowing, was likely to be temporary once domestic measures were taken to improve foreign exchange markets and normal commercial banking sources would resume lending.

87. This experience also brings out the possible usefulness of post-completion supervision, particularly in these instances where the objective was to create a more permanent institution and where operating conditions were subject to Bank covenants and could only be changed with the agreement of the Bank. Bank supervision missions have not visited UBB since mid-1985 before these problems began to emerge in such a dramatic fashion. In this connection, it must also be noted that supervision of this part of the SAL was rather limited after the initial months of operations and it appears desirable that the Bank review its procedures for allocating staff for the supervision of projects which cut across organizational lines.

88. The original intention of the Government supported by the Bank was to create a mechanism which would help to finance import needs of exporters throughout the country and considerable effort was devoted by UBB and the Yugoslav authorities to pursue that objective. Nevertheless, the characteristics of the banking business as well as the uniqueness of the domestic banking system permitted only partial achievement of that goal. As shown earlier, a disproportionately high share of EDF operations was located in Serbia which is the region principally served by UBB.

89. This result is similar to the Bank's experience with other projects involving financial intermediaries. Domestic commercial banks develop close relationships with their client-borrowers which play an important role in determining the extent to which direct credit lines provided to individual banks (by the World Bank or other international financial institutions) will be used. For this reason, as well as for more general policy reasons, the Bank has increasingly turned to second-tier or apex lending institutions which do not undertake direct lending but rather channel resources through the entire domestic banking system.

90. While the structure of the Yugoslav banking system limited the possibility of a second-tier approach, the issue was not examined since the Bank did not focus on the transfer mechanism in the preparatory stage of the SAL. To facilitate quick processing of the loan, the Bank accepted the proposal made by the Yugoslav authorities to leave to the YBA the decision on the executing agency. For example, it might have been possible to have used the Yugoslav Bank for International Economic Cooperation (YBIEC or YUBMES) which was established in the 1970s to deal with trade matters and thus less subject to competitive rivalries than any of the regional banks.\footnote{31/}

91. Virtually all future SAL lending in other countries can be expected to continue to rely on more direct import financing. Nevertheless, this experience highlights the importance of focussing on the mechanism for resource transfer as early as possible in the preparation stages. In the case of Yugoslavia, should there be a resumption in non-project lending, the issue is even more urgent.

\footnote{31/ Special arrangements, however, were made to include YUBMES as a participating bank and particularly favorable terms were provided to its clients which are mainly capital goods exporters who have special working capital credit needs due to the long production periods for those items.}
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1. The first SAL to the Socialist Federal Republic of Yugoslavia, a loan of US$275 million, was approved by the Bank's Board on June 28, 1983 and signed on July 7, 1983. The loan completed a wider international effort to help Yugoslavia--involving both commercial and government creditors--resulting in a financial assistance package of fresh money and rescheduling of debt, totalling about US$6.5 billion. The package, put together by the IMF, was intended to ease Yugoslavia's growing foreign exchange liquidity problems (in early 1983 reserves stood at only $1.7 billion, a month's imports from the convertible area). Indeed, the commercial banks saw the SAL agreement as an affirmation of Yugoslavia's commitment to medium-term economic reform, and the prospect of an eventual SAL was an important factor in the decision of creditors to provide financial support. Conversely, the prospect and need for a financial package was an important element in accelerating the speed with which the SAL program was concluded and approved by the Bank. The decision to proceed with the SAL also reflected a shift in Bank lending policy in Yugoslavia, from a focus on the less developed Republics and Provinces (RAPs), to helping improve the productivity and competitiveness of the national economy as a whole.

2. The SAL, which was made in support of the Government's Long-Term Program of Economic Stabilization (LTPES), consisted of a specific program of structural adjustment, policy and institutional measures described in a Letter of Development Policy (LDP) to the Bank dated May 25, 1983 (copy attached as Annex I). At the outset, the Government and the Bank viewed the structural adjustment program as a long-term series of policy adjustments to be supported by successive SALs, assuming successful implementation of the existing program (as stated in para. 77 of the President's Report). Indeed, the President's Report suggested that a second SAL should sharpen the sectoral focus provided by sector studies supported under the first SAL, in energy, industry and agriculture.

3. The SAL's principal intent was to start a process to improve resource allocation in Yugoslavia. At the same time, SAL was to finance an expansion of Yugoslavia's exports to the convertible currency area so as to alleviate its acute foreign exchange shortage. The proceeds of the loan were on-lent as subloans to eligible Yugoslav exporting enterprises, through an Export Development Fund (EDF), for financing the import of essential inputs, thereby removing a bottleneck to the expansion of exports.

II. BACKGROUND

4. Although Yugoslavia was able to maintain rapid rates of growth (14.6% in 1974) and employment during the 1970's, this was achieved through a massive investment program (from 1972-1980 the gross fixed investment to GSP ratio averaged about 34%), responding to a distorted set of incentives (including an appreciating exchange rate and high levels of protection through non-tariff
barriers). This led to deteriorating efficiency and international competitiveness. A highly decentralized system for investment decisions, combined with distorted prices, negative real interest rates, a lack of financial discipline, and little inter-regional resource mobility, resulted in poor investments and duplication of capacities from one region to the next. The volume of investment exceeded national savings by a wide margin, contributing to a widening current account gap. This was financed by large volumes of foreign borrowing which allowed the exchange rate to appreciate in real terms. The result of such deficiencies, combined with the oil price shock of 1979, was a record $3.7 billion balance of payments current account deficit in 1979, or about 6% of GSP.

5. This deficit, the subsequent interest rate shock, recession of the world economy and the growing realization that the rapid economic growth of the previous decade was unsustainable, prompted the Government in 1980 to introduce a series of stabilization measures to bring the balance of payments under control. These included attempts at restrictive monetary and fiscal policies to curb domestic demand, a more active use of exchange rate policy to encourage exports and strong administrative measures to reduce imports in line with foreign exchange availability. While Yugoslavia succeeded in significantly reducing its current account deficit in 1981 and 1982, its external liquidity remained tight, and commercial borrowers remained reluctant to increase or to maintain their exposure.

6. In March 1981, Yugoslavia put into effect its 1981-85 Plan. It soon became apparent, however, that the Plan targets, though modest by earlier standards, were unattainable given the severity of the liquidity crisis, and fundamental policy adjustments would be necessary over the medium- and long-term to achieve sustained economic growth. As a result, in July 1981 a high level advisory body called the Commission of Economic Stabilization was established to formulate a medium-term strategy for a return to sustained growth. Their report, the Long-Term Program of Economic Stabilization (LTPES) was issued and adopted as the Government's policy-action framework in July 1983. Its major elements, however, had been made known to the Bank much earlier as a result of internal Yugoslav discussion of the program and as a result of discussion with the Government of the Bank's economic report, Yugoslavia: Adjustment Policies and Development Perspectives (No. 3954-YU dated November 2, 1982).

7. To overcome Yugoslavia's structural deficiencies, the LTPES proposed creation of a more open economy, an export led growth strategy, and a greater role for the market in the allocation of resources within the economy. This orientation was generally in line with positions advocated by the Bank in its economic and sector work during the preceding years.

The Structural Adjustment Program and Loan

8. In late December 1982, the Government requested the Bank to urgently consider a SAL to Yugoslavia in support of its adjustment efforts. These were also supported by three IMF standbys covering the 1983-86 period and by agreements with official and commercial creditors in refinancing packages since 1983. Because of the Bank's earlier exposure to the LTPES, the LDP already reflected the outcome of the Stabilization Commission's report, albeit narrower in scope, and was fully consistent with and complementary to the
Policy actions being monitored by the IMF under its standbys. In late 1982, Bank representatives were also invited to attend meetings of an inter-governmental group held under Swiss government auspices, and a commercial bankers group under IMF auspices. The meetings were to agree on a program of assistance to Yugoslavia, and to establish a coordinated approach among Yugoslavia's international donors in an effort to strengthen Yugoslavia's capital account position. Following these meetings and the Yugoslav request, an exploratory SAL mission visited Yugoslavia in January 1983. Bank and Fund staff collaborated closely in the preparation of the SAL (and standby). Bank staff participated in the review missions for the first and second years of the standby and an IMF staff member participated in the Bank's economic mission that provided the background to the formulation of the SAL I supported program. The loan was appraised in February/March 1983, and a postappraisal took place in April. The SAL was approved by the Board on June 28, 1983, only six months after the Government's official request.

9. The policy undertakings in the LDP were consistent with and intended to complement the policy actions being monitored by the IMF under its standby arrangements, with the Fund concentrating more on the immediate need to resolve external liquidity problems through demand management, including the exchange rate and external financing actions, and the Bank concerning itself with a "medium-term framework" for increased efficiency in resource allocation which emerged through the work of the Stabilization Commission and intended Plan revisions. Not only was the Bank's concern reflected in the SAL but also in an intended shift to other policy-based lending which included a fertilizer sector loan in 1984 and prospects of future sector lending. The principal areas of common interest to the Fund and the Bank were in (i) interest rate policy; (ii) foreign exchange allocation; (iii) external debt monitoring; and (iv) price policy. With regard to interest rate policy, the IMF arrangement included an undertaking by the Government to review with the IMF the level of deposit interest rates if the annualized rate of inflation were to exceed 20% in the first half of 1983. Under the 1984 standby arrangement with the IMF, it was also agreed that by April 1, 1985, interest rates on three-month deposits would reach 1% in real terms. It provided for a steady adjustment (2% in real terms per month) of the exchange rate in 1983 to encourage exports. These measures were reinforced by understandings under the SAL covering floor lending interest rates and the creation of the Export Development Fund (EDF), as well as support for the exchange rate policy. In addition, the SAL included a substantial institution building component to strengthen the design and monitoring of investment projects, as well as a phased program to improve the operations of the foreign trade and payments regime. In the area of price policy, the IMF and the Bank were in general agreement on the direction of price liberalization and changes in relative prices as well as the need for an increase in the price of electricity, coal, meat, as well as railway fares, all of which were adjusted in collaboration with the Fund in 1983. The SAL pricing framework on energy, transport and agriculture pricing, were intended to reinforce these measures.

10. The SAL was disbursed in two tranches of $175 million (upon loan effectiveness), and $100 million. The original intention, as stated in the President's Report, was to have the second tranche released upon satisfactory review of progress with the Government of the specific release conditions listed in the Schedule to the Guarantee Agreement (attached as Annex II). A first review in October 1983 concluded that inadequate progress had been
made. As a result tranche release was delayed by about ten months to August 1984. After another review mission in June 1984, tranche release approval was given on August 23, 1984. The Bank staff recognized that progress had been slow in meeting specific tranche release conditions, i.e. (i) establishing a program for energy conservation studies—to have been supported by a technical assistance loan; (ii) the 'conclusion' of a "social compact on the social and economic justification of intended investment projects" amongst Yugoslav banks and planning institutes; (iii) improving foreign exchange mobility through improvements in the foreign exchange allocation system. However, Bank staff concluded that given substantial progress, at that time, in the areas of interest rates, exchange rate adjustment, pricing and financial discipline, overall performance justified release of the second tranche.

11. Although, as originally planned, the period within which SAL disbursements were to have taken place was too short to allow for any substantial improvement in overall economic performance, the lengthy delay in tranche release did reveal certain developments in the economy's performance which influenced the Government's application of SAL conditions after the tranche release. Specifically, in 1983 and 1984 Yugoslavia continued to improve its balance of payments position, registering surpluses in its current account. Under its standby agreement with the Fund, a major realignment of the real exchange rate took place in 1983 with a real depreciation of 26%, and Fund reports at the time acknowledged the Government's positive external adjustment performance under the standby. Despite the Government's attempts at restraint on expenditure and tighter demand management, however, inflation accelerated precipitously in the second half of 1983 resulting in a 55% increase for the year as a whole. The surplus in the convertible current account of the BOP rose to $779 million in 1984, while inflation remained around 53%. Ironically, the positive developments in the current account balance, doubtless served to ease the pressure felt by the Government to take the additional tough measures called for under the SAL, while the acceleration of inflation increased resistance to measures that were regarded as fueling inflation through cost push.

12. The internal debate between those supporting the SAL program and those who either opposed it or advocated alternative reforms, given the program's perceived costs, proved to be more contentious than anticipated. This was especially so in relation to the reforms of (a) the foreign exchange allocation system where differences emerged which essentially pitted the northern "exporting" republics against the southern "importing" republics, (b) the trade regime and (c) interest rates. In both the latter cases, Yugoslavia's largely protected and highly leveraged enterprises were not prepared to go as far in reform as the SAL program called for, and in the weak federal structure of Yugoslavia, the Federal Government was not in a position to require them to do so.
III. PROGRESS IN AREAS MONITORED UNDER THE SAL PROGRAM 1/

A. Investment Policy and Resource Allocation

13. A major objective of the SAL I was to support measures to improve the quality of the country's investment program through appropriate price incentives and strengthened design and monitoring of major investment projects. Although there is evidence that the reduction of fixed investment in the period 1983, 1984 and 1985 (by about 10% from 1983 to 1984 and 1984 to 1985) reflected a more careful screening of investment projects, there was no discernable shift in investment to priority sectors. Rather, cuts were implemented uniformly across the board. Three investment reports, intended to help monitor the quality of investments being undertaken, were submitted to and reviewed by the Bank, the first in September 1983 covering developments through March 1983, the second in March 1984, and the third in November 1985. Though the quality of the first report was sufficiently comprehensive to justify release of the second tranche, and the second report was in some respects an improvement over the first, the third report deteriorated in quality and contained little information on the larger investments (over Din.750 million) while the definition of priority sectors was so broad as to blur meaningful identification of priorities for the 1984-85 period. Although a core investment program in energy for 1983-1985 (including a commitment to ensure priority access to finance for "core projects") was submitted to the Bank for review (fulfilling one of the tranche release conditions) and was largely implemented (since it consisted predominantly of investments already well advanced in implementation), to date it has not resulted in any lasting system for ensuring rational and least-cost energy investments for the country as a whole. Moreover, it did not preclude investments excluded from the core program. On the other hand, the current Law on Planning does require the preparation of a "Joint Development Plan" in power, which is an attempt to establish a nationwide program for the sector. The JDP has suffered major delays. It is now expected to be finalized by end 1986.

14. At the same time, to ensure the use of uniform, rational economic criteria for investment selection in all sectors nationally, a "Social Compact on the Criteria for and Manner of Rendering Opinions on the Social and Economic Justification of Preferred Investment Projects" was to have been prepared by July 1983 as a tranche release condition. Due to the complexity of the Yugoslav self-managed system and the time needed to achieve consensus within it, however, the Compact was not finally approved until late summer 1985 (although we had been led to believe by Government authorities that lower level approval of an earlier draft in July 1984 constituted final approval). Although the Yugoslav Bankers Association appear to be firmly committed to application of the compact (a manual has been prepared, and planning for a first training seminar has recently been completed with EDI assistance), it is unlikely that the new procedures will be fully implemented before 1987. On the other hand, a new banking law, effective in January 1986, does require banks to prepare economic analyses (without defining the methodology) of all investment projects for which loans are sought, and holds the banks

1/ A complete list of policy undertakings described in the SAL President's Report is attached as Annex III.
accountable for bad loans. If properly implemented, the law, combined with the compact, would be a significant step towards rationalizing investment financing by banks (constituting about 40% of all investment financing) in Yugoslavia.

15. The SAL also sought to rationalize investments through the use of realistic capital pricing through gradual movement towards real positive floor lending interest rates. This undertaking was implemented in conjunction with an agreement under the Fund Standby of 1984 which, combined with the SAL undertaking, resulted in all Yugoslav banks in early 1984 signing a Self-Management Agreement (SMA) which called for three-month deposit rates to be adjusted to positive real levels by April 1985, and for bank floor lending rates to be adjusted to positive real levels by (i) 1986 for "noneconomic sectors"; (ii) 1987 for "economic sectors"; and (iii) 1989 for high priority sectors to which continued subsidization of credit was considered essential to increased production. The undertaking was also complemented by specific agreements reached in four agricultural and one IFD project financed by the Bank, on achieving positive real on-lending interest rates. Although there was some delay in making the initial adjustments on the deposit rates, by and large the adjustments were made through 1984 and 1985, with, for example, rates on three month deposits briefly reaching positive real levels in mid-1984 and again in early 1985. On the lending side, adjustments were generally made in the floor rates until late 1985, and in mid 1985 the rate came close to positive real levels. Beginning in 1986 however, real rates grew increasingly negative. There were problems both in the interest rate formula and in the Government's commitment to achieving positive real lending rates in the face of rising inflation. Implicit in the lending interest rate adjustment formula, agreed to in the LDP, was an assumption that inflation would decline. Instead, it accelerated, eroding the movement towards positive real interest rates. Moreover, the Government was reluctant to increase interest rates out of concern that this would fuel inflation (through cost-push). As a result, during the first quarter of 1986, less than 3% of new credits carried a positive real rate of interest. In July 1986, the SAL formula was unilaterally abandoned by the Yugoslav authorities and nominal lending rates were reduced substantially.

16. As a more direct means of restructuring, it was also agreed in the LDP to undertake a program of studies in selected industrial subsectors which would identify ways in which to restructure priority subsectors and improve industrial energy efficiency to increase productivity, reduce energy imports and promote competitiveness of industrial exports. Of these, only a report on the textile industry has recently been completed by the textile association. After the study is reviewed by the Bank and discussions are held with the Yugoslav authorities on sector improvement measures, it could provide a basis for identifying a future textile restructuring project. As for the other sectors identified, namely steel, cement, metals and chemicals, a strategy paper for the steel industry was received and reviewed by the Bank, but was not adequate for purposes of identification of subsector reforms and modernization. No studies for the other subsectors have yet been submitted to the Bank, although indications have been given by the authorities that they expect to submit these to the Bank before the end of 1986. Though the Government appeared to be committed to undertaking the studies at the time of appraisal, an insufficient appreciation by the Federal Government and the Bank of the reluctance of some industries to participate (knowing that austerity,
rehabilitation or bankruptcy might be a consequence), as well as of the complexities of decision-making in the Yugoslav system, have prevented the studies and their implementation from being carried out.

17. Finally, in an effort to improve the financial planning of banks, it was agreed, as a condition of tranche release, that investment plans would be prepared on the basis of current prices, with assumptions on inflation and exchange rate adjustments to be provided by the Federal Institute for Social Planning. It was subsequently agreed that the banks would use their own assumptions. Although at the time of tranche release, the authorities confirmed to the Bank that Yugoslav banks were consistently employing current prices in their investment planning, recent indications are that, as a result of their inability to accurately predict inflation and the possibility that such projections might prove to be self-fulfilling, only one or two banks are regularly applying current prices in their investment planning. This continued use of constant prices in Yugoslavia's highly inflationary environment makes the analyses and projections by banks and enterprises misleading as measures of expected profitability, particularly where foreign exchange transactions are concerned.

B. Foreign Exchange and External Trade

18. As a means of ensuring the external competitiveness of Yugoslav production, and in contrast to the past policy of minimal adjustments in exchange rates, the Government, under the terms of its standby with the Fund, from late 1982 pursued a policy of continued adjustments. Following the real effective depreciation of 1983 (see para. 11), the real value of the dinar was maintained against the currencies of its major trading partners. This policy, along with sharp cuts of imports, was instrumental in turning around the current account of the balance of payments. In 1986, however, in spite of adjustments in the exchange rate, the new foreign exchange regime which did away with parallel market transactions led to an effective appreciation of the real exchange rate thereby eroding Yugoslavia's ability to compete more effectively in the international market place.

19. Complementary to the flexible exchange rate policy, it was also agreed that, as a tranche release condition, a report be submitted to the Bank and the Fund, recommending measures to improve foreign exchange mobility nationally. It was understood that the measures would include the reactivation of an effective foreign exchange market. The report was received in December 1983 and a number of its measures were implemented in 1984 leading to some increase in the circulation of foreign exchange. This was essentially organized around a more centralized allocation system designed to ensure the availability of foreign exchange for priority imports and foreign exchange payments. Subsequently in January 1986, the current system was introduced requiring 100% surrender by exporters to the NBY. Though this system favors access to foreign exchange for eligible transactions regardless of whether enterprises are net exporters, and is seen by the Government as a transitional step to establishing a convertible currency, the system appears to have exacerbated problems by eliminating important incentives to exporters existing under the previous system (possibility of net exporters being allowed to earn premia from the parallel "sale" of foreign exchange to other enterprises), and by introducing an even more administered system for the allocation of foreign exchange.
20. With respect to the monitoring of foreign borrowing and debt, a computerized system for debt reporting was put in place in late 1983 thereby formally meeting the SAL undertaking. Though Yugoslavia was current for some time following adoption of the system, the full debt information available to the Bank now dates back to August 1985, and despite a Bank debt mission in November 1985, Yugoslavia is once again delinquent in its debt reporting.

21. In the area of foreign trade, a report was submitted to the Bank in December 1983 on ways in which to improve Yugoslavia’s infrastructure for export marketing. Flaws in export incentive schemes (relating to border trade, long-term cooperation agreements) led in 1984 and 1985 to increased counter-trade operations and prevented a foreign exchange market from emerging. The recommendations of the study, which fell well short of expectations, were not, however, seriously considered for subsequent implementation, with the exception of a few measures to reduce counter-trade. Similarly, although terms of reference were agreed to, a proposed study of effective protection, to have shown the effect of trade and payment restrictions on the domestic price structure and resource allocation, was never done. Though the study was considered a high priority by federal officials at the time the SAL was prepared, it would appear that strong vested regional interests were concerned that such a study would lead to erosion of protective barriers under which they have operated in the past. Although alternative studies were to have been done and provided to the Bank by Government, neither the studies nor their terms of reference were ever submitted. Without these studies, efforts to design reforms for the trade regime were constrained.

C. Price Policy

22. A major objective of the LTPES has been to increase the role of world market prices and domestic market forces in price formation, so as to provide to producers the right signals for efficient production. With the "Social Compact on Price Policy" of 1983, Yugoslavia embarked on a policy of progressive reduction of the number of commodities subject to price ceilings. The SAL program supported a liberalized price regime and in conjunction with the Fund Standby, identified a number of specific commodities and services for which prices were to be adjusted (petroleum products, natural gas, lignite, coal, electricity, railway tariffs and road user charges).

23. With respect to petroleum products and derivatives, price adjustments called for under the Standby have been made twice yearly as agreed. Similarly, adjustments to the domestic gas price agreed to under SAL and the Petroleum Sector Loan (2585-YU, June 22, 1985) have also been adjusted in line with the agreements, and are currently about 90% of the border price. The drop in crude oil prices and gas pricing arrangements with the Soviet Union have made this possible despite high inflation. The same cannot be said, however, for coal and lignite prices where little progress has been made on price adjustments or on establishing an economic methodology for pricing. As for electricity, adjustments have taken place, and, as a result, the average tariff increased from about 50% of estimated economic cost in 1983 to about 70% in mid-1986. Although unlikely to reach its economic cost by the original target of 1987 (as agreed under the SAL and the Power III project—Loan 2338-YU, July 26, 1983), the latest social plan calls for meeting the target by December 1988. The study to establish a pricing methodology for
electricity based on the long-run marginal cost has not been submitted to the Bank; instead, a methodology based on so-called "common elements" was recently provided to the Bank and is being reviewed. How these "elements" will be utilized to implement the covenant under the third Power Project, and the undertaking in the SAL LDP, however, is not yet clear.

24. As for the transport sector, railway tariffs have been adjusted in accordance with the SAL and the Sixth Railway Loan (2336-YU, July 19, 1983) agreements, and compensation payments to the railway organizations are being steadily reduced. As for road user charges, adjustments have been more sporadic, and have not fully matched the inflation rate. Arrangements for the future adjustment of road user charges have been strengthened by the Highways Sector Loan approved in June 1986.

25. On the whole, formal Yugoslav performance with respect to the pricing undertakings was largely in line with the SAL, though characterized by a stop and go application of policy. Most recently, however, there have been reverses in a number of areas. A short-lived price freeze was applied between December 1983 and May 1984, while a new pricing law intended to substantially reduce the proportion of administered prices was put into effect in January 1985. Assurances were also given to the most recent IMF mission (June 1986) that controls would not be reimposed, and that measures taken in January and April of 1985—which raised the share of industrial production on the "uncontrolled list" up to 42.5%—represent the Government's established policy. Notwithstanding these assurances, the Government felt there was a need to break what it perceived as the prevalent inflationary psychology and to this end, effective July 1, 1986, products which previously required 30 days advance notification (about 38% of the industrial producer price index) now require a 120-day notification period. In addition, there have been suggestions by some Yugoslav authorities that selected price controls might have to be reimposed if inflation continues to escalate.

26. Despite the progress made to date in liberalizing prices, these recent retreats in price policy, along with a weakening in other policy areas, e.g., monetary, credit, and personal incomes, suggest an indecisiveness and a lack of conviction on the part of the authorities of the critical importance of macroeconomic policies in dealing with their current stabilization problems, especially inflation.

D. Financial Discipline

27. A critical element in the successful implementation of structural adjustment in the Yugoslav system is increasing the financial accountability and discipline of enterprises and banks. This is also a most sensitive development since it touches the concepts of equity and interdependence which have provided the underlay for Yugoslavia's system of socialism. Yet the LTPES recognized that excessive enterprise losses could not continue to be supported by society as a whole, and that enterprise rehabilitation and positive returns were essential. As a result, the LDP expressed a commitment to amend the law regulating the behavior of loss-making enterprises to regulate the personal income payments paid by such enterprises, and to increase the automaticity of bankruptcy regulations. Targets were also set to reduce inter-enterprise credit in nominal terms and to limit the nominal value of social funds available to cover enterprise losses. These provisions under
the SAL were, in addition, complemented by the Fund's 1984 Standby, under which it was agreed that personal income payments in loss-making enterprises would be restricted, and that payments from Joint Reserve Funds to loss-making enterprises would be substantially reduced and eventually eliminated.

28. The amendments to the laws regulating personal income payments and bankruptcy were passed, though not put into effect as soon as intended, and because of consistently negative real deposit rates paid by the banking system, the target for limiting inter-enterprise credit was not met. Though the intent by Government to see these laws implemented appears to have been serious, implementation has lagged and been uneven. Self-management and the fragmentation of the Yugoslav financial market have made it difficult to apply the new laws systematically.

29. The effects of the measures to limit the amount of personal income payments in loss making enterprises are as yet uncertain, and given the obstacles to labor mobility and the prevailing tendency of banks to cover enterprise losses, the measures could have negative effects by enabling loss-making enterprises to survive at low levels of productivity (which is better than at low productivity and high pay). On the other hand, with respect to limiting the accessibility to capital of loss-making enterprises, recent information suggests that the measures taken appear to have had some impact, with a shift away from coverage of losses by nonreimbursable funds to coverage through rehabilitation credits. In addition, although not strictly a part of the SAL I program, positive changes were made in the enterprise accounting conventions to better reflect the actual financial condition of enterprises and banks, and a new banking law was passed intended to promote greater financial discipline and prudence in banking. The intentions for reform appear to be present in these changes. As in the past, however, probably due to the fragmentation of the system, the central issues of implementation and a regulatory framework (especially for the banking system) have not been addressed, leaving serious doubts as to the impact of these new laws.

E. Sector Reviews

30. As agreed under the LDP, after considerable delay and discussion on their scope, a set of action programs for each branch of agro-industry, was submitted to the Bank. The programs, narrowly focusing on the issue of the imbalance between production capacity and raw material availability, proved to be of poor quality and too limited for meaningful application by the industries concerned, although reviews by the Bank in a number of Bank-financed projects have provided an alternative for formulating typical action programs. In addition, after even greater delay, a study of primary production in agriculture was submitted to the Bank in November 1985 and though its recommendations were limited in scope, it has been useful as a source of information and data for the Bank's recently completed Agricultural Sector Memo which is to be discussed with the Government.
IV. LC:JN ADMINISTRATION

F. EDF Operations

31. The $275 million SAL was fully disbursed in July 1985. The Export Development Fund (EDF) through which the loan was disbursed became operational in August 1983, and the second tranche was disbursed in August 1985. At the outset EDF operations were slow, largely due to cumbersome requirements (the need for excessive documentation by exporters) by the borrower, Udruzena Beogradska Bank (UBB) and by the Yugoslav Bankers Association (YBA), and a lack of familiarity with the new subloan requirements. Once exporters had familiarized themselves with the procedures, which at the Bank’s recommendation were streamlined, EDF disbursements accelerated rapidly. Nevertheless, the initial estimates of fully disbursing the first tranche by December 1983, and the entire SAL by June 30, 1984, were unrealistic. Subsequent to full disbursement of the second tranche (once recycled funds were being on-lent), in May 1986 and August 1986, the terms and conditions for the use of the EDF were broadened, by amending the terms and conditions of certain categories of subloans and extending EDF access to Yugoslav international road transport firms, airline companies and railway organizations, all of which are engaged in the export of Yugoslav services. Administratively, loan implementation by UBB was fully satisfactory.

32. Although there was concern initially that EDF funds were being lent disproportionately to Serbian enterprises (68% of the first tranche), there was a discernable trend to a more even distribution over time (50% of second tranche funds) with only 35% of recycled funds going to Serbian exporters. Reasons given for this early trend included the fact that UBB, though nationally represented, was nevertheless a Serbian bank and that Serbian enterprises, particularly UBB clients, would have been familiar with the EDF before enterprises located in other Republics and Provinces. In addition, a number of other Republics (especially Slovenia, Yugoslavia’s largest exporter to the convertible countries) continued to have access to cheaper bilateral export and suppliers credits whereas Serbian enterprises did not. On the whole, however, the Yugoslav authorities were satisfied with the operations of the EDF which, with recycled funds, has to date financed close to $650 million (as of September 30, 1986) in loans for exports totalling about $1.2 billion (see Table 1 attached, for distribution of EDF funds by sector as of June 1986) and in so doing removed an important financial bottleneck to export growth.

G. Loan Monitoring

33. SAL implementation was closely monitored by the Bank, especially prior to release of the second tranche. This was considered necessary in view of the comprehensive package of policy reforms and sector studies to be implemented, and the numerous criteria for release of the second tranche which, as indicated earlier (see para. 10), was delayed by about ten months over original estimates. Major review missions took place in October 1983 and May 1984, with additional missions between June 1983 and August 1985 focusing on specific sector requirements and EDF implementation. Bank staff also participated in an IMF mission in December 1983 to review the proposed reforms to the foreign exchange allocation system (a summary of SAL related missions is attached as Annex IV). Subsequent to tranche release, monitoring of the
SAL was not as systematic nor as frequent, though reviews of progress in implementing policy adjustments were carried out in the course of SAL II preparation, with missions in May and October 1984, March and November 1985. In addition, Bank staff participated in an IMF mission to review progress on foreign exchange and foreign trade reforms in May-June 1984, and again in June 1985 and June 1986. Moreover, the need to meet the SAL I conditions were continually stressed to Government as a sine qua non for a second SAL. Despite the missions, and the collaboration between the Federal authorities and the Bank on the SAL I program, there appears nonetheless to have been insufficient appreciation by Federal and Bank staff of the ability of vested interests at the regional and local level to slow and resist the proposed reform program. Additionally, this resistance is supported by the chronic tendency in the Yugoslav federal structure, to dilute reform proposals - so as to achieve political consensus - to the lowest common denominator. Most recently there has been an apparent weakening in the Government's commitment to implementation of the policy reforms, as defined in SAL, as a result of the escalation in domestic inflation. The experience with SAL I suggests that future policy reform lending should be more closely linked to a clear commitment of the Government to the implementation of a few key, clearly monitorable, reforms over a multi-annual period. There would be an explicit understanding that adherence by the Government to their implementation would result in quick processing of follow-up Bank operations of a mutually agreed upon size without additional conditions. Carrying out of other reforms designed to deepen the process of economic restructuring would result in additional Bank lending along the same lines.

V. SUMMARY AND CONCLUSIONS

34. Performance under the Yugoslav SAL needs to be viewed in two distinct parts, though as originally conceived, these were to be complementary and self-supporting. On the one hand, the EDF was established as a means of providing subloans to exporters for the purchase of essential inputs. The objective, at a time of severe foreign exchange scarcity, was to ease Yugoslavia's balance of payments problems by helping to sustain an increase in industrial exports. In this respect, though there was some initial delay in disbursement of EDF funds and a more considerable delay in release of the second tranche due to delays in compliance on policy conditions and undertakings, the operations of the EDF were highly successful and contributed to the improved current account balance in 1983-1985. An important result of this improvement in the external balance was the continued willingness of Yugoslavia's commercial and official creditors to agree to a series of financial restructuring packages in 1983, 1984, and 1985.

35. Yet by its nature, the SAL was not intended as a one time operation, and the support to the EDF was intended to lead into and complement the long-term structural adjustments called for under the SAL. Indeed, the SAL was to mark the beginning of a process of adjustments outlined by the LTPES—a break with the past inefficiencies of excessive controls and fragmentation—and the new adjustment strategy was to be supported by a possible series of SALs from the Bank. A second SAL was therefore originally programmed for approval in FY84 or immediately following satisfactory completion of SAL I. Accordingly, preparation of a proposed second SAL, intended to deepen and extend the areas of reform covered under SAL I, is well advanced, though currently at a standstill. The largely unsatisfactory
implementation of SAL I policy undertakings since 1985, particularly in the areas of interest rate adjustments and the foreign trade/foreign exchange regime, combined with the recent weakening of overall macroeconomic management, have not allowed us to proceed with SAL II. Underlying these issues, are questions on Yugoslavia's commitment to a more market-based economic system and the Federal Government's ability to achieve the inter-regional consensus required for the effective implementation of major systemic reforms.

36. Therefore, as regards the implementation of SAL I commitments, and the broader movement towards meaningful economic adjustment as established in the LTPES and the LDP, Yugoslav performance has been disappointing. Our current inability to proceed with SAL II or a meaningful operations program almost 3-1/2 years after the first SAL, is testimony to this. Of the 24 conditions and undertakings agreed to under the SAL (see Table 2 attached) only 5 were clearly undertaken (7 if one includes the EDF operations). These include: under foreign trade and foreign exchange (i) exchange rate adjustments (para. 18); under pricing, the adjustment of (ii) petroleum, (iii) natural gas, (iv) electricity (para. 23), (v) railway tariffs (para. 24); and (vi) the submission of an agricultural primary production study (para. 30); in addition, the passage of a new law on pricing, though not a formal undertaking of SAL, nevertheless supported its policy direction. Though the exchange rate adjustment was met from a strictly legal point of view, as para. 18 points out, the Government has recently switched to a policy of discrete depreciations followed by periods of appreciation in order to break inflationary expectations. However, in 1986 Yugoslavia's export competitiveness has been eroded due to the change in the foreign exchange allocation (para. 18). Moreover, the allocation of foreign exchange and the import regime remain subject to a rigid system of administrative controls.

37. An additional 10 commitments could be considered partially undertaken. These include in the investment area (i) a cut-back of investment (para. 13); (ii) the preparation of the Social Compact on Investment Criteria (para. 14); (iii) submission of investment reports (para. 13); (iv) adjustment of floor lending rates (para. 15); (v) the submission of a textile sector study (para. 16); (vi) the application of current prices to investment planning by banks (para. 17); (vii) foreign debt monitoring and reporting (para. 20); in pricing (viii) road user charges (para. 24); and in financial discipline (ix) limitations on the growth of personal incomes in loss-making enterprises (para. 28); and (x) submission of a study on agro-industrial rehabilitation (para. 30). Even in these areas of partial compliance, however, for items (iii), (iv), (vi) and (vii) there has been, since release of the second tranche, a clear retreat from the policy objectives under the SAL program, and for item (v), only one (the textile study) of five subsector studies has been submitted.

38. For the remaining seven areas, the undertakings have not been met. These include (i) the continued use of a core investment program in energy (para. 13); (ii) an increase in foreign exchange mobility and movement towards the establishment of a foreign exchange market (para. 19); (iii) liberalization of the foreign trade regime (para. 21); (iv) preparation of an effective protection study (para. 21); (v) adjustment of coal and lignite prices (para. 23); (vi) preparation of an LRMC study for electricity pricing (para. 23); and (vii) limitations on the use of inter-enterprise capital transfers (para. 28).
39. Of the major policy areas for the SAL as a whole, taking into consideration the latest policy initiatives of the new Government, only in the area of pricing could one conclude that meaningful adjustments were made during the SAL implementation period, though even here, as para. 25 points out, there has recently been a disquieting retreat from the progress made earlier. In the other major policy areas, particularly investment, interest rates, foreign trade, foreign exchange, and financial discipline, performance has been for the most part well below expectations, with whatever progress made in the early part of the SAL's implementation, since eroded by the internal pressures of regional and institutional interests to ease the hardship of the structural adjustment process.

40. What conclusions can one draw from the experience of the first Yugoslav SAL? Can one conclude in retrospect that the country was not ready for a SAL and that the systemic obstacles to meaningful structural reform cannot be overcome in the absence of major reforms of the current political and social system? That the current post-Tito system of a weak Federal Government, which does not have in hand the needed policy instruments, is not suited to implementation of SAL reforms? Or should one conclude that the SAL was too comprehensive, too ambitious, too hurriedly put together (under the pressure to conclude a major financial package), and not mindful enough of the political realities of the Yugoslav federation, suggesting a different structure for a second SAL?

41. Certainly, the process of reform in Yugoslavia, given its rather unique political and social make-up, is slower and more uneven than in many countries, but reforms have taken place in the past, and some meaningful progress was being made during the earlier part of SAL implementation when the Fund was present with standbys, and EDF funds remained to be disbursed and external debt management was a critical issue. A sustained commitment to reform has to be there to start with. The prospect of a second SAL and expanded Bank lending have not been incentive enough to overcome the countervailing pressure, supported by high inflation and unemployment—to ease the pace and the process of reform. In view of the time elapsed since SAL I approval, its momentum is being eroded, and unless the Government soon indicates a willingness to proceed with the reforms proposed in SAL II or with acceptable alternative proposals, thereby reversing the recent trend away from the use of market signals and financial discipline, one would have to question the Government's ability and commitment to carrying out a meaningful program of structural adjustment. Indeed, at the recent Bank Annual Meetings (October 1986) the Government stressed again that the policy conditions the Bank views as essential to the adjustment of the economy are, for the moment, not acceptable.

42. On the other hand, the process of SAL implementation has helped to increase awareness within the Government and the Bank of the difficulties and costs involved in the adjustment process and the need to minimize the complexity of future SAL programs to what is implementable. It has also served as an indispensable means of providing the Bank with substantial insights into the workings of the Yugoslav system.
Should the newly appointed Government (May 1986) reach agreement with the Bank on the policy measures for achieving medium-term adjustment, based on the experience of SAL I, any future policy-based lending should (i) limit the scope of conditions and undertakings to only the most essential and for which clearly identified arrangements and commitments for undertaking and applying them have been established beforehand. While policy packages for each loan should be specific and monitorable, they should avoid a multiplicity of subcomponents within each area. Not only does such complexity create difficulties for the Government authorities in monitoring and implementing, but it also limits the effectiveness of Bank staff supervision; (ii) require the creation of a counterpart economic team which, in addition to designing the program and monitoring progress, would have the means and the authority to analyze and recommend mid-course corrections to policy undertakings should circumstances warrant. Without some such authority at the Federal level, it is difficult to see SAL as a feasible approach in the Yugoslav system. This could be complemented by measures (for example, technical assistance) to strengthen key institutions involved in SAL implementation; (iii) to the extent possible, seek to ensure that the Federal authorities include the Republics and Provinces in the formulation, preparation and formal approval of the SAL program itself so as to have their full commitment to its implementation and ensure that they consider it their program (iv) focus more systematically on ensuring the effectiveness of regulations, and where appropriate, recommending the creation of regulatory bodies to ensure that policy measures are being applied; (v) more clearly articulate how the SAL reform package would practically assist in dealing with the Government's major economic concerns, notably export development, inflation and unemployment.

(3) Annex III, List of Criteria and Monitorable Actions
(4) Annex IV, Summary of SAL-related Missions.
(5) Table 1, Distribution of EDF Funds as of June 11, 1986.
(6) Table 2, Summary List of SAL Conditions and Undertakings.

October 24, 1986
Mr. A. W. Clausen  
President  
The World Bank  
1818 H Street, N.W.  
Washington, D.C. 20433  
U.S.A.

Dear Mr. Clausen:

1. In view of the positive experience and the heretofore very successful cooperation between Yugoslavia and the World Bank, the Federal Executive Council has formulated this Letter on Yugoslavia's development policy till the end of 1985, directly connected with the talks on new forms of our long-standing cooperation i.e. relevant to the request for granting Yugoslavia the first loan for the structural adjustment of the Yugoslav economy.

2. In this letter the Federal Executive Council has articulated the directions of development and current economic policy which it will submit before the SFRY Assembly, and along the lines of which it will evolve its activity in implementing the economic stabilization policy, and inform the World Bank on the results on a regular basis. Taking account of the opinions of your mission advanced during the talks conducted with the Yugoslav authorities in Belgrade in February and April of this year that the World Bank through these forms of cooperation in no way wants to bring into question the self-management system and decision-making modes on national development and economic policy based on our constitutional order, the Federal Executive Council shall submit to the SFRY Assembly and execute the declared intent of this letter within its jurisdiction as well as take decisions in accordance with the socio-economic system established and constituted in Yugoslavia.

3. We also wish to express the view and the assurances of the Federal Executive Council that, in view of the degree of Yugoslavia's development, the prevailing external circumstances affecting the development of our country, as well as the efforts and results in the implementation of the economic stabilization policy and in dealing with certain problems in our economy, the intent of this letter is part of a more comprehensive strategy and policy of the development of our country expressed through the long-term stabilization program. The Federal Executive Council shall pursue the long-term stabilization program with determination with a view to the successful continuation of the country's social and economic development based on socialist self-management and a non-aligned foreign policy.
The Macroeconomic Situation

4. As you are aware, developments in the international economy since 1979 have placed a great strain on the Yugoslav economy. The rise in oil prices, taken together with the weak performance of Yugoslav exports in that year and in the years preceding and the burden of increased interest payments on international debt, had led to a balance-of-payments deficit of $3.7 billion in 1979. This deficit, together with other disturbances in commodity and money relations in the domestic economy, had led the Government as early as the second half of 1980 to begin to introduce and implement a program of stabilization measures which between 1981 and 1983 have become increasingly comprehensive and better defined and are still in the course of implementation. The main characteristics of these measures, which have been supported by substantial assistance from the IMF since June 1980, are primarily related to a considerable increase of production through increased capacity utilization and strengthening of its competitive capabilities in relation to foreign countries and increase of exports, particularly to the convertible currency area. It has been necessary to act more resolutely to adapt all forms of consumption to real income and material possibilities, and to this end we opted for more restrictive monetary and fiscal policies, a more active policy of the rate of exchange of the dinar to encourage exports, curb public consumption, curb investment demand and promote investment efficiency by increasing the share of organizations of associated labour in financing investments, with a concurrent restriction on credit demand, and take other similar measures aimed at removing generators of unstable relations in reproduction. At the same time action has been taken to reduce import purchases in line with revenues accruing from export earnings and from a more restrained program of foreign borrowing than has been the case in the preceding period.

5. As a result of these measures, Yugoslavia was successful in reducing its balance-of-payments deficit substantially to $2.3 billion in 1980 and to $0.9 billion in 1981. These improvements were based upon a considerable increase in exports of goods and nonfactor services, which increased by 11% in 1980 and 12% in 1981 in real terms. Notwithstanding this export performance, achieving the balance of payments deficit mentioned above involved outright cuts in imports of 10% in 1980 and a further 2% in 1981. These changes have resulted in an increase of the coverage of imports by exports to 59.6% in 1980 and 70.2% in 1981 as compared to 48.5% in 1979. The cuts in imports were necessitated by several factors, including insufficient merchandise exports, the weak performance of exports of invisibles and the continued adverse impact of rising international interest rates. In addition, the deteriorating climate in international capital markets led to a reduction in the level and certainty with which foreign funds could be used in Yugoslavia, adding further to the need to constrain imports.
6. Although we had reason to feel encouraged by developments in the balance of payments between 1979 and 1981, these gains were at an appreciable cost to the economy as a whole and were accompanied by other, less positive developments. The growth rate of social product of 7.0% in 1979 was sharply reduced to 2.2% and 1.5%, respectively, in 1980 and 1981, with industrial output especially hard hit, its 1979 growth rate of 8.2% falling to 4.1% in 1980 and 1981. The need to step up exports and to address the country's external liquidity problems despite low economic growth involved reductions of all forms of final consumption. Particularly noteworthy were trends in real fixed investment, from growth of 6.4% in 1979 to reductions of 1.7% in 1980 and a further 9.3% in 1981 as well as reductions in real personal incomes in the social sector by 8% in 1980 and 5% in 1981. Despite significant reductions in domestic demand, inflationary pressures remained considerable and have necessitated measures of social price control in accordance with our Anti-Inflation Program.

7. Developments in 1982 did not, unfortunately, lead to any significant reversal in these trends. Despite our best efforts there was a revival in domestic demand in the first half of that year, accompanied by a worsening in inflationary pressure. At the same time exports to the convertible currency area were reduced as compared to the preceding year and there was a reduction of foreign exchange inflow from tourism as well as from workers' remittances due to a number of external and internal causes. External liquidity difficulties of some of our banks prevented us from completing our borrowing program and maintaining our short-term debt liabilities at planned levels. The consequence of these developments was to put further pressure on our imports from the convertible area. While the balance of payments deficit with the convertible area was reduced substantially, this was almost wholly due to reductions in imports to an extent that has been harmful to the smooth running of the economy, above all industrial production. Additional measures to restrict demand were taken in 1982 leading to a further reduction in real personal incomes in the social sector of about 3%. Fixed investments were also further reduced by about 6%.

Structural Aspects

8. While on the one hand trends in the external environment were important proximate causes of our current difficulties, on the other the severity of our present economic situation also reflects certain structural problems in the development of the Yugoslav economy in recent years. Of particular importance were investment policy and certain aspects of the framework for the allocation of the available resources.

9. In the area of investment policy our fundamental objective, embodied in Yugoslavia's 1976-1980 medium-term plan, was to direct
investment into certain priority sectors whose accelerated development was seen as necessary by mutual agreement between the socialist republics and the socialist autonomous provinces, and which are of particular importance to the development of the Yugoslav economy as a whole. Our experience in the 1976-1980 medium-term plan period revealed certain weaknesses in the envisaged material and financial frameworks for implementing the investment policy agreed upon. The assumptions and frameworks of the plan were designed to give stronger expression to the principle that organizations of associated labour have a decisive role in investment proposals and in taking decisions to invest with a view to the accelerated development of the economy and society in general. However, the eagerness to attain the agreed development objectives as set in the plan and the fact that, owing to a number of external and internal factors the required domestic capital was not available, accompanied by relatively high inflation and the underpricing of capital (as reflected in negative real interest rates), led to excessive investment demand in comparison with the financing possibilities available. Consequently, the very ambitious program initiated in the 1976-1980 plan period led to too many projects being simultaneously launched throughout the country, with the inevitable consequence that investable resources were stretched too thinly over too many projects. A number of factors contributed to these difficulties: the definition of priority sectors for investment proved to be too broad and insufficiently selective; expectations regarding the growth of investors' own sources of financing did not materialize to a sufficient degree, which in turn led to increased reliance on external sources of financing, one of the causes of this being the very slow progress in the pooling of resources between enterprises; insufficient attention was paid to the financial planning of investments and in connection thereto to establishing the framework for the allocation of resources for the accelerated development of priority sectors; insufficient attention was paid to the economic evaluation and market viability of projects in the project appraisal and selection process; as stated, in view of the high rate of inflation, interest rates did not play a sufficiently important role in directing investable resources; price rises in the investment sector led to high cost overruns reflected in reduced investment efficiency and other factors caused by general economic instability.

10. These problems, and particularly the problems generated by a regime of increasingly negative interest rates were complicated by other distortions in the allocative framework. In the area of trade policy an overvalued exchange rate for the dinar, together with the protective mechanisms that became necessary to defend such a rate, insufficiently stimulated production for exports, which in turn resulted in a worsening of structural problems. At the same time, certain relative price distortions in the transportation, energy and agricultural sectors discouraged efficient investment and consumption decisions. Finally, the overall
conditions of economic activity in which economic decisions were taken by organizations of associated labour made them less responsive to market laws than was desirable, since a wide variety of mechanisms existed to absorb losses and to protect the economic agents involved from the adverse consequences of such decisions.

11. Given the consequences of this policy regime toward the end of the last plan period, and the aggravated state of external and internal conditions, the framework of Yugoslavia's 1981-1985 Social Plan aimed for a much slower growth of the economy with a reduction in the investment rate and a stress on the completion of on-going projects through allocating more resources to more narrowly defined priority activities with a view to a faster elimination of basic structural problems. However, due to the further deterioration in the world economy and in the external position of Yugoslavia, it soon became clear that even these scaled back targets were too ambitious, given the resources envisaged in the Social Plan of Yugoslavia. It also became clear that considerable changes in the functioning of mechanisms and instruments of the economic system and economic policy would be needed to undertake the faster structural adjustment of the economy, if the economy was to be put back onto a relatively fast and stable growth path.

12. In keeping with our specific political and socio-economic system, a special Commission, called the Stabilization Commission, was set up in July 1980, within the Federal Social Councils to deal with the issues of economic stabilization. The main task of this Commission was to work out a comprehensive and long-term program of economic stabilization. This program was to be the basis for the work of the appropriate competent organs in solving the most pressing issues in the fields of current economic and developmental policy. With the participation of a large number of scientists, experts and other public workers from the whole country, the Commission has been working on eighteen studies, which concern the strategic development of the country and measures of economic policy. The work of this Commission is now nearing completion, and it is expected that a program of economic stabilization in the form of a legal act will be submitted to the Assembly of Yugoslavia in the first half of this year, to be adopted by the Assembly this year with the consent of all the assemblies of the republics and provinces. Proceeding from the results of the work of this Commission to date, and in parallel with this, as specified in more detail below, we have been undertaking a series of economic policy actions designed to address the major socio-economic issues referred to above.

13. One consequence of the deliberations of the Stabilization Commission, and of the discussion and debate of its proposals that have ensued, has been the revision of the medium-term development orientation of the country. In this connection, work is in progress on the amendments to
the Social Plan of Yugoslavia and the social plans of the republics and autonomous provinces for the 1981-1985 period. At the same time, these revisions will serve as the basis for the long-term concept of the country's development policy through 1990 and 2000. The main characteristics of the revised framework are: the faster structural adjustment of the economy aimed at a more efficient and complete inclusion of our country in the international division of labour; adjustment of domestic demand in line with realistically available resources; a greater reliance on market forces, coupled with appropriate guidance by the plan; and the adaptation of appropriate economic policy measures and instruments to achieve macroeconomic balance in the economy. At the same time, given the current unsettled conditions in international financial markets, there has been a reaffirmation of the policy of economic stabilization to restrict the growth in external indebtedness of the country, through greater reliance on domestic potential, and by facilitating increased exports and improved utilization of resources.

14. Details of our medium-term economic adjustment program are presented below. As you will see, this program is directly aimed at eliminating the weaknesses in the regime of socio-political measures identified earlier, as well as towards attaining the developmental objectives which we deem appropriate in view of the present situation in our economy. With the support provided to us by the World Bank, the IMF and other financial institutions in recent months, we feel that this is the appropriate time for intensifying activities aimed at the faster structural adjustment of our economy, as a necessary condition for implementing the program of economic stabilization and restoring the trend of relatively dynamic economic growth which would reflect more accurately the use of the available economic potential during the next medium-term period 1986-1990.

The Medium-Term Adjustment Program

15. The Yugoslav program for 1983 is articulated in the Annual Plan Resolution for 1983, currently in effect. The salient features of this program are also described in a Letter of Intent addressed by Yugoslavia to the Managing Director of the IMF. This program, among other things, envisages further restrictions in all forms of domestic consumption and continued significant reductions in fixed investments, in line with the possibilities for ensuring resources from realistic sources. These restrictions, coupled with the strengthening of qualitative factors in economic activities and an active dinar exchange rate policy, should have a favourable impact on the competitiveness of the Yugoslav economy and boost export efforts. Other elements of this program include increases in interest rates and selective price increases designed to correct relative price distortions.
16. The 1981-1985 five-year Social Plan of Yugoslavia and the plans of the republics and autonomous provinces for the same period are also in the process of revision. Their revision is expected to be completed by the end of this year. The orientation of economic policy will remain, broadly speaking, unchanged. One of the main objectives of the plan is to put the balance of payments with the convertible currency area on a more secure footing through a vigorous expansion of exports while reducing the relative external indebtedness of the country. Given the scaled down material possibilities, these amendments to the plans are not expected to bring about a more dynamic economic growth and a more considerable increase in domestic consumption before the end of this planning period. More dynamic growth in the following planning period should however be possible on the basis that is established. Within this general framework the principal directions of economic policy and activities in the current plan are given below. Our intention is to conclude, by the end of June this year, an agreement on amendments to the Agreement on the Bases of the Social Plan of Yugoslavia for the 1981-1985 period and to prepare appropriate analytical materials on the developmental possibilities of the country to the end of 1985, which will serve as a basis for amendments to the Plan. The competent organs shall inform the Bank, not later than the end of September 1983, on the results of the work on amendments to the plan documents with particular emphasis on the main development objectives and the priority sectors of the economy, submitting to the Bank plan documents which in the meantime are to be enacted. Prior to adopting the Annual Resolutions of Economic Policy for 1984 and 1985 the Bank shall be informed on the macroeconomic assumptions on which investment policy is to be based and the proposed sectoral allocation of investment for the relevant year, and the necessity for discussion on specific issues emanating from these documents will be jointly assessed.

Investment Policy and Resource Allocation

Ongoing Investments

17. As already noted, there have been significant reductions in the volume of investments in the last three years, and the Annual Plan for 1983 envisages a further reduction in real fixed investments by 20%. This process of bringing investments in line with real investable resources is expected to continue into 1984 and 1985 so that the volume of fixed investment over the 1981-1985 period will be about 20-25% lower than in the original plan. In the course of implementing these cuts and in preparation for the remaining years of the medium-term plan we have been engaged in narrowing and refocussing our investments in the desired direction. We have already successfully reduced the volume of non-economic investments to a far greater extent than that of investments in economic activities, as had been our intention. Within economic activities, our orientation has
been to concentrate on completing ongoing projects, particularly those which will provide the most immediate effects as regards increased production and the improvement of the balance of payments. We have severely limited the initiation of new projects, except those which will clearly in a relatively short time have a beneficial impact on the balance on payments and solve, on a more permanent basis, the structural problems in the economy. In addition to improving the balance of payments, through increased production for export and rational import substitution, we intend to accord priority to energy production and conservation and to food production. Our views of priorities will be reflected in the sectoral allocation of investment resources, to be incorporated in the revised medium-term plan.

18. While the total number of ongoing investment projects is still very large, a relatively small number of large projects account for a substantial portion of the work in progress. We have therefore paid particular attention to these large projects with a view to reducing their number and rephasing their execution in line with our financial capabilities and the above-mentioned priorities. In the context of our review of the program of ongoing investments, and related to changes in the social development plans, and in view of the importance of the energy sector in our overall adjustment strategy, we intend to complete a special review of our investment program in the energy sector by June this year, in conformity with the long-term development of the energy sector of Yugoslavia. Results of this special review will be communicated to the Bank. In accordance with our economic system, we intend to rely on indirect measures to reorient investment towards priority activities and away from those considered non-priority. In this connection, a number of measures have already been undertaken aimed at curbing investment in non-priority activities. Under the credit policy for 1983, the level of bank credits for non-priority investment projects will in nominal terms be considerably reduced in comparison with 1982. In addition, under the Law on Temporary Injunction against Issuing Guarantees and Other Instruments for Securing Resources from Future Revenues and against Granting Credits and Issuing Guarantees for Cost Overruns in the Financing of Investments, the banks are prohibited from issuing guarantees and financing cost overruns in non-priority activities. Given the inflation to date, it is expected that these restrictions will lead to a significant real decline in the share of non-priority investment in total investment. These measures will enable us to effect structural changes in the pattern of investments, not only in the large projects mentioned above, but also in medium-size and smaller projects.

19. In order to strengthen project monitoring capabilities, the Federal Social Planning Institute, the Federal Social Accounting Service and the Federal Institute of Statistics have begun work on an improved
system for recording the progress on ongoing investment projects. The first step in this process shall be the preparation of semi-annual reports on ongoing investment projects, particularly on projects exceeding 750 million dinars, starting in October 1983. Particular attention will be given to reporting on progress in projects included in the revised program of priority activities, especially those in the energy sector mentioned above. The Bank shall be informed in an agreed format about findings based upon these reports and evaluation of competent organs, and discussion on these reports shall be held as considered necessary. In addition, we intend to move to a system of more frequent quarterly reporting during 1984 once the system of recording investments and the technical procedure become established. Information on the economic and financial rates of return on new projects the value of which exceeds 750 million dinars, shall also be communicated to the Bank starting April 1984.

New Investments

20. An indispensable part of our structural adjustment effort and of the improved environment for investment decisions is to elaborate criteria and parameters which would ensure a more rational selection of investment projects in a way that is compatible with our self-managed system of decision-making. In our view such improvements should consist of improved criteria for the appraisal of investment projects and of appropriate mechanisms to implement them, the more realistic evaluation of investment costs and the greater accountability of investing units for the outcome of these investment decisions.

21. A number of steps have already been taken to improve the institutional and legal framework for investment approval and coordination. Firstly, for all proposed investments, assured sources of financing must be secured. Secondly, the contributions of the investors are clearly specified in the Law on Special Conditions for Approving Investment Credits, and are based on a sliding scale ranging from 10-90%, depending on the purpose of investments. Thirdly, in contrast to past practice, the banks are now prohibited from issuing guarantees against the future income of the organization of associated labour to cover its contribution to the financing of investment (except in a limited number of priority areas). It is expected that these measures will in combination serve to reduce the demand for investable resources, and by requiring investors to contribute more of their own resources to investment projects also to introduce a more cautious approach to new investments.

24. We are also in the process of implementing a program to improve project selection and appraisal procedures in Yugoslavia, in accordance with the agreed development policy. The first step in this process was taken in November 1982 when the Social Compact on Registering Proposed
Investments was concluded, requiring investors to register proposed investment projects in the economic sectors with a value in excess of 50 or 100 million Dinars with the Regional or Federal Chambers of Economy. We intend, by June 1983, to conclude, in Yugoslavia, a Social Compact on the Criteria for, and Evaluation of, the Socio-economic Justification of Proposed Investments which will be used in conjunction with the existing compacts in some republics which deal in greater detail with such matters and with criteria determined by individual banks. The draft Compact provides for a number of minimum criteria that must be met by projects throughout the country, and for the methods of institutional implementation and monitoring of these criteria. These criteria will, inter alia, include the economic rate of return (calculated according to the World Bank methodology) for investment projects in the economic sectors in conformity with the Social Compact mentioned above. This Compact would provide for a minimum economic rate of return on the investment, taking into account the criteria of the World Bank, although the minimum rate of return would vary depending on the nature of the activity. The proposed Social Compact will provide for the establishment of appropriate bodies attached to the Chambers of Economy which would give opinions regarding the social and economic justification of registered proposed investments, taking into account the agreed criteria and their implementation, in conformity with the right of working people independently and in a self-management manner to decide on investments. In line with the legal regulations, this opinion would be, within an appropriate time frame (which shall be fixed in the mentioned Compact), submitted to the management body of the BOAL concerned, which would, on its part, be obliged to inform the workers on this opinion before the final investment decision is taken, as well as for the purpose of informing all other interested OALS, communities, banks as well as the Federal, Republican and Provincial Institutes for Social Planning.

23. Complementing the conclusion of this Social Compact, it will be necessary to strengthen the capacity of personnel in the OALS, commercial banks and chambers of economy for the purpose of monitoring and implementing this Compact as well as other established and agreed criteria and to work on the promotion of the system of criteria for the evaluation of socio-economic justification of investments. Accordingly, Federal, Republican and Provincial Chambers of Economy and the commercial banks will, by December 1983 prepare personnel training and recruitment programs for improved investment efficiency review procedures, so that by December 1984, the Federal and regional Chambers of Economy and commercial banks will have sufficient trained personnel for the revised investment procedures.

24. With the financial aid of the World Bank we intend to conduct studies in important subsectors of industry and other studies with a view to improving the investment efficiency in these subsectors. These
subsector studies could form the basis of future subsector lending by the World Bank to Yugoslavia. The framework and modalities of these studies would be discussed with the World Bank in September 1983.

**Interest Rate Policy**

25. During the past year, the interest rate mechanism has been actively used in support of our adjustment efforts. Since March 1982, nominal deposit interest rates have been raised on three occasions. The most recent increase occurred in February 1983, with the result that the lending rates on commercial bank credits from their own resources have risen significantly. Although new lending rates vary significantly according to the particular circumstances of each bank, lending rates for non-priority purposes, and in some instances even priority projects, are approaching or have reached real levels. However, despite these increases in nominal interest rates, owing to the continued relatively high rate of inflation in Yugoslavia, average lending rates on commercial bank resources and more especially on selective credits and special funds have remained negative in real terms. There is a firm intention of gradual attainment of real interest rates over several years through, primarily, reducing inflation rates and gradually adjusting the nominal interest rates to these trends, in conformity with the long-term orientation of the Anti-inflation Program.

26. The most recent increase in borrowing interest rates, effected in February this year, was based on our assumptions of likely annual growth in producers prices. In accordance with the objectives of the medium-term policy and determination to gradually adjust the interest rates to the rate of inflation, if the information shows that producers prices rise at a rate of growth faster than the planned one, we shall review the need to adjust interest rates to such trends.

27. As concerns the interest rate policy in the coming years providing for the adjustment of interest rates in line with the movements in inflation, it is proposed to introduce a floor lending rate for new credits from domestic commercial bank resources. This floor interest rate would be introduced as of January 1, 1984 and would initially amount to 18%. Should inflation in 1983 (January 1 to December 31, 1983) be higher than anticipated, this initial interest rate would be increased by at least one-third of the difference between the initial floor rate (18%) and the rate of inflation in 1983 (as measured by the index of producers prices). The process of adjustment of interest rates resulting in the attainment of real interest rates would be concluded in 1986. In the course of this period, real interest rates should be gradually introduced, namely:

- For economic sectors, in January 1985 the floor interest rate would be increased by at least one-third of the difference
between the growth of producers prices and the floor interest rate set for 1984. However, if in 1984 the rate of growth of retail prices should exceed the growth of producers prices, the floor interest rate for 1985 would be increased by an additional amount equal to at least one-third of the difference between the increase in the index of producers prices and the index of retail prices. The same formula would be applied for setting the floor interest rate in 1986. In January 1987 the floor interest rate would be adjusted in accordance with the index of producers prices for 1986, unless the rate of increase of retail prices in 1986 was higher than that of producers prices, in which case the floor interest rate would be at least equal to the level of the increase of retail prices in 1986.

For non-economic sectors, starting in January 1984, floor interest rates would be adjusted annually in the course of the following two years so that by January 1986 they reach the level equal to at least the rate of inflation measured by the index of retail prices for 1985.

28. In the above context, exceptions would be made where interest rates would also be increased in accordance with this adjustment but not with the same intensity and time frames, because of the selective financing which is the function of the implementation of the policy of economic stabilization in accordance with the medium-term development plan of the country, namely:

(a) all export credits;

(b) all short-term credits for agriculture approved within the framework of the selective credit policy of the Yugoslav National Bank;

(c) investment credits for primary agricultural production (cereals, milk, meat, industrial crops and conditions for significantly increasing their production, that is large irrigation and drainage works, land consolidation and bringing new land under cultivation); for other agricultural investments including agroindustry the provisions of paragraph 27 shall apply;

(d) investment credits for other priority activities which will be defined and identified in the Amendments to the Social Plan of Yugoslavia for the 1981–1985 period;

(e) resources paid into the special funds for accelerated development of less developed regions at the level of the
The total volume of investment credits in fixed assets approved by domestic banks under items (c), (d) and (e) will not in any given year, through 1985, exceed 25% of the revised volume of annual total investments in fixed assets in the social sector in the 1983-1985 period. In January 1986, more favorable interest rates on investment credits for fixed assets for these purposes can be applied to not more than 25% of the total investment credits of domestic banks for fixed assets in the social sector. The floor interest rate for credits under item (c) will, as of January 1984, amount to 18% augmented by one-fifth of the difference between the floor interest rate (18%) and the inflation in 1983 measured by the index of producers prices. In January 1985 the floor interest rate would be increased by at least one-fifth of the difference between the growth of producers prices and the floor interest rate set for 1984. However, if in 1984 the rate of growth of retail prices should exceed the growth of producers prices, the floor interest rate for 1985 would be increased by an additional amount equal to at least one-fifth of the difference between the increase in the index of producers prices and the index of retail prices. The same formula would be applied for setting the floor interest rate in 1986, 1987 and 1988. In January 1989 the floor interest rate would be adjusted in accordance with the index of producers prices for 1988, unless the rate of increase of retail prices in 1988 was higher than that of producers prices, in which case the floor interest rate would be at least equal to the level of the increase of retail prices in 1988. We intend each year gradually to adjust interest rates on credits under items (d) above in such a way as to reach the level of real interest rates over a five year period starting on January 1, 1984 with the proviso that the floor interest rate for these credits, in January 1984, will not be less than the average rate of reproductive ability of the economy of the country (i.e. the ratio between amortization and accumulation and average use of business funds). In January 1985 the floor interest rate would be increased by at least one-fourth of the difference between the growth of producers prices and the floor interest rate set for 1984. However, if in 1984 the rate of growth of retail prices should exceed the growth of producers prices, the floor interest rate for 1985 will be increased by an additional amount equal to at least one-fourth of the difference between the increase in the index of producers prices and the index of retail prices. The same formula would be applied for setting the floor interest rate in 1986, 1987 and 1988. In January 1989 the floor interest rate would be adjusted in accordance with the index of producers prices for 1988, unless the rate of increase of retail prices in 1988 was higher than that of producers prices, in which case the floor interest rate would be at least equal to the level of the increase of retail prices in 1988.
29. The intention of the policy is to eliminate the difference between the rate of inflation and the floor interest rate within the stated period by appropriately increasing interest rates to reduce the gap between the two in each successive year. Similarly, should there be a reduction in the rate of inflation which was used as the basis for adjusting interest rates, interest rates would be revised downwards accordingly. This means in the event that the rate of increase in retail prices in any year should be lower than the floor interest rate in that year, then the floor interest rate would be revised downwards so that the floor rate of interest cannot be lower than the rate of increase in retail prices.

30. In accordance with our medium-term development policy and with the system of stimulating accelerated development of economically less developed republics and the SAP Kosovo, as well as other less developed regions, and in accordance with the policy of interest rates proposed above, an appropriate policy of differentiated interest rates would be developed for all resources channelled to these regions through development funds. The reason for this being that these are solidarity resources targeted for a more harmonious development of the country and the reduction of differences between more and less economically developed regions in Yugoslavia. Another reason is that 50% of these resources are in the form of the association of resources between those providing and those using resources, which means that they jointly bear risks, effect the transfer of experience, bring about technological and organizational improvement and jointly generate income. The policy of economic stabilization envisages an increasing share of resources associated in this manner as compared with resources provided on the basis of obligatory loans.

31. Our existing regulations enable the introduction of variable borrowing and lending rates, so that the banks may provide for the application of such interest rates in their credit agreements.

Financial Planning

32. A particular problem that has been encountered in financial planning in recent years has been the treatment of inflation, particularly in the planning of the banks and of the financing of investment projects. Under the present law, commercial banks must prepare investment plans on the basis of constant prices. In this connection the plans of banks do not cover the movement of inflation, leading to unrealistic planning and often underfinancing of specific investment projects. It is our firm intention to introduce financial planning at current prices, including planning in the banks and financial planning of investment projects. To this end, the Yugoslav Bank Association in consultation with the Federal Institute for Social Planning will, not later than the end of 1983, propose an appropriate methodology to enable the banks to make their financial and
operational projections at current prices starting in 1984. Starting at the end of 1983, the Federal Institute for Social Planning with the assistance of other competent federal bodies shall each year provide the necessary medium-term assumptions to be used by all banks in preparing their financial and operational planning at current prices.

33. Improvements of the financial base and accountability of the commercial banks relates to their provision for reserves (funds of joint liability and reserve funds). Under the Credit and Banking Law of 1978 all commercial banks are required to maintain a Joint Liability Fund which can be used to write off bad debts. The Law requires that the Joint Liability Fund not be less than 3% of each bank's total investments on December 31 of the preceding year. The same Law requires that banks create a reserve fund to maintain their liquidity. This fund should amount to 3% of each bank's total investments in the preceding year. The banks are obliged to allocate to it not less than 0.3% of their total investments until the level of 3% is attained. A number of banks are currently in breach of both requirements. In this connection, appropriate steps will be taken to ensure that all banks reach these requirements over a period of several years and subsequently maintain both funds at the level prescribed by the Law. As regards the Joint Liability Fund amendments to the statutory regulations will be proposed making it obligatory for all banks to replenish this fund over a period of 6 years and maintain it thereafter at the level of 3% of their total investments. In addition, we have been successful in reducing the use of short-term deposit resources for long-term lending by the banks. The 1983 Annual Plan Resolution prohibits banks to use more than 20% of their short-term reserves for long-term lending. It is felt that this is consistent with prudent financial management and measures shall be taken so as to ensure that banks maintain this practice in the future.

Foreign Exchange Allocation and External Trade

34. As was noted earlier, the acceleration of export growth to the convertible currency areas is the most urgent and important priority of economic policy. The performance in this area has been disappointing over the course of 1982 and can be attributed to several factors including continuing stagnation in the economies of our partner countries, and in world trade, shortages of imported inputs and inadequate movement in the exchange rate of the dinar. In response to the poor performance in the first half of the year, the dinar was devalued by 20% in October 1982, and continuous exchange rate adjustments (in order to ensure continued competitiveness of the Yugoslav economy) has become an accepted part of the official policy and will remain so in 1984 and 1985.
35. The intention of the 1978 Law on Foreign Exchange Operation and Foreign Credit Relations was to make possible the flow of foreign exchange within the economy on the basis of self-management. However, in conditions characterized by a foreign exchange shortage, the operation of the inter-bank foreign exchange market became extremely limited. The implementation of a policy of realistic dinar exchange rates will in itself contribute to reversing these trends. However, it was also considered necessary to amend the provisions of the Law on Foreign Exchange Operations and Foreign Credit Relations with effect from January 1, 1983. Therefore it can be said that efforts are being exerted to ensure the stimulation of exports and greater foreign exchange mobility in conditions when there was a shortage of these resources. The competent federal authorities will monitor and assess the operation of the existing system and submit a report to that effect to the Federal Executive Council by September 1983. The report which would be available for discussion with the World Bank and the IMF will include a program of activities to improve foreign exchange mobility by undertaking necessary measures for reactivating the domestic foreign exchange market and more liberal procedures for stimulating organizations with surplus foreign exchange to sell it to deficit organizations.

### External Debt Reporting

36. To assist in more rational planning of foreign exchange, importance is attached to improving the information on foreign exchange transactions. Measures have already been taken to revise the basis on which the balance of payments is calculated, from a system of statistical exchange rates to one of market exchange rates. The highest priority is now being given to the completion of the program for the computerization of external debt data, and necessary measures (including provision of staff and financial resources) will be taken to ensure that the computerized system of debt reporting and analysis is fully operational and capable of providing analytically usable information by the end of 1983. By July 1, 1983 the World Bank will agree with the National Bank of Yugoslavia on reporting formats and a timetable that will provide a suitable test of the system while providing information of use to the Bank and the Yugoslav authorities.

### Export Promotion

37. In October 1982 a Law was introduced which gives priority in foreign exchange allocation to exporters with signed export contracts. With the proceeds of the Structural Adjustment Loan we shall establish a permanent revolving Export Development Fund (EDF) from which potential
exporters could borrow the foreign exchange they need. In addition to the proceeds of the SAL this fund shall be increased by foreign exchange permanently purchased from the exporters that have benefited from EDF resources. We also propose to augment the fund with additional amounts in 1984 and 1985.

38. In June 1980 a new bank for export credits - The Yugoslav Bank for International Economic Cooperation (YBIEC) was established. This bank provides export credit insurance against non-commercial risks and refinancing in dinars of medium- and long-term export credits made by commercial banks to exporters of capital goods. The operations of the YBIEC have expanded rapidly. The financial resources needed by this bank to meet the demand for export credit financing up to 1985 as indicated in its medium-term plan shall be made available by the banks, the National Bank of Yugoslavia and other appropriate sources through the Annual Plan Resolution for 1984 and 1985. Regarding the general development of the institutional capability of the YBIEC, particularly with respect to market information for capital goods and engineering exports, institutional and personnel changes are already in progress. A detailed action plan will be prepared by October 1983 which will cover activities regarding the further institutional strengthening of personnel for these jobs. It is our intention to fulfill this action plan by September 1984.

39. In the past 30 years Yugoslavia has developed a solid infrastructure for export promotion, market information, and marketing. However, there is a need to assess the efficiency of this infrastructure, to improve the coordination among the various institutions and various trade organizations and to develop their capability, in particular, for the promotion of Yugoslav exports to the developing countries and the OECD area. The responsible organs will, by May 31, 1983, form a group which will evaluate Yugoslavia's infrastructure for promoting exports and marketing and formulate a program which will cover activities for improving export promotion, organization, marketing as well as the further qualification of personnel for these tasks. It is our intention to carry out this program by the end of 1984.

40. Yugoslavia's export incentive system is quite comprehensive. Its administration is divided among several institutions at the federal, republican and provincial levels. It needs to be rationalized so as to encourage the expansion of efficient export activities in terms of domestic costs, and to reflect the principles of uniformity and automaticity. During the last two years the Federal Community of Interest for Foreign Economic Relations, the Federal Secretariat for Foreign Trade and the Federal Secretariat for Finance have conducted a review of the various export incentives, while draft proposals have been the subject of detailed consideration among the republican and provincial communities of interest.
for foreign economic relations, chambers of economy, banks and various associations concerned. The export incentive system will be revised along the following lines: with the real exchange rate of the dinar becoming the main incentive for economic exports, direct subsidies granted by the republics and provinces will gradually be phased out. Fiscal incentives, such as direct and indirect tax exemptions and drawbacks will be the same for all industrial branches and related to export value added and export performance in order to encourage export specialization and exports with high net foreign exchange earnings. Proposals are currently before the Federal Assembly to grant exports duty-free access to imported inputs wherever justified by the level of net foreign exchange earnings. The revised system of export incentives will be discussed with the World Bank at the end of 1983, prior to its implementation on January 1, 1984.

41. It is our intention to build on the successful cooperation which has been established between foreign enterprises and Yugoslav work organizations by providing additional incentives for foreign investment in Yugoslavia. We are currently engaged in a review of the laws regulating foreign investment and expect modifications to this regulation before the end of the year.

Import Liberalization

42. The balance of payments difficulties with which Yugoslavia has been faced for a certain period now, have made it difficult for us fully to adhere to our long-term and essentially liberal policy of protection which reflects a generally open trade regime with low tariff levels and few quantitative restrictions. While tariff levels remain generally low, goods subject to various types of quantitative restrictions account for approximately 45% of the value of total imports, of which oil imports accounted for 16% in 1982. This does not include the restrictions on imports that have been enforced through the foreign exchange allocation system.

43. Measures are being taken to eliminate gradually this system of quantitative restrictions, parallel with the improvement in the balance of payments situation. As already indicated, in our program in the area of foreign exchange allocation a progressively greater role will be played by the dinar exchange rate in allocating foreign exchange. In connection with this we intend to prepare by September 1983 a program for phased implementation starting in 1984 with a view to reducing the value of goods subject to any form of quantitative restrictions (excluding oil imports) to no more than 20% of the value of total imports by the end of 1985. A study of existing Yugoslav protection measures will also be undertaken with a view to establishing whether further adjustments in the trade regime are warranted. Terms of reference for this study will be prepared by June 1983
(in consultation with the World Bank), and the study will be completed by April 1985.

Price Policy

44. As a temporary measure to control inflation, price ceilings for all commodities except those sold on farmers markets were introduced in July 31, 1982 and extended for another six months in January 1983. Until January 1983 the authority for granting prices increases has rested solely with the Federal Executive Council (FEC); thereafter, the authority for granting price increases of some products and services has been transferred to the Communities of Interest for Prices (COIPs) at the Federal, Republican and Provincial levels.

45. In January 1983, a Social Compact on Price Policy for 1983 was signed establishing procedures for gradually phasing out ceiling prices of goods and services, and in February and March 1983 the prices of some key commodities were increased, including electricity, oil products, railway transport and some food items.

46. The number of commodities subject to price ceilings is being progressively reduced in accord with the Social Compact on Price Policy for 1983. On the other hand, long-term price policies are being prepared in the energy, ferrous and non-ferrous metallurgy, basic chemicals, agriculture, forestry and rail transport sectors. These long-term price policy measures will be established at the latest by September 1983. It is expected that the SFRY Assembly shall adopt by September 1983 the Law amending the 1980 Law on Premises of the Price System and Social Price Control. In accordance with the Anti-Inflation Program, it is our intention to attach enhanced significance to the role of world prices and market forces in price setting and in that way enable the organizations of associated labour in conditions of mutual linkage, interdependence and joint responsibility to form the prices of their goods and services. In May 1983 the FEC freed a substantial share of industrial products from its direct price control. Consequently only a limited number of defined commodities (e.g., petroleum and petroleum derivatives) are now subject to direct federal control. The intention is to continue to increase the proportion of commodities where prices are formed independently by the organizations of associated labor and are registered with the COIPs. In the last quarter of 1983 and 1984 we will propose the basis of price policy and our intentions of increasing the independent decision-making of the BOALs regarding the formation of prices in accordance with the 1980 Law on Premises of the Price System, and we will inform the World Bank immediately thereof. Within the framework of these measures a policy aimed at eliminating the distortions in the basic branch sectors (agriculture,
energy, transport, ferrous and non-ferrous metallurgy, etc.) will be implemented.

47. In agriculture, only the purchase prices of major commodities are subject to federal regulations. These are in general above world prices and their relative prices are broadly in line with world prices. These prices are normally set each September for the coming year and will take into account world prices and the projected dinar exchange rate over the coming year.

48. We have already formulated a comprehensive strategy for the rationalization of energy production and consumption. One of the cornerstones of this strategy is the movement of energy prices to levels that would be at parity with world prices. The prices of domestic and imported crude oil are now at parity and the prices of petroleum products are at or substantially above these prices. The intention is to maintain these prices at least at their current level in real terms by adjusting prices periodically to world market trends, the dinar exchange rate and the domestic rate of inflation. The price of these products will be reviewed at least twice a year to determine whether adjustments are required in the light of these factors.

49. As regards natural gas, the price of domestic gas is significantly below that of imported gas. The intention is to move the domestic price of gas to achieve parity with the imported price of gas by January 1987. Towards attaining this objective the first major adjustment was made in May 1983. Further annual real adjustments in domestic gas prices will be implemented in conformity with the long-term price policy in the sector of energy, and we will regularly inform the World Bank of our progress in reaching this goal.

50. As for the pricing of lignite, coal and electricity, it is our intention to formulate a long-term policy for achieving parity with economic prices over a period of 4-5 years; however, in order to assist the authorities in the formulation of the proposed policy, we plan to initiate by September 1983 and complete by December 31, 1983, a study by JUCEL and the Mining Association to outline the appropriate pricing methodology.

51. Presently the average tariff for electricity is below the economic cost of supply, depending on conditions prevailing in the individual republics and provinces. In order to ensure that consumers use electricity efficiently, the average tariff for electricity for all consumers will be moved, over a period of 4-5 years, towards parity with economic prices. Towards attaining this objective the tariffs were increased by 25% in March 1983. We intend to review the trend in producers prices during the period since March this year, and increase tariffs for electricity in January 1984.
by 15% in real terms (over the increase of producers' prices during April to December 1983). Further annual real adjustments in tariffs for electricity, towards reaching the stated objective, will be implemented in subsequent years.

52. The long-term price policy in transport will provide for annual tariff increases in the railway transportation sector above annual rates of inflation so that, by the end of 1990, compensation payments to all Railway Transport Organizations (RTOs) will be eliminated, with some minor exceptions. Towards attaining this objective, railway tariffs were increased by 17% in December 1982 and 16% in February 1983. We intend to increase railway tariffs in January 1984 by at least 10% in real terms (over the increase in producers' prices during January to December 1983). In subsequent years starting in 1985, railway tariffs would be increased by at least 6% in real terms to ensure that compensation payments decline over the previous year. For road user charges, the long-term policy is to adjust the charges in line with inflation rates in order to provide adequate funds for road investments and maintenance. With this orientation in mind, we intend to earmark road user charges for road expenditures. In addition, at the time of the increase in liquid fuel prices the portion of these prices earmarked for road user charges will be adjusted in accordance with the price policy in force. The Council of Republican and Provincial Self-managing Communities of Interest for Roads will prepare, by September 1983, a study defining a program of road maintenance and rehabilitation requirements.

Financial Discipline

53. In order to strengthen financial discipline in Organizations of Associated Labour by increasing accountability for unprofitable operation, a Law on Rehabilitation and Dissolution of Organizations of Associated Labour was passed in 1980. This Law established a timetable for closing loss-making organizations which cannot obtain resources for their rehabilitation programs. It also provides for the reduction of personal incomes of the workers in loss-making organizations, participation by banks and other entities providing support for rehabilitation programs in their design and monitoring, and for determining the causes of unprofitable operations and responsibilities of workers, bodies of management and managers for the losses.

54. Draft amendments to this Law, currently under consideration, would further strengthen the role of banks and other organizations, which participate in financing the rehabilitation procedures, in the design and monitoring of rehabilitation programs, and they also provide for the possibility of replacing and recalling managers and bodies of management. The Social Accounting Service (SDK), which has the power to block payments
of personal incomes in excess of the levels set in rehabilitation programs, will closely monitor both the financial situation of such organizations and the execution of their rehabilitation programs. Should the bodies of self-management fail to determine the causes of losses, fix responsibility for such losses, and take appropriate measures to eliminate them, including the replacement or recalling of those responsible, the draft amendments to the Law provide for intervention by bodies of socio-political communities. If it has not been possible to cover the losses by the end of the year following the year in which they were incurred, the SDK will initiate bankruptcy procedures. (These provisions do not apply to energy generation and coal production organizations.)

55. In addition, amendments to the 1975 Payments Law which have now been proposed would restrict the volume and nature of inter-enterprise credits arising from trading operations outside the banking system. Inter-enterprise credit not covered by instruments of payment will be reduced by 50 billion dinars in 1983 as compared with 1982. It is expected that the amendments to the above Law as well as those to the 1980 Law on Rehabilitation and Dissolution of Organizations of Associated Labour, and a new law designed to prevent organizations from the investing and crediting for which they lack adequate working capital will be passed by June 1983.

56. By December 1983 additional measures will be prepared designed to reduce the real value of payments to cover the losses of organizations of associated labour so that these measures will limit the nominal value of financial support from common reserve funds of socio-political communities and from communities of interest to its 1983 level in both 1984 and 1985.

Energy Conservation

57. The point of departure of our strategy for energy conservation, substitution, rationalization and use is our Program for Energy Conservation and Increased Use of Domestic Energy Resources. This program has been passed by the Federal Executive Council, the Chamber of Economy of Yugoslavia and the Standing Conference of Yugoslav Cities and Communes. The program defines guidelines which are to be included in social compacts and self-management agreements on energy conservation, substitution, rationalization and consumption. The republican and provincial committees for energy and industry have already initiated the application of the program to concrete activities and plans to be pursued by work organizations, especially by major energy consumers.

58. With a view to implementing this program the Federal Executive Council has taken a considerable number of measures, including laws and other regulations already in force. The republics and provinces have also developed their energy conservation programs, while organizations of
associated labour have elaborated their specific conservation programs by type of energy source and location of consumption. All these programs are already being implemented and have already had a positive impact on energy conservation and substitution. The implementation of these programs is already reflected in the reduction of the liquid fuel consumption of about 8% in comparison to 1979 and in the increased consumption of domestic coal and gas of 8% and 4% respectively.

59. With a view to accelerating the implementation of the programs for the rationalization of energy consumption, we intend to apply to the World Bank for a loan which would be used for preparing studies and elaborating projects for conservation of imported energy and its substitution by domestic energy resources. These studies would cover those organizations of associated labour which are major consumers of energy and which would be interested in such studies. The organizations would be selected in consultation with the Bank. The studies would be prepared by internationally experienced institutes which would do the job in consultation with the Yugoslav party and in accordance with the terms of reference to be completed by June 30, 1983 and initiated by September 30, 1983 at the latest. It is expected that the studies would be completed within 12 months from the date of signing the contracts.

Agriculture

60. In view of the importance of agriculture in our overall economic adjustment strategy we have launched a number of initiatives to improve our agricultural policy framework. Agricultural development issues received particular attention in the context of the work of the Stabilization Commission, and we expect to introduce a number of important measures to modify our agricultural development strategy so as to reflect the revisions of the 1981-85 five-year plan. Recently a study of the agro-processing industry prepared under the Third Agricultural Credit Project was submitted to the World Bank. We expect that the results of this study will be used in preparing the revised medium-term plan for 1981-85 for agriculture and we intend to establish teams of experts to study the problem of agroindustrial capacity imbalance and prepare action programs for each branch of agroindustry. It is our intention that these programs be prepared in November 1983 so that the results of these studies could be used for the adoption and implementation under the 1984 and 1985 planning documents. In addition we are currently engaged in a joint study with the World Bank on the question of primary production in Yugoslav agriculture. The Bank participates in the financing of the study. Following the completion of this study in December 1983, we will establish additional working groups who will be responsible for preparing, by March 1984, a program for the phased implementation of the recommendations of the said study.
Conclusion

61. This Letter of Development Policy was prepared on the basis of extensive and well-documented talks with World Bank missions which visited Yugoslavia between February and April 1983, and in negotiations in Washington in May 1983. Through this letter we are requesting a loan for the structural adjustment of the economy. We can conclude with a sense of appreciation that a comprehensive and complex task has been accomplished to the satisfaction of both parties. We would appreciate it if you considered our request and lent it adequate support so as to make possible timely approval of the structural adjustment loan which would be of vital importance for the implementation of our program of economic stabilization.

Jose Florjancic
Federal Secretary for Finance

May 25, 1983
Belgrade
CONDITIONS OF TRANCHE RELEASE

SCHEDULE

Review with Respect to Paragraph 4 of Schedule I to the Loan Agreement

The Guarantor and the Bank shall review the measures taken with respect to:

(a) the completion of a program of priority investment projects in the energy sector for the period 1983 through 1985, required to achieve planned targets;

(b) the adequacy of progress in monitoring investment expenditures incurred during the previous six-month period;

(c) the adequacy of progress in monitoring the operation of the system of foreign exchange allocation and in the formulation of a program aiming at an increase of foreign exchange mobility;

(d) the adequacy of progress in the carrying out of energy conservation studies for enterprises which shall have been selected in consultation with the Bank; and

(e) the adequacy of progress in finalizing: (i) the conclusion of a social compact on the criteria for and evaluation of the socio-economic justification of proposed investments; (ii) the revision of the Guarantor's five-year development plan (1981-1985) including sectoral and sub-sectoral priorities; and (iii) the improvement of financial planning procedures in commercial banks.
### List of Criteria and Monitorable Actions

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#### 1. INVESTMENT POLICY AND RESOURCE ALLOCATION

(a) **Revision of Investment Plan**

There have been substantial reductions in the volume of investment in the last three years, with especially deep cuts imposed on non-economic investments. Strict budgetary controls will be implemented during 1983 curbing investment expenditures in non-economic activities. For economic activities new investment laws restrict the access of non-priority investors to bank credit for financing cost overruns and raise self-financing requirements for new projects. They are expected to lead to a significant real reduction in investment expenditures in non-priority investments.

Action

The authorities are preparing a revised plan for the 1981-85 period to be finalised by the end of the year. Submission to Parliament of the Revised 1981-85 Plan is a condition of the second tranche release. Plan revisions are likely to assume continued implementation of stabilization policies and restricts on the level of investment. It is expected that, when taken together with investment cuts in 1981 and 1982, the volume of fixed investment will be 20-25% lower than in the original five-year plan. The details of the proposed amendments to the plan, with particular emphasis on the main development objectives and the priority sectors for investment, will be submitted to the Bank no later than the end of September for discussion in October/November along with the first semi-annual report on investment (see below). In addition, prior to adopting the annual resolutions on economic policy for 1984 and 1985, the Bank will be informed on the content and macroeconomic assumptions on which the resolutions are based, with particular stress on the growth of investment, its financing, and its sectoral allocation in the relevant year. There will be a full discussion and exchange of views between the Bank and the appropriate authorities.

Work has begun on improving the system of monitoring investment approvals and expenditures in both new and ongoing projects. Beginning August 1983 the Government will issue semi-annual reports on investment which will show: (i) sectoral allocation of investment expenditures in relation to annual plan targets; (ii) expenditures on individual large projects with a view to determining whether priority activities are accorded preference; (iii) information on new projects including projected economic rates of return on all projects exceeding 750 million dinars in 1983 prices (from April 1984). Beginning in June 1984 these reports will be issued on a quarterly basis. These reports will be provided to the Bank for discussion. Submission of the first such report to the Bank is a condition of the second tranche release.

(b) **Reprogramming of Individual Investments to Improve Quality of Ongoing Investment Program**

At the project level individual republics and provinces have been reexamining their investment program to reassess the desirability of individual investments. However, there is no federal level agreement on the replanning of major projects.

(c) **Improving Project Selection and Coordination**

New legislation imposes stricter controls on the sources of financing that must be secured prior to initiation of investment, including mandatory minimum self-financing by the investor on a project scale, which varies by purpose of investment. Since February 1983 new investment proposals must be registered with regional or federal Chambers of Economy (depending on project scale) to enable other enterprises to comment on desirability of project. Yugoslav Banks Association (TSA) has developed a new manual for project evaluation (largely based on Bank materials).

Program Development

For Large Projects

The Yugoslav authorities have prepared a project list of ongoing projects exceeding 750 million dinars in value (about 50% of investment program) for inclusion in the monitoring system described above. As a condition of second tranche release, the authorities will define a program of priority investment projects in the energy sector for the period 1983-85, required to achieve planned targets (the core investment program in energy).

Program Development

The institutional mechanism for evaluating projects is to be strengthened. Chambers of Economy, banks and other signatories will agree on minimum uniform investment criteria, including minimum economic rates of return (differing by sector), calculated according to the Bank methodology, for projects in the economic sectors through a special Social Compact on Uniform Investment Criteria to be passed by June 1983. The Compact will establish inter-agency groups, attached to the Chambers of Economy, to "give opinions" on proposed projects taking into account agreed criteria. Conclusion of the compact will be a condition of second tranche release. By December 1984, Federal and regional Chamber of Economy and banks will prepare personnel and training recruitment programs to provide necessary staff capacity for improving investment review procedures with a view to having sufficient trained staff in place to fully implement these investment review procedures by December 1984.
I. INVESTMENT POLICY AND RESOURCE ALLOCATION (continued)

(d) Industrial Restructuring

(e) Investment Incentives

Interest rates on long term deposits have been increased by between 10 and 18 percent in the past 12 months to a range of 13-26 percent, thus significantly raising the cost of funds to borrowers of bank resources.

If inflation rate exceeds 20% during the first half of 1983 the Government will review interest rate levels with the IMF with a view to introducing further upward adjustments during 1983.

Agreement to reach positive rates for intermediated funds by gradual increases in minimum lending rates to achieve positive lending levels for non-economic activities by beginning of 1986 and for economic activities with certain exceptions by the beginning of 1987. Exceptions for (a) export credits, (b) short term credits of the National Bank of Yugoslavia for agriculture, (c) credits for primary agricultural production and (d) investment credits for priority activities in the revised 5 year plan, (e) special funds for less developed regions. During 1982-85 the value of (a), (d) and (e) will be limited to 25 percent of the total annual investment. From 1986 more favorable rates on investment credits can be applied to only 25% of total investment credits of domestic banks. For items (c) and (d) positive interest rates by the beginning of 1989.

Action

Additional legislation will be introduced by December 1983 to stimulate foreign investment.

Action

Under the present Law on Planning banks prepare investment plans on basis of constant prices. Inflationary movements are not adequately accounted for leading to unrealistic planning, and frequent underfinancing of specific investment projects. By the end of 1983 the necessary methodology will be developed to enable the banks to make their financial and operational projections at current prices, starting in 1984. Progress in this area will be a condition for releasing the second tranche. Starting at the end of 1983 the Federal Planning Institute, with the assistance of other competent federal bodies, will provide assumptions of future inflation and exchange rate movements for use by financial institutions in their financial and operational planning.

Action

Improvements of the financial base and accountability of banks are needed. Under the Credit and Banking Law of 1978, banks are required to maintain a Joint Liability Reserve which can be used to write off bad debts. ...
## Sector and Policy Issues

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<td><strong>1. General</strong></td>
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<tr>
<td><strong>(a) Exchange Rate</strong></td>
<td>A gradual depreciation of dinar during 1982, together with step devaluation of 20% in October 1982 produced 12% (year on year) real devaluation in 1982.</td>
<td>The Government intends to ensure continued competitiveness of the Yugoslav economy through a program of continuous exchange rate adjustments.</td>
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<tr>
<td><strong>(b) Foreign Exchange Allocation</strong></td>
<td>The 1978 Law on Foreign Exchange Operations and Foreign Credit Relations was substantially amended in December 1982 with a view to promoting interregional foreign exchange mobility. However, the likely effects of the new law are as yet difficult to gauge, given its recent implementation.</td>
<td>A monitoring group has been established by the Federal authorities to assess the effects of the new arrangements. The group's terms of reference have been agreed with the Bank. The group will report to the Federal Executive Council (FEC) by September 1983. The report would be available for discussion with the Bank and the IMF, and will include a program of activities to improve foreign exchange mobility by undertaking necessary measures for reactivating the domestic foreign exchange market and more liberal procedures for stimulating organizations with surplus foreign exchange to sell it to deficit organizations. Following these discussions the modalities for implementing revised procedures resulting from the report will be decided. Submission of the report to the Bank will be a condition of release of the second tranche.</td>
</tr>
<tr>
<td><strong>(c) Monitoring of Foreign Borrowing and Debt Information</strong></td>
<td>The National Bank of Yugoslavia (NBY) has been engaged for some time in a program to computerize its debt reporting system; it has also worked closely with the IMF and the commercial banks to improve the quality of the data on Yugoslavia's current debt situation.</td>
<td>NBY will take necessary measures (including provision of staff and financial measures) to ensure that the computerized system of debt reporting is fully operational and capable of providing analytically usable information by the end of 1983. By July 1, 1983, the Bank will agree with the NBY on reporting formats and a timetable that will provide a suitable test of the system while providing information of use to the Yugoslav authorities and the Bank.</td>
</tr>
<tr>
<td><strong>2. Export Incentives</strong></td>
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<tr>
<td><strong>(a) Access to Imports</strong></td>
<td>Law introduced in October 1982 giving priority in foreign exchange allocation to exporters with signed export contracts.</td>
<td>A permanent revolving &quot;Export Development Fund&quot; (EDF) will be established with SAL funds to provide imports to exporting enterprises. Creation of the EDF will be a condition of loan effectiveness. In addition to the proceeds of the SAL the EDF shall be enlarged with foreign exchange permanently purchased from exporters that have benefited from EDF resources. The EDF will be further augmented in 1984 and 1985.</td>
</tr>
<tr>
<td><strong>(b) Increasing Yugoslav Export Credits</strong></td>
<td>Yugoslav Bank for International Economic Cooperation (YSCIC) established 1980.</td>
<td>The YSCIC has prepared projections of its resource needs to meet the demand for refinancing medium and long term export credits up to 1985. The necessary financial resources will be made available by the banks, the NBY and other appropriate sources in the annual Plan Resolution for 1984 and 1985. An action plan will be prepared by October 1983 to strengthen YSCIC's institutional capability, particularly in the area of market information for capital goods and engineering exports. Necessary institutional and staffing changes will be implemented by September 1984.</td>
</tr>
<tr>
<td><strong>(c) Export Marketing</strong></td>
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**ANNEX III**

Page 3 of 6
### Annex III

#### Page 4 of 6

**Sector and Policy Issues**

**STEPs to Be Taken**

<table>
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<tr>
<td>ETERNAL TRADE (continued)</td>
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#### (d) Strengthening Export Incentives

During the past two years the Federal Community of Interest for Foreign Economic Relations (CIFER), the Federal Secretariat for Foreign Trade, and the Federal Secretariat for Finance have conducted a review of the various export incentives.

#### 3. Import Liberalisation

Since 1977 there has been a significant reduction in the share of imports subject to quantitative restrictions and quantitative imports. Between 1977 and 1982 the proportion of non-oil imports subject to quantitative restrictions declined from 42% to 29% of total imports. However, the impact of this liberalisation has been negated by de facto restrictions on use of foreign exchange.

### III. Price Policy

Under a temporary price control law passed in July 1982 price ceilings were introduced on all commodities except for produce sold in farmers markets. Until January 1983 the authority for setting prices was the FEC. Thereafter, the authority for setting prices has rested with the Federal Community of Interest for Prices (COIs) for Prices at the Federal, Republican and Provincial levels. However, inflation has not moderated significantly since the introduction of these new measures and price controls have become distortions between the relative price structure in Yugoslavia and world prices.

In January 1983, the Social Compact on Price Policy for 1983 was signed, and in February the price ceilings on some key commodities, including electricity, oil products, rail transportation, rents and some food items were raised by an average of about 25%.

#### Action

Under the Social Compact on Price Policy for 1983, the number of commodities subject to price ceilings is being progressively reduced. Long-term price policies are being prepared for the energy, ferrous and nonferrous metals, basic chemicals, agriculture, forestry and transport sectors to be finalised by September 1983. By September 1983 the Federal Assembly is expected to adopt the Law amending the 1980 Law on the Price System to: (i) substantially increase the role of world prices and market forces; and (ii) limit the number of commodities subject to the review of the COIs for Prices. In May 1983 the FEC freed a substantial share of industrial products from direct control. Only a limited number of defined commodities (e.g., petroleum and petroleum derivative) are now subject to direct federal control. The intention over the medium-term is to continue to increase the proportion of commodities where prices are set independently by Organisations of Associated Labor (OALs), and are subject only to registration with the COIs for Prices. This intention will be reflected in proposals to be made in the last quarter of 1983 and 1984 regarding price policy in the forthcoming year. Provisions have also been made for an exchange of views between the Bank and the Yugoslav authorities on the progress of price liberalisation in the last quarter of each year. A timetable will be agreed by September 1983 for further liberalisation in 1984 and 1985 such that by December 1985 only a limited number of defined commodities of special social significance will be subject to the review of the COIs for Prices.

#### (a) Agriculture

Purchased prices of major commodities subject to Federal regulation are generally above world prices and relative prices are broadly in line with world prices. Prices are normally set in September for the coming year and will take into account world prices and projected exchange rate changes.
PRICE POLICY (continued)

(b) Energy. Prices of domestic and imported crude oil are currently at parity and petroleum products are substantially above world prices. This price structure will be at least maintained in real terms by adjusting prices periodically to world market trends, the dinar exchange rate and domestic inflation. The prices of the products will be reviewed at least twice a year to determine whether adjustments are required in the light of these factors. In the case of natural gas, the internal price of domestic gas is significantly below that of imported gas. Prices of domestic gas will be increased to achieve parity with the imported price by January 1987. Towards reaching this objective the first major adjustment was made in May 1983. Further annual real adjustments, in the prices of domestic gas will be implemented in conformity with the long-term price policy, after exchange of views with the World Bank. In the case of lignite, coal and electricity the intention is to formulate a long-term policy for achieving parity with economic prices over a period of 4 to 5 years. Detailed terms of reference have been agreed between the Bank and the Yugoslav authorities on a study aimed at setting a pricing methodology for coal, lignite and electricity. The study will be initiated in September 1983 and completed by end 1983. The results of the study and the recommended pricing measures would be discussed and reviewed with the Bank in January 1984. Further, in the case of electricity tariffs, the average tariff will be moved toward parity with the long-term marginal cost of supply over a 4-5 year period (implying, on average, a 100 percent increase in real terms). Towards reaching this objective prices will be increased by 15% in real terms (over the increase of producer prices during April-December 1983) in January 1984. Further annual real adjustments in tariffs will be implemented in subsequent years, whose level would be annually agreed with the World Bank prior to the increases being put into effect.

(c) Transport. Railway tariffs will be increased in real terms each year so that compensation payments to Railway Transport Organizations are eliminated, with minor exceptions, by the end of 1990. Towards this objective railway tariffs are to be increased in January 1984 by at least 10% in real terms (over the increase of producer prices during January-December 1983). From 1985 to 1989, railway tariffs will be increased by at least 5% in real terms every January to ensure that compensation payments decline over the previous year, after an exchange of views with the Bank. Road user charges will be adjusted in line with inflation, to provide adequate funds for road maintenance and maintenance. The Council for Republican and Provincial Self-Managing Communities of Interest for Roads will prepare, by September 1983, a study defining a program of road maintenance and rehabilitation requirements.

IV. FINANCIAL DISCIPLINE

Law on Rehabilitation and Dissolution of Organisations of Associated Labor of 1983 ('Bankruptcy Law') establishes automatic timetable for closing loss-making enterprises which cannot arrange financial support programs. Law on Social Accounting Service (554) modified to enable it to enforce income policy.

Action

The following legislative measures are to be passed by June 1983: (i) amendment to the Bankruptcy Law which will strengthen the role of external creditors in the design, execution and monitoring of rehabilitation programs which will give the SSK the right of initiation of bankruptcy procedures; (ii) amendments to the Law on Payments of 1975 designed to restrict inter-enterprise credits arising from trading operations outside the banking system. Inter-enterprise credit not covered by instruments of payment will be reduced by 50 billion dinars in 1983 as compared with 1982; (iii) a new law preventing investment in enterprises with insufficient working capital will be passed.
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<th>Actions Already Taken</th>
<th>Steps to be Taken</th>
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<tr>
<td>V. SECTOR POLICIES</td>
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<tr>
<td>(a) Energy Conservation</td>
<td>National Program for Energy Conservation has been passed; program defines guidelines which are to be included in social compacts and self-management agreements on energy conservation, substitution, rationalization and consumption. Measures have been taken to convert factory and home heating from oil to domestic coal; electric power for domestic use is being rationed and petrol ration coupons have been introduced for passenger vehicles. Bank missions have visited Yugoslavia to examine energy use patterns in steel, cement, and refining subsectors.</td>
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<td>(b) Agricultural Investment</td>
<td>A study of Agricultural Processing Industry focusing on problems of excess capacity was submitted to Bank in December 1982.</td>
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<tr>
<td>(c) Agricultural Production</td>
<td>Yugoslav authorities have agreed to terms of reference of a joint study with the Bank of Primary Agricultural Production. Bank financed regional development projects aimed at strengthening cooperation between social and individual sectors are under preparation.</td>
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<td>Program Development</td>
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<td>Establishment of control mechanism to limit aggregate value of payments from common reserve funds of sociopolitical communities and COIs to cover operating costs in loss making enterprises. Government will prepare by December 1983 a program to monitor and maintain scope of such interventions at their nominal level in 1983 in 1984 and 1985. This would imply a significant decrease in the value of such interventions in real terms.</td>
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<td>The Federal Committee for Energy and Industry will be responsible for preparing a program of energy conservation studies of enterprises which shall have been selected in consultation with the Bank, which may be financed in part by a $15 million Bank loan. Agreement with the Bank on the terms of reference for these studies will be a condition of release of the second tranche. These studies are expected to be initiated by September, and would take no more than twelve months to complete.</td>
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<td>Action programs for each branch of agroindustry will be prepared by November 1983 and discussed with the Bank. The results of these studies and programs would be used for adoption and implementation of the 1984 and 1985 Annual Plan Resolutions.</td>
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**List of SAL-Related Missions**

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<td>(2) F. Kilby</td>
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<td>(3) I. Elwan</td>
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<td>Mar 1984</td>
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June 11, 1986 (date of original table)
Translator: G. Vojicic

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* Has been a retreat from progress made earlier.

** Of which 1 regressing.

*** Of which 5 regressing.

†† Only 1 of 5 studies has been submitted to date.
ATT: MR. ALEXANDER NUIWICKI, DIVISION CHIEF, OPERATIONS EVALUATION DEPARTMENT

RE: REMARKS TO AND SUGGESTIONS FOR THE PROGRAM PERFORMANCE AUDIT REPORT ON YUGOSLAVIA - SAL (LOAN 2324-YU)

IN LINE WITH YOUR REQUEST PLS FIND BELOW THE FOLLOWING REMARKS TO AND SUGGESTIONS FOR THE ABOVE REPORT WHICH WERE PREPARED TOGETHER WITH COMPETENT FEDERAL ENTITIES.

PART ONE

IN SOME PARTS THE REPORT ASSESSES OUR SOCIO-POLITICAL SYSTEM IN OUR VIEW THE REPORT SHOULD EXCLUSIVELY FOCUS ON AND ELABORATE THE FINANCIAL ASPECTS OF THE SAL UTILIZATION. WE, HOWEVER, INSIST THAT ALL COMMENTS OF THIS TYPE BE EXCLUDED FROM THE REPORT. IN THIS CONTEXT WE ARE PARTICULARLY POINTING TO THE PARTS OF THE REPORT WHICH SHOULD BE EXCLUDED AND/OR REFORMULATED:

Text modified.


Text modified.

TWO. IN PARA. 4 IN THE LAST SENTENCE THE PART READING 'WHERE DECISIONS ARE GENERALLY TAKEN ON THE BASIS OF A CONSENSUS' SHOULD BE DELETED.

Text modified.

THREE. IN PARA 51. OF THE REPORT AT THE OF THE SECOND SENTENCE THE WORDS 'TWO DECADES' SHOULD BE REPLACED BY 'THIRTY-FIVE YEARS'.

Text modified.

FOUR. IN PARA 56. OF THE REPORT TWO LAST SENTENCES SHOULD BE DELETED.

Text modified.

FIVE. IN PARA 52 OF THE REPORT THE LAST SENTENCE SHOULD BE DELETED.

Text modified.

SIX. IN PARA 70. OF THE REPORT THE LAST SENTENCE SHOULD BE DELETED.

Footnote modified.

SEVEN. IN PARA 74. OF THE REPORT THE THIRD SENTENCE SHOULD BE DELETED.

Footnote modified.

EIGHT. PARA 76. SHOULD BE FULLY DELETED.

Footnote modified.

NINE. PARA 78 SHOULD BE FULLY DELETED.

Footnote added.

TEN. IN PARA 81 THE LAST SENTENCE SHOULD BE DELETED.
PART TWO

YOUR COMMENT IN THE REPORT ON THE ECONOMIC DEVELOPMENT IS REALLY GROUNDLESS, IN THIS CONNECTION WE WANT TO POINT TO THE FOLLOWING.

1) YOUR VIEW CONTAINED IN PARA 34 OF THE REPORT THAT FURTHER DESTRUCTION IN THE MAJOR ECONOMIC INDICATORS WAS REGISTERED IN 1986 IS INCORRECT. IN THIS YEAR, NAMELY, AFTER A THIRTY-YEAR LONG STAGNATION, A RISE OF THE SOCIAL PRODUCT HIGHER THAN 3 (THREE) PERCENT WAS REGISTERED, AS WELL AS A SURPLUS IN THE BALANCE OF PAYMENTS OF USDOLL 245 MILLION. THE PHYSICAL VOLUME OF INDUSTRIAL OUTPUT ROSE BY 3.9 PCT IN RELATION TO 1985 AND EMPLOYMENT BY 3 0/0.

THE COMMENT ON THE INFLATION RATE, OF THE SAME PARAGRAPH, SHOULD BE SUPPLEMENTED BY SAYING THAT THIS RATE WAS PARTIALLY THE RESULT OF ADJUSTMENT OF PRICE DISPARITIES IN ENERGY AND TRANSPORT. THE COMMENT GIVEN IN THE LAST SENTENCE OF THIS PARAGRAPH, ACCORDING TO WHICH THE INCREASE OF CONSUMPTION WAS SUPPORTED BY INADEQUATE FINANCIAL DISCIPLINE, SHOULD BE ALSO AMENDED. THE IBRD DECEMBER 1986 MISSION WHICH WAS IN YUGOSLAVIA HIGHLY ASSESSED THE GOVERNMENT MEASURES AIMED AT IMPROVING THE FINANCIAL DISCIPLINE.

2) THE LAST SENTENCE OF PARA.849 SHOULD BE DELETED, AS IN THE PRECEDING MONTHS OF THIS YEAR POSITIVE CHANGES IN THE MATERIAL PRODUCTION TRENDS OCCURRED, AS WELL AS IN THE AREAS OF HARD CURRENCY EXPORTS AND CONSUMPTION.

3) IN PARA. 54 THE LAST SENTENCE SHOULD BE DELETED AS INTERVENTION MEASURES INTRODUCED IN FEBRUARY ‘87 DID NOT RESULT IN A ‘WAGE FREEZE’, BUT RATHER IN OBLIGATION TO HAVE THE RISE OF WAGES ADJUSTED TO THE LABOUR PRODUCTIVITY RISE AND/OR REAL MATERIAL POSSIBILITIES, IN THE PRICE AREA ONLY THE PRICES WHOSE RISE WAS IN EXCESS OF THE INFLATION RATE RISE WERE REDUCED.


PART THREE

THE REPORT WILL HAVE TO UNDERSCORE THAT THE SAL LENDING WAS TO SUPPORT A SPECIFIC PROGRAM WHICH WAS FOR THE FIRST TIME APPLIED IN OUR COUNTRY, WITH THIS SAL OPERATION AN IMPORTANT EXPERIENCE WAS GAINED, BOTH IN YUGOSLAVIA AND IN THE WORLD BANK. THE BANK NEITHER HAD LARGE EXPERIENCES IN THIS TYPE OF LENDINGS AS THEIR APPROVAL STARTED ONLY IN EARLY EIGHTIES, THE FIRST EXPERIENCES HAVE SHOWN, INCLUDING THOSE OF OTHER COUNTRIES, THAT CONDITIONALITY FOR WB SAL OPERATIONS WAS SUBSTANTIAL AND INVOLVED A WIDE RANGE OF RADICAL STRUCTURAL UNDERTAKINGS IN PURSUING THE ECONOMIC POLICY AND ACHIEVING CERTAIN LONG TERM OBJECTIVES. REALISTIC POSSIBILITIES OF THOSE COUNTRIES AND CONDITIONS WHICH HAD TO ALLOW IMPLEMENTATION OF THOSE PROGRAMS WERE FREQUENTLY NOT TAKEN INTO ACCOUNT WHICH MAINLY RESULTED IN A PARTIAL IMPLEMENTATION OF THE TARGETED GOALS SET FORTH IN THE SAL LENDING RELATED PROGRAMS.

THE NOTE CONTAINED IN THE REPORT THAT OF A TOTAL OF 76 'CONDITIONS' ONLY SIX WERE FULLY IMPLEMENTED, MIGHT LEAD TO ERRONEOUS CONCLUSIONS, BECAUSE FOLLOWING THE SAL I APPROVAL YUGOSLAVIA ACHIEVED VERY REMARKABLE AND IMPORTANT RESULTS IN VITAL SECTORS OF THE ECONOMIC DEVELOPMENT AND ECONOMIC POLICY, THE EXAMPLES ARE THE ACHIEVEMENTS IN THE INVESTMENT INTEREST RATES, FOREIGN EXCHANGE ALLOCATION, PRICE AND FINANCIAL DISCIPLINE POLICIES, IN THE FOREIGN TRADE (REGIME, ETC., ON THE RESULTS ACHIEVED IN THESE FIELDS THE WORLD BANK WAS WELL INFORMED THROUGH ITS DECEMBER '86 MARCH '87 MISSIONS, THE SCOPE AND EXTENT OF THE ECONOMIC REFORMS INTRODUCED IN THE COUNTRY IN 1983 HAVE NOT ONLY DEPENDED ON OUR PROPER POSSIBILITIES AND DETERMINATION TO CARRY THEM OUT, THEY HAVE BEEN ALSO DEPENDENT ON THE GENERAL TRENDS AND TENDENCIES PREVAILING IN INTERNATIONAL ECONOMIC RELATIONS (HIGH INFLATIONNESS OF DEVELOPING COUNTRIES, RELATIVELY HIGH INTEREST RATES, INCREASED PROTECTIONISM IN THE WORLD TRADE, ETC.), WHICH IS INSUFFICIENTLY HIGHLIGHTED IN THE REPORT.

WE CANNOT SHARE THE VIEW THAT THE 'DIALOGUE' ON THE SAL OPERATIONS WORSENED IN THE COURSE OF ITS IMPLEMENTATION AND THAT IT COULD NOT BE CHARACTERIZED AS 'CONSTRUCTIVE'. THE FIRST SENTENCE OF
Para. 81 should therefore be shifted since otherwise the developments in connection with Sal-1 utilization will seem unrealistic. The success of the Sal-1 utilization is evident, both in terms of its disbursements and the speed of its implementation.

In connection with the comment in para 46 of the report on the impact of the weakening of the US dollar on the export development fund and/or the borrower - Udružena Beogradska Banka - on our side, the increased costs of the loan are emphasized as a matter of concern, which can be illustrated by the first repayment of the loan, due on January 13, '87, when the borrower had to pay US DOLL 33.3 million on account of principal and other costs, according to the repayment schedule of the loan agreement the obligation on account of the principal payment was 11.5 million. The amount augmented by US DOLL 5.2 million due to inter-currency changes and/or the weakening dollar, this further means that three dollars repay one utilized dollar. This is of an increasingly great concern as this phenomenon is not just characteristic for Sal operation, it also holds true for all other loans entered into after 1980, when the decision on the currency pooling system was taken so as to transmit inter-currency risks to all borrowers. This is something that may essentially influence future demands for WB loans. In this context some other more favourable solutions will have to be immediately searched for which would be more favourable for the borrowers in concrete cases.

The observations in para 82 of the report, related with the possibilities for approval of new Sal’s to Yugoslavia, will have to be amended in the light of the agreements reached with WB December '86 and April '87 missions. On these occasions both the management and the staff were thoroughly informed on the directions of the economic system reforms upon which the Bank noted that a few pending issues had still remained. It was also noted that the solution of these pending issues was expected in July this year, in the view of both sides the possibilities would open thereafter for a much wider program of the financial assistance to Yugoslavia, including the Sal type lendings. First regards, Boris Skapin, Assistant Federal Secretary for Finance.
COMMENTS RECEIVED FROM UDRUZENA BEOGRADSKA BANKA

JWA0288 J6M625 IN 08/04/36 OUT 08/04/47
11712 BGBANK YU 1038H
BEograd, 08 05 87 NR 19601/DZS

THE WORLD BANK, WASHINGTON, USA
ATTENTION: MR. ALEXANDER HOWICKI, DIVISION CHIEF
OPERATIONS EVALUATION DEPARTMENT

RE: COMMENTS ON THE PROGRAM OF THE PERFORMANCE AUDIT REPORT MADE
BY THE WORLD BANK (COMPLETION REPORT RELATED TO YU SAL LOAN
(2326-YU LOAN))
HAVING CONSIDERED THE PROGRAM OF THE PERFORMANCE REPORT OF
THE WORLD BANK, PRECISELY THE SECTION RELATED TO THE OPERATIONS OF
THE EXPORT DEVELOPMENT FUND, WE DEEM IT NECESSARY TO MAKE THE
FOLLOWING COMMENTS:

1. ITEM 43 (PAGE 22):
The insufficient demand for the SAL proceeds characterized the
first half of 1986 but since the end of 1986 it has been on a steady
increase. Since the beginning of 1987 USDollars 30 M, on the
average, have been granted, per month, to sub-borrowers and such
tendency has been continued.

2. ITEM 44 (PAGE 23):
Interest rate applicable to funds granted to sub-borrowers is high,
due, for the most part, to the 2‰ spread necessary to cover opera-
tion risk and losses incurred by EDF.

3. ITEM 45 (PAGE 23):
Information added to text.
Foreign exchange market has not been active to the extent which has
been expected, so that traditional exporters have not been sufficient-
ly secured. On that basis and are oriented towards the use of the
SAL proceeds.

4. ITEM 46 (PAGE 23):
Information added to text.
It has been properly noticed that the most serious problem that
EDF has been confronted with concerns cost increase, due to the US
Dollar devaluation.
In the meantime, the first instalment of principal totalling USDollars 16,116,717,179.18 was paid, of which USDollars
5,257,179.18 account for exchange rate differential made on the
grounds of currency pooling system, on the basis of the aforesaid, it
appears that the first instalment was paid in the amount of 46-0/0
over the amount envisaged by the repayment schedule which is beyond the
the projected figures in the said report.
5. ITEM 58 (PAGE 28):
WE THINK IT WAS PROPERLY OBSERVED THAT THE MAIN PROBLEMS ARE BEYOND THE EDF CONTROL, SO THAT THE WORLD BANK SHOULD, THE SOONEST POSSIBLE FIND THE WAY TO ASSIST UBP AND YUGOSLAVIA AS A WHOLE.
IT SHOULD BE UNDERLINED THAT, ACCORDING TO THE PREVAILING ALLOCATION SCHEME OF THE SAL PROCEEDS, THE RISK HAS NOT BEEN TRANSFERRED TO SUB-BORROWERS, BUT HAS TO BE BORNE BY UBP.

6. ITEM 85 (PAGE 41):
IF THE WORLD BANK FINDS THE SOLUTION OF THE CURRENCY RISK PROBLEM, MADE ON THE GROUNDS OF CURRENCY POOLING SYSTEM, IT IS QUITE CERTAIN THAT THE EDF FUTURE WOULD BE SAFE, HAVING IN MIND ALSO THAT, IN SUCH A MANNER THE PROBLEM OF UNCOMPETITIVENESS OF ITS PLACEMENTS TO SUB-BORROWERS WOULD BE ALSO SOLVED.
OUR OPINION IS THAT THE MAIN CONCLUSION OF THE REPORT SHOULD COVER THE OVERCOMING OF THE ADVERSE IMPACT OF CURRENCY POOLING SYSTEM FUNCTIONING ON THE EDF OPERATIONS.
BEST REGARDS DR. M. RANIC, GENERAL MANAGER
B. VUCIC, EXECUTIVE VP
UDRUZENA BEOGRADSKABANKA
ROPI 7-9, 67

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