Recent Developments in Yugoslavia

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It is very hard to say anything very important from the Yugoslav point of view after hearing the very nice presentation by Mr. Crow. All the things he mentioned are very relevant from the Yugoslav point of view. But anyway, maybe I can give you some examples of implementing the Yugoslav economic reform program and what we learned during the implementation of this program over the last six months.

Since the beginning of 1990, the Yugoslav economy has been suffering from an almost continuously accelerating inflation. The accelerating inflation, budget financing problems, built-in indexation, and strong inflationary expectations have been preventing any successful attempt toward stabilization. The structural problems relating to an inadequate definition of ownership, lack of financial discipline, and unbalanced relative prices in the economy—especially negative real interest rates and subsidized prices of primary products and services—have been creating the institutional and structural preconditions for runaway inflation in the 1990s. As a consequence of that, an efficient program for transforming the Yugoslav economic system into a market economy required a two-stage approach. This is the crucial point.

First, it was necessary to hold down this accelerating inflation as a precondition for further structural changes. The stabilization program launched in mid-December 1989 was a consistent response to these demands. Second, after initiating the stabilization program over the first six months of this year, the government introduced at the end of June the second package of economic policy measures concerning the ownership program, bank and enterprise restructuring, and the long-term conditions for sustainable economic development in Yugoslavia.

The first program, adopted last December, consists of three sets of measures. Perhaps these measures will provide some answers to questions posed by Mr. Crow. The first set of measures aims at furthering systemic and institutional changes—adopted and initiated earlier—as required for establishing an open, decentralized, and full-fledged market economy. Let me discuss four of them:

(1) the transformation of social ownership—a major problem of the Yugoslav economy—into all possible clear-cut and transparent ownership forms, including privatization;

(2) the transformation of the banking and enterprise sectors into profit-oriented economic entities during capitalization and restructuring, including identifying the deficit in both sectors, as well as financing this deficit from real resources, and, or in some cases, partial shifting to the public sector debt;

(3) reform of the state sector, including a clear definition of public services and their prices, full transparency of budget revenues and expenditures, and elimination of any hidden public debt—a very serious problem of the Yugoslav economy during the 1980s; and

(4) tightening of financial discipline through changes in the accounting system and particularly through the strict interpretation of bankruptcy rules.

This is the core of the program, with its medium-term targets.

The second set of measures concerns the macroeconomic policy tools with the following main features. First, consistent with the anti-inflation program, our restrictive monetary policy was further tightened in both January and February. The reason was to offset the monetary effects of the larger than expected increase in foreign exchange reserves. Since the beginning of the Yugoslav program, there has been a strong inflow of foreign exchange, mainly from the household sector and in some cases, due to a lagged effect, from the enterprise sector. For example, more than $2 billion came into the central bank during January and February. Second, tight fiscal policy was aimed at generating a surplus of real revenues, with limited possibilities for borrowing by the government. According to the agreement with the IMF, neither the federal nor republican governments are allowed to borrow in the secondary market during the first six months of this year. The third set of measures involves the continued liberalization of imports. It has already proven to be profitable by increasing the foreign exchange inflow. Fourth, the program has forced domestic monopolies to cut their inventories and prices. The last measure is a further liberalization of interest rates on bank deposits and loans. This is a very tricky question.

The interest spread in the Yugoslav banking sector is enormous, more than 20 percentage points. Interest rates on loans are around 40 to 45 percent. Since the inflation rate is almost zero, real rates are also 40 to 45 percent. Interest rates on deposits are between 10 and 15 percent, so you can see what the interest spreads are currently in Yugoslavia. Of course, only enterprises in distress would consider borrowing from such a very expensive source. If banks refuse to fulfill the enterprises' cash needs, the enterprises cannot continue to operate.

The third set of measures presents an emergency anti-inflation program, very similar to the Polish program. It has been influenced by Professor Sachs and some of the people sitting here. First of all, over a period of six months, the exchange rate of the dinar is to be pegged to the German mark at a rate of 7 to 1. Second, average personal incomes were frozen at the November 1989 level through June of this year. Third, there was a currency reform that knocked off four zeros from the dinar—that is, the new dinar is worth 10,000 old dinars. Widespread indexation was also abolished, especially for interest rates and the accounting system. Fourth, prices were liberalized, and this is more in accordance with the Bolivian program than with the Israeli program. There was no general price freeze, except for the prices of coal, oil, steel, nonferrous metals, railroad transport, public utilities, and drugs. These sectors account for only 15 to 20 percent of the industrial sector. Fifth, the dinar was made convertible in current account transactions. Whereas enterprises already enjoyed completely free access to foreign exchange since mid-1988, citizens are now allowed to make almost unlimited purchases and sales of foreign exchange.

This was a short description of the main idea of the two-stage program. It may be interesting to say something about the results of this program during its first six months, and the role of the National Bank of Yugoslavia in the whole program.

We currently have a very strong foreign exchange position, with more than $9.8 billion of foreign exchange reserves. We also have more or less stable prices. In June, inflation was -1.2 percent; in July, the inflation rate was 2.2 percent. The July inflation rate, in large part, was due to the liberalization of frozen prices at the end of June. Monetary policy until the end of June was very restrictive. We implemented very firmly this currency board approach. During the first six months, the National Bank of Yugoslavia withdrew a substantial amount of liquidity to decrease in nominal terms the domestic credit activity of banks. Between February and April, we also implemented credit ceilings as an emergency measure.

On the other hand, there are several very unpleasant developments. First, industrial production (not seasonally adjusted) is declining at a 10 to 15 percent annual rate; on a seasonally adjusted basis, the rate of decline is almost 40 percent. We may be reaching the social limit of the program if you consider the recessionary movements in industrial production. The second very important feature is that wages and salaries are not very much under control, which is I suppose the main problem in socialist countries. The only available policy instrument which is very effective is in my view illiquidity in the enterprise sector. Any other measure is very short-term oriented, and people are not very much aware of profits in the enterprise. So I think that in Yugoslavia during the first six months, only illiquidity of the enterprise sector has done much to keep down wages and salaries in that sector. Yet a very dangerous situation could develop in the next few months if the National Bank of Yugoslavia does not stay very firmly on a restrictive monetary policy.

The next point which is very important is public sector expenditures. Yugoslavia may be a little bit different from other countries because of our multinational structure and multinational expenditures also. The federal budget accounts for only 15 to 20 percent of total public sector expenditures. A lot is due to republics and provinces. There is no Yugoslav law which allows the central government to restrict expenditures by republics and provinces. So a very heavy burden is on the federal budget to compensate for the excessive republican and provincial expenditures. Anyway, it is my personal view that federal budget expenditures are also too high right now. In summary, then, the primary threats to achieving economic stability are public expenditures and excessive increases in wages and salaries.

Just a few final remarks on the restructuring of the banking and enterprise sectors, which are important from our point of view and may be interesting for my colleagues in other countries. We know that without substantial restructuring in the banking sector, we will not be able to reduce the excessive interest spread. Yet we must do so because business investment will suffer since no enterprise can pay 45 percent in real terms. There are several activities which are under way and some of them are under negotiation right now with the World Bank. First of all, we implemented some changes in the legal framework. We are also adopting several changes in the institutional framework and we are preparing special restructuring programs for banks.

Let me give you a few figures to show the magnitude of the problem. In our banking sector, at least 35 to 40 percent of total banking assets are more or less nonperforming. In absolute terms, this means that at least $8 billion to $10 billion of assets compared to the total GDP of $55 billion to $60 billion may soon be in default. So it is quite obvious, given that the capital of the banks in Yugoslavia is not more than $3 billion to $3.5 billion, that the banking system in Yugoslavia is, on average, insolvent. So we need strong measures against this problem.

First, we need to establish a special agency on the federal level which is authorized to write off part of these bad loans, to recapitalize these banks, and later on to sell the banks to the highest bidder. In the enterprise sector, we are planning to start the procedure of privatization, selling enterprises to special agencies on the level of republics and provinces, and special mutual funds will be established at the level of republics. Enterprises which are eligible for bankruptcy procedures according to the law will be under the control of these special agencies, and a trigger mechanism is under way to implement these activities for privatization of these enterprises. Enterprises have not yet taken advantage of this program, but it now appears that at least 100 big and medium-sized enterprises will be eligible for this program either this year or over the next three years.