



United States Department of State

Washington, D.C. 20520

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November 15, 1982

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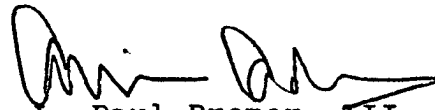
Interagency Group No. 29

<p>TO :</p> <p>OVP</p> <p>NSC</p> <p>Agriculture</p> <p>CIA</p> <p>Commerce</p> <p>Defense</p> <p>EXIM Bank</p> <p>OMB</p> <p>Treasury</p> <p>USTR</p> <p>Federal Reserve</p>	<p>- Mr. Donald P. Gregg</p> <p>- Mr. Michael O. Wheeler</p> <p>- Mr. Raymond Lett</p> <p>- [Redacted]</p> <p>- Mrs. Helen Robbins</p> <p>- COL John Stanford</p> <p>- Mr. William H. Draper, III</p> <p>- Mr. Alton Keel</p> <p>- Mr. David Pickford</p> <p>- Mr. Dennis Whitfield</p> <p>- Mr. Charles Seigman</p>
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SUBJECT: Discussion Paper: Yugoslavia

Attached is a discussion paper for use at the IG meeting November 15. This is an interagency draft and is subject to further amendment at the meeting.


 L. Paul Bremer, III
 Executive Secretary

Attachment:

Discussion Paper

State Dept. review completed.

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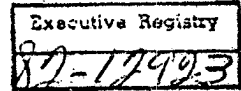
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United States Department of State

Washington, D.C. 20520



November 5, 1982

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Interagency Group No. 29

TO	:	OVP	-	Mr. Donald P. Gregg
		NSC	-	Mr. Michael O. Wheeler
		Agriculture	-	Mr. Raymond Lett
		CIA	-	[Redacted]
		Commerce	-	Mrs. Helen Robbins
		Defense	-	COL John Stanford
		EXIM Bank	-	Mr. William H. Draper, III
		OMB	-	Mr. Alton Keel
		Treasury	-	Mr. David Pickford
		USTR	-	Mr. Dennis Whitfield

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SUBJECT: Interagency Group on Yugoslavia

A meeting of the Interagency Group on Yugoslavia is scheduled for Tuesday, November 9 at 2:30 p.m. at the Department of State, Room 6226. A representative from each addressee agency is invited to attend. Attached is a paper for your consideration before the meeting.

L. Paul Bremer, III
 L. Paul Bremer, III
 Executive Secretary

Attachment:

As stated.

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United States Department of State

Washington, D.C. 20520

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DISCUSSION PAPER:

YUGOSLAVIA-- CONSIDERATION OF ASSISTANCE MEASURES

Yugoslavia is in deep economic trouble. Two and one-half years after the death of Tito, the country is at a political and economic crossroads. How we respond now to Yugoslavia's pressing economic problems and related political concerns will be critical factors in whether U.S. interests in this key strategic country can be sustained in the near and medium term.

This paper is designed to provide the basis for a comprehensive strategy for dealing with U.S.-Yugoslav relations over the next few years. It reviews the economic/political problem; our strategic interests; and measures we could take in the economic, military and political fields. Ultimately it will become an NSSD for Presidential consideration and decision.

ECONOMIC SITUATION

The Yugoslav economy is in a severe liquidity crisis and may be approaching default on its international obligations. Industrial output is sharply falling, energy consumption is being rationed and a sharp decline in short-term and medium-term lending by major international banks has dried up liquidity essential to the normal functioning of the economy. U.S. bankers and other close observers seem agreed that, barring a massive rescue effort, Yugoslavia may have to face general rescheduling of its Western debt - perhaps in early 1983.

External borrowing to finance burgeoning current account deficits in the late 1970's pushed Yugoslavia's convertible (hard) currency debt to nearly \$20 billion. The GOY has acted decisively to correct internal and external imbalances, signing on to a \$1.8 billion, 3-year IMF standby in 1980. Moreover, the Yugoslav debt service ratio, at 25%, is not excessive. However, the ripple effects of the Polish crisis and sloppy GOY foreign exchange management (failure to deal effectively with commercial bank arrears) has sparked an abrupt decline in private lending, including the withdrawal of short-term deposits/lines of credit, and resulted in a swift depletion of official foreign exchange reserves.

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Western European and Kuwaiti banks continue to provide to Yugoslavia modest amounts of medium term funds--about \$500 million in CY 1982. The UK and Canadian banks are standing back. The GOY may soon regain access to US and Japanese markets. A \$200 million Citibank-led syndicated loan should be concluded soon, subject to the elimination of small remaining arrears of a major Croatian commercial bank, Privredna Banka Zagreb (PBZ). However, the difficulty experienced in scraping the package loan together, and the fact that the participation of the New York agency of a Yugoslav bank was necessary to put the loan over the top, will dilute the hoped-for image of improved market receptivity and the positive catalytic effect on other private lenders.

The financial strain will not abate in 1983. Even if the full year current account is in balance, as expected, Yugoslav financing needs will exceed \$4.0 billion. Due to the seasonal pattern of the Yugoslav balance of payments, the entire financing requirement for the year appears in the first half. The IMF estimates first half needs of \$4.25 billion--a current account deficit of \$1.25 billion; and principal payments of \$3.0 billion, of which \$1.8 billion is on short-term debt. The IMF figures are consistent with BIS and CIA projections.

The only readily identifiable source of financing for 1983 is the expected IMF/IBRD disbursement of about \$1.0 billion. Continued private lending at 1982 levels (about \$700 million) and a rollover of all short-term debt would be necessary to reduce the Yugoslav financing gap to \$750 million. The risk is that Yugoslavia could rapidly accumulate arrearages in the first half of 1983, scuttling the IMF program, and shattering what is left of private market confidence. The immediate next step would be a general debt rescheduling.

POLITICAL ASPECTS OF RESCHEDULING

Yugoslav top political leaders remain adamantly opposed to any major rescheduling. This point was made forcefully by Yugoslav Foreign Secretary Mojsov in his October 4 meeting in New York with Secretary Shultz. The reasons are more political than economic. While we may not agree with all the Yugoslav reasoning, the political implications for the West of a worsening Yugoslav economic crisis are serious.

Yugoslavia's decentralized economic and banking system would make a general rescheduling a complex and intrusive undertaking. It has complicated efforts to implement economic reform. The existing system of autonomous regional banks reflects Yugoslavia's delicate internal political balancing act. GOY leaders are now convinced that regional financial

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transactions must be better coordinated and backstopped. There is also serious attention being given to the need to restructure the Yugoslav economy to be more efficient and competitive -- more market-oriented. The Yugoslavs' ability to carry out structural reforms of this magnitude depends on getting over the near term debt hump, since in current circumstances the GOY cannot afford the luxury of adopting a long-term focus. It is hoped to achieve all this without turning the clock back on decentralization in general, which has become a Yugoslav political hallmark. The current leadership is caught in the middle. It wants to exercise increased central control over fiscal matters in a way which does not spill over into other areas. There is concern that a general rescheduling would be accompanied by outside pressures for central controls going beyond what is politically tolerable. (Obviously, even without general rescheduling, outside assistance to Yugoslavia will be conditioned, as it already has, on meeting international lending criteria.)

As a coalition of historically-warring national groups and economically-disparate regions, Yugoslavia is not easy to govern - especially by committee - even in good economic times. Growing economic strains could interact with the latent nationality problem, leading to increased domestic unrest. The choices before the top Yugoslavs over the next few months pose a serious test of the post-Tito leadership and perhaps the greatest challenge since the 1948 break with Stalin. If the present market-oriented leaders are discredited, the old-style, directed-economy types would be in a position to pose a serious challenge, threatening to undo progress over the years in that country's gradual democratic evolution.

The Yugoslav leaders are also concerned about the broader implications of reaching an economic nadir in which rescheduling becomes necessary and of what is seen in Yugoslavia as a Western refusal to help. We are already hearing comments from influential Yugoslavs that the West has decided to "abandon" Yugoslavia. Some of this is a form of pressure, but most of these persons are well-disposed to the West and all of them want Yugoslavia to remain truly nonaligned and politically and economically independent of the USSR. GOY leaders have watched with concern the expansion of the Yugoslav trading relationship with the Soviet Union, as Yugoslavia's ability to buy and sell in Western markets has stagnated or diminished.

For all of these reasons, the Yugoslav leaders view the prospect of general rescheduling not as a new beginning or fresh start but as a formal admission of failure. Directives from outsiders regarding conditions to be met for rescheduling

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would be a serious blow to Yugoslav pride. One cannot predict how serious the "abandonment" syndrome will become, or how this will change attitudes within Yugoslavia toward the West and the U.S. in particular. The top leaders are deeply worried, however, that rescheduling will be widely interpreted outside Yugoslavia as symbolizing the failure of the vaunted Yugoslav alternative to traditional, centralized communist control. It would also, in their view, project economic and leadership weakness so serious as to leave the country vulnerable to outside pressures. Foremost, of course, is concern over potential Soviet pressures for concessions in political and military areas.

YUGOSLAV ADJUSTMENT EFFORTS

GOY top political leaders still hope that something can be done to give their economy a boost and avoid reaching the point where general rescheduling is unavoidable. Unpopular domestic measures have been taken. The GOY has acted firmly to compress the domestic economy and to reduce the current account deficit. In the past two years, it has adhered to the conditions of its three-year IMF stand-by agreement and is in the process of negotiating the terms of the third and final leg. Setting the stage for the third year of the IMF program, the GOY has devalued the dinar by a further 20%, raised interest rates and taken further steps to control the growth of credit and nominal incomes. Gasoline has been rationed and politically-explosive disincentives have been placed on travel abroad and withdrawals from individual hard currency accounts.

However, private markets remain unconvinced of the GOY's capacity to manage this situation, and with good reason. Frequent payments delinquencies and uncoordinated requests for mini-reschedulings by some regional commercial banks (especially PBZ), together with the GOY's failure to provide timely and accurate economic information, have turned off private lenders. The primary constraint on improved Yugoslav performance in this area is, as noted above, the Yugoslav domestic political situation and structure.

Moreover, GOY requests for official financial assistance, at least in their initial form, lack realism. The Yugoslavs recently approached the BIS informally concerning their interest in obtaining \$500 million in four-year money. Central bankers, stressing the short-term nature of BIS arrangements (Mexico and Hungary obtained maturities of only three and six months, respectively), reacted negatively and suggested that, when a formal request is made, it be more realistic. The GOY has not yet come back, awaiting first the completion of the current IMF review assessment.

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The Yugoslavs recognize that their independence hinges on internal stability and the country's economic viability. They also believe that American perceptions and interest coincide with their own in this respect. This seems to explain why the leadership, despite its suspicions and desire to avoid dependence on either "super power", has turned first to us. Examples include then-President Kraigher's meeting with the President at Cancun, Foreign Secretary Mojsov's Westward-looking inaugural foreign policy address this summer, and President Stambolic's July letter to the President asking that he support Yugoslavia's loan effort.

U.S. INTERESTS:

Yugoslavia's unity and stubborn independence of "blocs" serves our strategic interest in the Balkans and Mediterranean as well as our political interest in encouraging the attenuation and eventual dissolution of the Soviet empire:

a. Geopolitical

The Adriatic is an open sea, the Warsaw Pact is denied bases there, and the Soviet threat to NATO allies Greece and Italy and to the Middle East is, as a consequence, substantially less. Yugoslavia controls the only air corridor from the Warsaw Pact to the Mediterranean and the Middle East through non-NATO airspace. The Soviets are denied Adriatic airfields. Thus they have no tactical air support for the Soviet Mediterranean Fleet. The Yugoslav ground defense is primarily geared to repelling an attack from the Warsaw Pact. It is presumably determined to block any move through northern Yugoslavia by Pact forces seeking to enter northern Italy via the Gorizia Gap.

b. Economic

U.S. economic interests in Yugoslavia are substantial. The Yugoslavs have purchased billions of dollars worth of U.S.-made industrial equipment, agricultural products, and manufactured goods (\$6.3 billion since 1965). The presence of well-known U.S. and other Western products throughout the country constantly underscores the efficacy of the industrial democracies in producing a rising standard of living and the material well-being associated with Western life. Seeing this, the Yugoslavs have continued to work toward a market-oriented economy, seeking to stimulate their firms to greater efficiency through competition with foreign firms both in export and domestic markets. Foreign private investors are welcomed, and the U.S. is the largest foreign equity investor in Yugoslavia. Yugoslavia is a full member of the GATT, the IMF, and the World Bank. All this takes place under a system

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that is nominally socialist, greatly magnifying the Yugoslav example's impact on its neighbors to the East.

c. Political

Yugoslavia, the prize that eluded Stalin in 1948, has not been forgotten in the Kremlin. The U.S. gave Tito the help that was essential to keep Yugoslavia independent while he began the slow process that has resulted in opening Yugoslavia to the West and permitted evolution in the direction of pluralism, and fostered receptivity to Western attitudes and culture. As a result, Yugoslavia is now well along a course that is the envy of the Eastern European countries of the Warsaw Pact (with the partial exception of Hungary), and has made significant progress toward liberalization. What happens in Yugoslavia has obvious implications for future developments with respect to Romania and other Eastern European countries.

A protracted Yugoslav economic crisis accompanied by a loss of faith in the West could lead that country in several possible directions, none of them in our interests. At a minimum, the Yugoslav model would stand as a less powerful example of the benefits of pluralism for the communist world. A prolongation of Yugoslavia's problems could threaten that country's independent course and seriously weaken Yugoslavia's ability to withstand Soviet pressures for political and military concessions.

OVERALL POLICY

In sum, it is in the strategic interest of the United States to preserve the independence and territorial integrity of Yugoslavia, and to promote its gradual liberalization and integration into the West. This has been our basic policy for three decades. We now face a critical juncture in ensuring its success.

There is only so much that the USG can do to help the Yugoslavs economically and to bolster their confidence in our general support. Much depends upon the U.S. and international commercial banking community, over which we have no control. Other Western countries have as great a stake as we do in preserving Yugoslavia as an independent bulwark and as an alternate model for the communist world. There are, nevertheless, certain areas in which the USG is already involved and require urgent attention:

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a. Economic/Financial

-- U.S. support for a Bank for International Settlement (BIS) facility. The Yugoslavs have informally raised the question of a \$500 million BIS facility. Pursuit of this request must await an IMF approval of the next IMF tranche, anticipated following a visit within the next several weeks to Yugoslavia of an IMF team.

-- Commodity Credit Corporation (CCC) credits could ease the hard currency burden for needed imports this year of wheat, cotton, soy beans, vegetable oils, and soybean meal.

-- Eximbank facilities. Eximbank programs available for Yugoslavia at this delicate juncture play a crucial role. Curtailment of any of them would be read by the Government of Yugoslavia as a hostile signal.

-- Reprogramming of Eximbank loans. Three of Yugoslavia's most financially troubled projects (the Krsko nuclear power plant, the DOW/INA petrochemical complex, and the Feni nickel complex) were constructed with Eximbank loans and the most modern U.S. technology. Debt service for these projects represent the bulk of approximately \$460 million due as interest and payments to Eximbank in 1982-84. We should consider being prepared to respond sympathetically to requests for a payment stretch-out for all U.S. official debt. The Germans, French, British, and Japanese would readily agree to do the same for their official debts in the "Paris Club" context.

b. Military Cooperation

--- Procurement of U.S. weapons systems. A significant group within the GOY leadership is concerned by the degree to which Yugoslavia is dependent upon the Soviet Union for military hardware. U.S. policy has sought to assist the Yugoslavs in the procurement of specialized weapons systems based on the premise that diversification of supply would strengthen Yugoslavia's dependence from Moscow. Yugoslavia's severe financial constraints have compromised our efforts to develop a meaningful military sales program. There are, however, a number of areas where we see scope for close military cooperation with the Yugoslavs over the long run, and where major purchases would not take place for a number of years.

--F5-G and release of the PW1120 aircraft engine. Discussions for the purchase of the F-5G are at a relatively advanced point. The next step is to obtain NDP approval. If Washington approval for release of classified information and an eventual sale is forthcoming, a possible sticking point will

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be financing for the aircraft and the degree of offset purchases that Northrop may be willing to accept. We may wish to encourage Northrop to be flexible in this area, but as a matter of policy the USG does not become involved in the specifics of commercial offset arrangements. We may also wish to explore the possibility of FMS credits, although this approach does not look promising during the FY 85 budget cycle in view of current budget stringency. (Heretofore the Yugoslavs have seen FMS credits as inconsistent with their nonaligned status.) The planned visit of Secretary Weinberger to Belgrade in early December will provide an occasion for discussions on this topic.

--IMET Training. While not a substitute for expanded cooperation in arms procurement, an expanded IMET program in FY 85 would provide an important signal to the Yugoslavs and enable us to monitor more effectively attitudes in the Yugoslav armed forces. Our access to the upper echelons of the Yugoslav military should be enhanced as officers with exposure to the U.S. military move up the command chain. Our current program for FY 83 and 84 will fund about six students. We should be able to give Yugoslavia a high priority if IMET funds become available late in FY 83 for reprogramming.

c. Bilateral High-Level Dialogue

Visits by senior U.S. officials can complement the measures listed above and have an intrinsic value of their own because they visibly give value to and stimulate the bilateral relationship. The recent conversation in New York between Secretary Shultz and Secretary Mojsov is a good example of the worth of high-level talks. The GOY expects, however, that material support will be linked with these exchanges. In other words, there must be substance to bilateral exchanges, such as the prospective visit of Secretary Weinberger, in order to achieve the desired impact.

d. Encouraging the NATO Allies

Our own bilateral measures need to be in a larger framework of actions by others. The Allies should be encouraged to initiate bilateral actions of their own, namely debt relief, bilateral trade, as well as joint Franco/Anglo/German initiatives to alleviate EC trade restrictions which have hampered Yugoslav trade with western Europe. We will need to consult closely with our key allies regarding multilateral measures as well.

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U.S. OPTIONS

The measures above can contribute to the U.S. policy of maintaining Yugoslav independence (and encourage Allied help). However, although the BIS facility, maintenance of Eximbank facilities, and CCC credits are all significant steps, these measures by themselves are not adequate in all probability to stave off the need for general rescheduling. A debt rescheduling is inevitable absent official financial support, a resurgence of confidence among private lenders and further significant actions by the GOY. Thus, we have three options: (1) take the lead in marshalling official assistance at a level sufficient to insure Yugoslavia against the need to reschedule its debts, (2) arrange a more modest support package, hoping that a concrete demonstration of Western governments' commitment to Yugoslavia would induce a change in private sector lending behavior; or (3) candidly inform the GOY that their financial problems appear to have reached the point where a "more permanent" solution is necessary, stating that the US would accede quickly to a GOY request for an official rescheduling. These options are discussed below.

(1) Provide financing, in coordination with other Western governments, sufficient to insure against a rescheduling. IMF sources estimate that Yugoslavia will require, at a minimum, \$750 million from the BIS and a \$1.0 billion consortium loan from governments to "avoid default" in the first half of 1983. Our assessment is that official financing at this level would be overkill if the banks continue to lend at last year's level and hold constant their short-term exposure; it would be inadequate if private credit dries up. Increasing the amounts to cover the worst-case scenario would constitute a "bail-out" of the banks. Moreover, any package with a US share much above \$150 million would require a supplemental appropriation.

(2) Arrange a more modest package--\$750 million - through the BIS. The US portion would be \$150-200 million, roughly consistent with our share of Yugoslavia's external debt. The sources of funds would be the Treasury's Exchange Stabilization Fund (ESF) and the Federal Reserve swap line with the BIS. This would decrease, but still not eliminate, the probability of rescheduling. On the assumption that such a concrete demonstration of Western governments' political and economic support for Yugoslavia would induce a substantial change in private lending behavior, rescheduling might not be necessary. Some US banks have suggested to us that they would welcome such a signal from Western governments. In addition, the BIS loan to Hungary was apparently a factor in inducing banks to reverse their withdrawal of funds.

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In return, we should require much more extensive financial information than we are now receiving, before proceeding with an official assistance effort. We will be compiling a list of specific types of information which we should require the Yugoslavs to provide and look at other measures in such areas as foreign exchange management--which could have a beneficial effect.

We should expect significant action on economic reform from the GOY, although imposition of performance conditions should ideally come from the IMF, BIS or other international "club". We may also insist on collateral--the BIS has indicated that most of the GOY's \$800 million in gold is unpledged (which will need to be verified). GOY actions would also be essential to spark a positive catalytic effect in the private sector, and thus would be critical to the success of the exercise.

The costs of US participation in a loan package for Yugoslavia are reduced flexibility to respond to similar crises in other countries and the risk of non-repayment. (Collateral would insure us against non-repayment.) Rescheduling would reduce the non-repayment risk as it would release substantial amounts of foreign exchange. The BIS funds would not be rescheduled.

(3) Candidly inform the GOY that their financial difficulties have reached the point where a "more permanent" solution is necessary, noting that the U.S. would accede quickly to a GOY request for an official rescheduling. Because of the serious political implications, this alternative would seem a first choice only "by default," i.e. only after having reached the conclusion that rescheduling is an unavoidable foregone conclusion. Our present projections indicate that, given some outside assistance, rescheduling is not inevitable because Yugoslavia's debt service ratio is only 25%, the maturity structure of the debt is favorable, with the short term component only 10% of total outstanding obligations and economic policy is moving in the right direction. We are currently updating the balance of payments forecasts, and seeking a detailed maturity schedule. We are also seeking from the GOY detailed information on the size and location of gold and foreign exchange reserves.

Obviously Option 2 may fail, either because of a shortfall in private lending or on the current account. Rescheduling may still be necessary. If so, we should encourage the GOY to face reality, stressing that a buildup of arrears would lead to a broken IMF program and thus to an extended period of financial uncertainty.

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