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CIA/OER/IM 73-7

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DIRECTORATE OF
INTELLIGENCE

Intelligence Memorandum

Yugoslavia's Balance of Payments: In the Black Though Not for Long

Confidential

ER IM 73-7
January 1973

Copy No. 125

Approved For Release 2006/04/19 : CIA-RDP85T00875R001700050006-9

CENTRAL INTELLIGENCE AGENCY
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INTELLIGENCE MEMORANDUM

YUGOSLAVIA'S BALANCE OF PAYMENTS: IN THE BLACK THOUGH NOT FOR LONG

INTRODUCTION

1. After an unbroken series of balance-of-payments deficits since the mid-1960s, Yugoslavia managed to achieve its second current account surplus since World War II. The government is using the opportunity to liberalize trade much as it did in 1966-67 following the 1965 surplus. Now, as then, Yugoslavia is burdened with a heavy external debt, largely the legacy of erratic inflationary growth. This memorandum discusses recent trends in Yugoslavia's balance of payments, assesses the current burden and structure of indebtedness abroad, and explores prospects in view of the impending import liberalization and basic longer term economic problems.

SUMMARY AND CONCLUSIONS

2. The massive debt servicing required on Yugoslavia's external debt – the largest in Eastern Europe – has forced the government to appeal to its Western creditors for major financing assistance three times during the 1960s and again in 1971. The latest refinancing, together with stringent import controls and continued gains in earnings from invisibles, has eased the immediate pressure on Yugoslavia's balance of payments. An estimated current account surplus of about US $185 million was generated in 1972.

3. The 1972 surplus may be simply a temporary pause. The trade deficit was trimmed by strong import controls which choked off imports of consumer goods and raw materials, while exports were helped out by an extraordinary increase in livestock exports to the Common Market. The liberalization of imports scheduled for 1973 could lead to another surge

Note: This memorandum was prepared by the Office of Economic Research.

of imports if controls are not carefully exercised or if domestic credit restrictions fail to hold growth in the domestic economy to around the 5.5%-6.5% planned for 1973.

4. Over the longer run, growth in Yugoslavia's economy will still be dependent on large imports of raw materials and intermediate materials from the West. Paying for these large imports and servicing external debt will continue to be a major problem for the Yugoslavs. Their hard currency exports -- largely consisting of food, livestock products, and semifinished materials -- have been relatively slow growing and are highly sensitive to short-term economic fluctuations in Western Europe. The large remittances from Yugoslav workers abroad, which have largely offset recent trade deficits, also are highly dependent on Western Europe's economic climate.

5. To stimulate economic development over the long run without an ever-increasing debt burden, the Yugoslav leadership has looked to foreign investment capital and, more recently, to long-term Soviet economic assistance. Thus far, the volume of foreign investment has been disappointingly small -- only about $90 million in hard currency -- and most, contrary to the regime's expectations, has gone to the more developed north. The south, on the other hand, will receive the lion's share of the large Soviet soft currency credits. With Tito -- now over 80 -- about to leave center stage, the Yugoslav balancing act is becoming ever harder to hold together. And the Soviet credits, by pushing the south still further in the direction of CEMA, may add to the already difficult task of reconciling the divergent economic attitudes of the north and south.

DISCUSSION

Background

6. Yugoslavia's chronic difficulty in balancing its external accounts became increasingly acute in the late 1960s. As part of the 1965 economic reform, import regulations were substantially liberalized in 1967. The response to that liberalization was almost immediate -- in the first half of 1967, hard currency imports rose by 37%, and Yugoslavia's first-half trade deficit doubled even though the economy was in a major recession. To get the economy growing again, the government loosened monetary and credit controls in 1968. By early 1969 the economy began to move out of control; industrial output rose by 12%; and hard currency imports, which had grown only moderately after the jump in the first half of 1967, increased by 24% during 1969.

7. As the boom continued into 1970, the trade picture worsened. Imports remained at high levels during the first half of 1970 and skyrocketed after Tito prematurely announced that "devaluation would come, but not now." As a result, the hard currency trade deficit leaped from $578 million in 1969 to $1.1 billion in 1970 (see Table 1). Despite an impressive increase of 56% in invisibles earnings, the global current account deficit tripled to $340 million (see Table 2). The hard currency current account deficit -- much more significant to Yugoslav policymaking -- quadrupled to $374 million.

8. Not only was the deficit rising rapidly, but aid from traditional sources – the United States, the International Monetary Fund (IMF), Italy, West Germany, and the United Kingdom – was drying up. Compounding the financing problem was the overreaction of Yugoslav enterprises to the 1967 trade liberalization, which permitted them to obtain foreign credits without funneling their requests through the National Bank. Thus the volume of hard currency indebtedness – with most of the increase in the form of medium-term suppliers' credit – rose from $1.8 billion at the end of 1966 to $2.5 billion at the end of 1970.[1]

9. The regime attempted to stabilize its external accounts early in 1971 by devaluing the dinar by 16.7%, imposing a dinar deposit scheme designed to choke off imports, and adding a temporary import surcharge of 2% to existing tariffs. From the outset, the stabilization measures appeared to be too little, too late. A public debate over devaluation undermined public confidence in the dinar and led to speculative stockpiling of imported raw and intermediate materials. And in any case, much of the anticipated benefit from the devaluation already had been eroded by the 11% rise in prices during 1970. In the first six months of 1971, the tide of imports – up by 33% over the first half of 1970 – continued unabated, while exports declined by 1%.

10. The trade deficit for just the first half of 1971 reached a staggering $834 million – mostly in hard currency and 94% above the level for the first half of 1970. Coming on the heels of a massive $500 million debt servicing which had been required in 1970, the trade deficit sent the Yugoslavs scurrying to both East and West for help. The IMF – at the strong urging of the United States – was the first to respond, approving a standby credit of $51.75 million in February 1971, which was later increased to $83.5 million in July. Other major creditors, including the United States, West Germany, Italy, Japan, and France, agreed to roll over

1. All dollar figures in this memorandum have been converted at 1970 exchange rates. The realignment of exchange rates in 1971 resulted in an appreciation relative to the dollar of the values of the major currencies in which East-West trade is conducted and East European indebtedness is booked.

Table 1

Yugoslavia: Hard Currency Balance of Payments[a]

Million US $

	1967	*1968*	*1969*	*1970*	*1971[b]*
Current account balance	**-132**	**-124**	**-88**	**-374**	**-242**
Trade balance	-432	-470	-578	-1,100	-1,230
Exports (f.o.b.)	715	738	922	1,033	1,080
Imports (c.i.f.)	-1,147	-1,208	-1,500	-2,133	-2,310
Services, net	300	346	490	726	988
Tourism and foreign travel	88	121	145	132	158
Transportation	84	92	96	112	155
Worker remittances	89	122	206	440	630
Investment income	-66	-76	-88	-110	-112
Other services and net transfers	105	87	131	152	157
Capital account balance	**103**	**129**	**224**	**346**	**131**
Total long-term loans, net	159	151	192	205	290
Long-term loans received[c]	305	337	449	568	625
Long-term loans repaid	-163	-180	-232	-331	-410
Agricultural commodity credits, net	17	-6	-25	-32	75
Total short-term capital	-56	-22	32	141	-159
Export credits, net	-13	-30	-59	-25	-55
Other short-term capital (including errors and omissions, net)	-43	8	91	166	-104
Monetary movements, net	**29**	**-5**	**-136**	**23**	**111**
Special Drawing Rights	0	0	0	19	22
Gold and convertible currencies	Negl.	-52	-158	109	14
Net IMF account, National Bank, and commercial banks' credits	29	47	22	-100	75
Balance on capital and monetary accounts	**132**	**124**	**88**	**374**	**242**

a. Data are from the IMF.
b. Preliminary IMF estimate.
c. Including joint venture capital.

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Table 2

Yugoslavia: Global Balance of Payments[a]

Million US $

	1967	1968	1969	1970	1971[b] Total	1971[b] Jan-Jun	1971[b] Jul-Dec
Current account balance	**-82**	**-106**	**-108**	**-340**	-324	**-468**	**144**
Trade balance	-455	-532	-660	-1,194	-1,439	-854	-585
Exports (f.o.b.)	1,253	1,265	1,475	1,680	1,814	792	1,022
Imports (c.i.f.)	-1,708	-1,797	-2,135	-2,874	-3,253	-1,646	-1,607
Services, net	341	388	507	793	1,045	357	688
Tourism and foreign travel	98	136	168	146	175	8	167
Transportation	140	144	163	201	244	95	149
Worker remittances	89	122	206	440	630	278	352
Investment income	-67	-77	-88	-110	-115	-60	-55
Other services	81	63	58	116	111	36	75
Transfers, net	32	38	45	61	70	29	41
Capital account balance	**147**	**63**	**186**	**241**	168	**260**	-92
Total long-term loans, net	151	165	253	269	295	133	162
Long-term loans received	334	390	517	636	640	318	322
Long-term loans repaid	-200	-219	-239	-335	-420	-200	-220
Agricultural commodity credits, net	17	-6	-25	-32	75	15	60
Total short-term capital	-4	-102	-67	-28	-127	127	-254
Export credits, net	-39	-46	-92	-50	-72	-20	-52
Other short-term capital (including errors and omissions, net)	35	-56	25	22	-55	147	-202
Allocation of IMF Special Drawing Rights	**0**	**0**	**0**	**25**	**22**	**22**	**0**
Monetary movements, net	**-65**	**43**	**-78**	**74**	**134**	**186**	**-52**
Special Drawing Rights	0	0	0	-6	4	-1	5
Net IMF accounts	33	-18	-38	-60	71	29	42
Gold and convertible currencies	Negl.	-52	-158	109	14	-30	44
National bank credits	22	-21	27	-16	Negl.	57	-57
Commercial banks' credits	-26	86	33	-24	Negl.	91	-91
Bilateral balances	-94	48	58	71	45	40	5
Balance on capital and monetary accounts	**82**	**106**	**108**	**340**	**324**	**468**	**-144**

a. Data are from the IMF.
b. Preliminary.

and consolidate part of existing Yugoslav debts. And in the early fall, after Brezhnev's visit to Belgrade, serious negotiations for long-term developmental credits were begun with the USSR.[2]

11. In July 1971 the regime belatedly enacted yet another stabilization package, which included a prohibition on credit sales of imported automobiles and domestic goods with more than 50% import content; tighter import quotas; a tougher prior deposit scheme for raw material imports; an increase in the import surcharge from 2% to 6%; and licensing changes designed to make it harder to import certain products. To complement the new restrictions on imports, the National Bank instituted a revised reporting system and credit deposit scheme to control the volume and credit terms of external indebtedness.

12. These steps were more effective in constricting the demand for imports. In the second half of 1971, exports increased by 16% over the last half of 1970, while imports declined by 1%. A strong surge in receipts from invisibles helped to provide a $144 million current account surplus in the second half of 1971, in contrast to the $468 million deficit incurred in the first half of the year.

13. The turnaround in the balance of payments continued during 1972 and resulted in a current account surplus of about $185 million. Exports in the first half of 1972 – paced by the extraordinary 78% increase in meat and livestock exports – were 30% higher than in the first half of 1971. Beginning in July 1972, exports began to stagnate, but the clamp on hard currency imports – especially of consumer goods and raw materials – cut deeply into the trade deficit. For all of 1972, the Yugoslavs have estimated that global exports rose 18% above the 1971 level and imports declined by around 4%, thus trimming the trade deficit to about $1 billion. Another good year in invisibles earnings – up by 24% to a net of $1.3 billion – more than offsets the trade deficit, yielding a surplus for the first time since 1965.

14. The government is taking advantage of the balance-of-payments surplus and the increase in hard currency reserves to a record $650 million (including $130 million in Western bank loans) to revert to freer trade. As in 1967, the free import category will be increased most significantly – from 28% (1971) to about 37% of imports. The 1973 liberalization comes after several years of selective retrenchments on the 1967 reform. In most years after 1967, additions had been made to the free import list, but other items had been moved to more restrictive categories, making the import regime, on balance, more restrictive.

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15. As part of the overall trade liberalization, the government will also put into operation in early 1973 the long-delayed domestic market in foreign exchange. Designed to replace eventually the current system of retention quotas – a complex allocation formula in which most enterprises are allowed to retain an average of only 20% of their foreign exchange earnings – the market's operations will be rather limited initially. Only commercial banks will be allowed to participate, and only "spot" exchanges of dinars for foreign exchange will be permitted as opposed to speculative trading in futures. The National Bank aims at keeping the dinar parity within a range of plus or minus 2.25% of existing exchange rates and presumably would close down the market if the banks attempted to purchase excessive amounts of foreign exchange.

16. The regime apparently believes that the import deposit scheme it implemented in early 1971 and subsequently beefed up in July will keep imports at manageable levels. To make sure, restrictions on foreign credits will also be continued and are expected to dampen the demand for capital imports. And to help keep the lid on imports, the government is attempting to enforce a domestic growth rate of only 5.5% to 6.5% for 1973 – well below the growth rates in recent years. Lacking fiscal controls, the regime is relying, as in the past, on selective credit controls and a restrictive monetary policy to hold the growth rate down. The government calculates that if the target growth rate can be achieved, liberalized imports will increase by only $120 million, with most of the increase accounted for by imports of raw and semifinished materials. At the same time, the regime hopes that the foreign exchange market will contribute to a more rational foreign exchange allocation – long demanded by the more developed Yugoslav republics – and provide a means of checking the dinar's value against foreign currencies. Whether this round of liberalization can be maintained will depend, as in the past, on the performance of Yugoslav exports and the continued growth of earnings from invisibles.

Commodity Trade Problems

17. Even though the deficit in commodity trade was narrowed in 1972, the trend has been toward a widening trade gap. In each year from 1965 to 1971, the trade deficit expanded – and, until the second half of 1971 – at an increasing rate. In 1965 the commodity deficit totaled only $196 million; by 1971 it had increased about sixfold to $1.4 billion (see Table 3). Moreover, most of the commodity deficit – $1.2 billion (1971) – is with the hard currency area.

18. Yugoslavia's earnings from commodity exports grew by 43% from 1968 to 1971 – ordinarily a satisfactory gain, but no match for the 81% leap in imports. The overall structure of Yugoslav exports changed relatively

Table 3

Yugoslavia: Balance of Trade

Million US $

	1967	1968	1969	1970	1971
Exports	1,253	1,265	1,475	1,680	1,814
Imports	-1,708	-1,797	-2,135	-2,874	-3,253
Trade balance	-455	-532	-660	-1,194	-1,439
Hard currency trade balance	-432	-470	-578	-1,100	-1,230

little during this period, but a comparison of the commodity breakdowns for 1967 and 1971 shows that Yugoslavia's trade balance deteriorated in every product category, and particularly in fuels and power, semimanufactures, and machinery and transport equipment (see Table 4). The large decline in the balance of trade for agricultural products was caused in part by the relatively poor agricultural harvest of 1970, requiring larger-than-normal food imports in 1971.

Table 4

Yugoslavia: Imports and Exports[a]

Million US $

	1967			1971		
	Exports	Imports	Balance	Exports	Imports	Balance
Total	**1,253**	**1,708**	**-455**	**1,814**	**3,253**	**-1,439**
Food, beverages, fats, and tobacco	338	213	125	339	344	-5
Raw materials	106	199	-93	148	312	-164
Fuels and power	22	85	-63	4	193	-189
Chemicals	74	167	-93	129	297	-168
Semimanufactures	281	402	-121	494	917	-423
Machinery and transport equipment	255	572	-317	445	1,018	-573
Consumer goods and light manufactures	175	70	105	256	172	84

a. Because of rounding, components may not add to the totals shown.

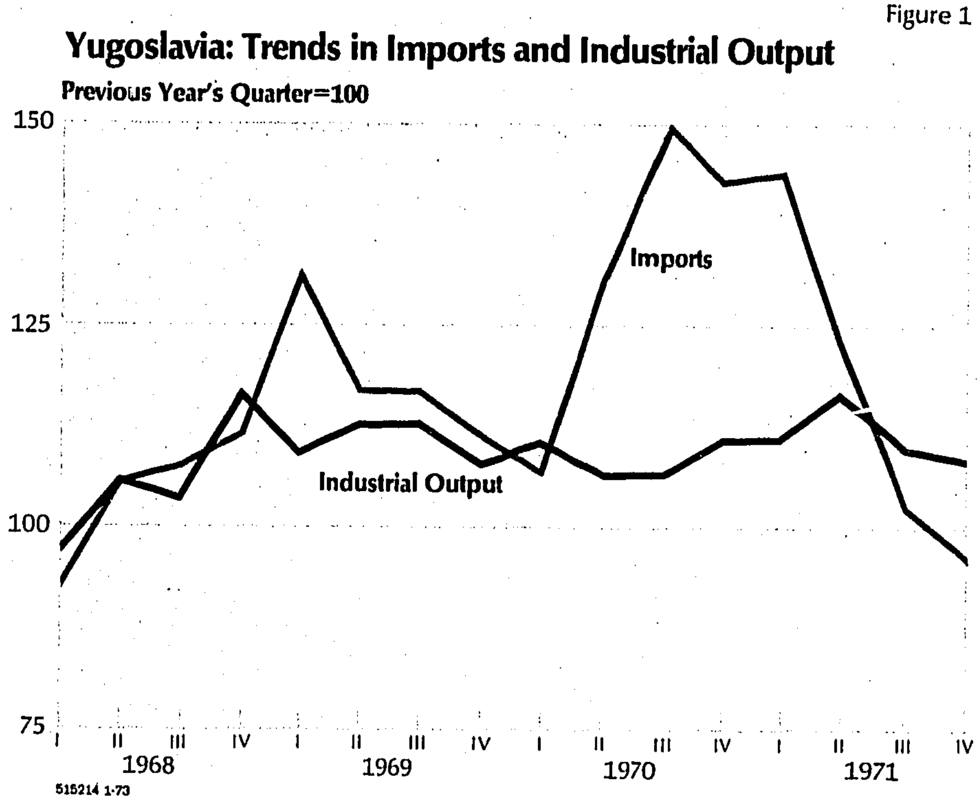
19. Most of Yugoslavia's hard currency exports continue to be relatively unsophisticated goods such as food and livestock products, semifinished nonferrous metals, textiles, leather goods, furniture, and construction materials. Supply and demand problems have interacted to prevent a more rapid rise in these traditional exports. Efforts to expand the export of agricultural products have been frustrated, on the one hand, by the unresponsiveness of peasants – who control over 80% of agricultural land – to trade opportunities and, on the other, by the inability of the larger agricultural cooperatives to attract investment to livestock expansion. Exports of semifinished nonferrous metals products, textiles, and construction materials, while not subject to supply constraints, have relatively slow-growing markets which are highly sensitive to price increases and to short-term growth trends in Western Europe. The more sophisticated products of Yugoslavia's industrial sector such as consumer durables, electrical machinery, transport equipment, and synthetic fibers are not up to quality standards of Western producers. Although many of these products are produced with Western machinery, most of the goods still have to be unloaded on CEMA markets or in the less developed countries.

20. Not only has Yugoslavia had difficulty in getting the industrial West to buy its manufactured products, but it has compounded its balance-of-payments problems by creating industries that rely heavily on imported materials and intermediate products. And the various Yugoslav republics have contributed to the investment problem by demanding, and all too often getting, their own steel plants and chemical combines. This has resulted in the construction of uneconomical smaller scale facilities as well as unnecessary duplication. Meanwhile, potentially profitable investments to develop Yugoslavia's most abundant resources, such as nonferrous metals, have been underfunded.

21. The encouragement of industries dependent on imports is best reflected by the doubling of imports of raw materials and intermediate goods since 1966 – to more than $2 billion in 1971. The largest – and most damaging – increases in imports obviously have occurred in periods when industrial output is booming. In fact, recent experience suggests that growth in industrial production would have to be held to less than 9% in order to keep import expansion within bounds. Imports shot up rapidly – by an annual rate of as much as 35% – when industrial output grew by faster rates, as in 1968, the second half of 1970, and the first half of 1971 (see Figure 1).

22. Other factors have also contributed to large increases in imports. First, many materials required by Yugoslav enterprises are not produced in sufficient quantities at prices competitive with those of Western suppliers. Second, the tight domestic credit market in recent years has often worked

Figure 1



to the detriment of domestic suppliers, who are often unable to finance sales of many products on credit terms that match Western offers. Finally, to protect themselves from inevitable delays in deliveries which occur as the economy becomes overheated, many enterprises simply bypass domestic suppliers and purchase materials in Western markets when production begins to soar.

23. The rapid increase in wages and personal incomes since the 1965 reform has also played a major role in undermining export growth and boosting the demand for imports. The watchword for the 1965 economic reform had been efficiency through decentralization. In the hope of generating greater efficiency, workers' councils in Yugoslav enterprises were given wider discretion over the distribution of operating revenues. Many workers' councils responded to the efficiency challenge by understating depreciation rates, deferring modernizing investments, and granting wage hikes which far exceeded productivity gains. The resulting increases in unit costs were then passed along to foreign as well as domestic consumers in the form of higher prices as suggested in the following tabulation. The impact of the wage hikes probably most affected export sales of price-sensitive raw and semifinished materials.

	Annual Percentage Increase			
	1968	*1969*	*1970*	*1971*
Personal income per employee	10	15	17	22
Unit labor costs	4	8	12	14
Industrial producers prices	0	3	9	15
Industrial export prices	1	3	8	4

24. The gains in personal income – coupled with the trade liberalization and easy consumer credit terms available during 1967-70 – also helped to boost imports. From 1967 to 1970, imports of goods for personal consumption, excluding food and beverages, increased by nearly $120 million, or 58%. Moreover, the rapid increase in disposable incomes created a sellers' market at home, effectively siphoning off potential exports.

25. Finally, wide fluctuations in the year-to-year performance of Yugoslavia's agricultural sector have further aggravated the problem of balancing commodity trade. Despite gains in productivity through irrigation projects, improvements in new seeds, and greater mechanization, Yugoslavia's agriculture remains highly susceptible to bad weather conditions. To be sure, agricultural exports have been largely stabilized by sales of livestock and meat products to the Common Market and consistently have earned about $330 million annually since 1967. However, poor or even average agricultural years necessitate large hard currency imports of wheat, corn, soybean oil, and other agricultural products, both to maintain domestic food supplies and to provide fodder for livestock production. Thus the trade balance of agricultural imports and exports since 1967 has ranged from $125 million in 1967 to -$5 million in 1971.

Invisibles: Covering the Deficits

26. If it were not for the rapid surge in receipts from invisibles, the regime would have been forced to intervene with more than periodic curbs on economic growth and imports. Foreign exchange earnings from invisibles – most in hard currency – have increased as a share of total exports of goods and services from 27% in 1965 to nearly 47% in 1971. Gross receipts from invisibles in 1971 totaled more than $1.6 billion, practically all of it coming from three sources: workers' remittances, tourism, and transportation receipts.

27. The inflow of foreign exchange from workers' remittances has shown the most remarkable growth, increasing at an average annual rate of 63% between 1967 and 1971. The source of this major inflow is the estimated one million Yugoslavs employed more or less permanently in Western Europe, of whom almost 500,000 are in West Germany alone. Workers' remittances began to emerge as a major source of hard currency earnings after 1965, when the regime adopted a more liberal attitude toward foreign travel by Yugoslavs. Foreign exchange remitted by the emigre workers grew by about $28 million per year from 1965 to 1968 before jumping by $84 million in 1969, $234 million in 1970, and another $190 million in 1971.

28. Although the currency inflow from workers' remittances has provided a welcome offset to Yugoslav commodity trade deficits, it has introduced another cyclical factor into the balance of payments. Not only does the employment of Yugoslav workers in Western Europe depend upon the economic climate there, but the remitting of workers' savings is linked to confidence in the Yugoslav economy. The general downturn in Western Europe in late 1971, and particularly in West Germany, raised fears in Yugoslavia that hundreds of thousands of workers might be dismissed and sent back home. Although mass dismissals did not materialize, a significant decline in the number of official departures[3] of workers -- with its implication of a leveling of worker remittances -- has continued to worry policymakers. In 1971 the number of workers abroad increased by about 120,000, while in 1972 the number of returning workers will probably offset the number who are departing from Yugoslavia.

29. The confidence of workers abroad in the Yugoslav economy may have been shaken by Tito's recent attack on "capitalist-acquired" wealth. Immediately after the government's statements that an investigation of land speculators, technocrats, and wealthy party members was to begin, a run began on at least two major banks in Yugoslavia. While the National Bank has since assured the public that personal foreign exchange savings accounts will remain secure, the campaign on "unearned" wealth may have raised similar anxieties among workers abroad who have deposits in branches of Yugoslav banks in Western Europe. A serious situation could develop if large numbers of workers were to withdraw their savings deposits and redeposit them in West German banks.

30. The outflow of workers also has had mixed effects on the domestic scene as well. Initially, the exodus was hailed as a godsend; it

3. Official departures are those registered with government employment bureaus. An official of the Federal Secretariat for Labor estimates that as many as 50% of those seeking work abroad do not register, but instead apply for work permits at foreign embassies or upon their arrival in Western Europe. As a result, official Yugoslav figures for workers abroad grossly understate actual numbers.

significantly eased strains on the domestic employment situation and contributed to greater labor efficiency in the industrial sector. Returning workers were expected to lead to an upgrading of the skills profile in the Yugoslav economy. Policymakers are now beginning to realize that the skills learned by many of the emigre workers either are not currently applicable to the Yugoslav economy or do not conform to the structure of employment openings. For example, there are an estimated 250,000 Yugoslavs working in construction projects abroad, of whom no more than 10% could find gainful employment with domestic building enterprises. In other industries, however, particularly in Slovenia and Croatia, the heavy outflow of skilled workers has created key manpower shortages. Many enterprises have been forced to bid up wage rates to forestall workers from going abroad or to attract new workers. Finally, emigre exposure to Western standards of living has probably tended to increase the desire of many of the Yugoslavs at home for consumer imports from the West.

31. The steady inflow of Western tourists also padded the invisibles account during the late 1960s.[4] After Tito gave the tourist industry his official sanction in 1962, investment in the industry grew rapidly, aided by preferential treatment from the federal government. Unlike many investment schemes, this one began to pay quick dividends. The annual increase in tourists jumped from 100,000-200,000 during 1957-61 to 400,000-500,000 in 1963-65. By 1970, Yugoslavia was entertaining upwards of 5 million tourists – mostly from hard currency countries. Gross earnings from tourism rose from $81 million in 1965 to $355 million in 1971. Moreover, unlike many of the sectors in which Yugoslavia has invested heavily, the tourist industry has added little to the import burden. Purchases of foreign equipment to support tourism in most years have averaged less than $1 million.

32. In recent years, however, increased foreign travel by Yugoslavs has cut sharply into gross tourism receipts. In fact, expenditures by Yugoslav tourists since 1965 – mainly in hard currency countries – have been rising more rapidly than receipts from foreign tourists. Much of the increased currency outflow reflects Yugoslav shopping sprees in neighboring Austria and Italy for consumer goods that are in short supply domestically or of inferior quality – for example, clothing, footwear, or durables such as refrigerators and washing machines. As shown in the following tabulation, the result has been a slowdown – and in 1970 an absolute decline – in net earnings from tourism.

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	Million US $		
Year	*Receipts*	*Payments*	*Net*
1965	81	18	63
1966	117	35	82
1967	150	52	98
1968	189	53	136
1969	241	73	168
1970	275	129	146
1971	355	180	175

33. The third major component of the Yugoslav exports of invisibles is the considerable earnings from transportation. These have grown at a relatively leisurely pace when compared with the dynamic worker remittances and tourism receipts. The trend of net receipts has more or less followed the general trend of commodity trade, rising by 70% from 1965 to 1970 as total trade grew by 92%. Moreover, unlike earnings from tourism and workers' remittances, which are almost completely in hard currency, 35% of net and 75% of gross transportation receipts are earned in the soft currency area. The main impact of the earnings has been to offset the small soft currency trade deficits, particularly with Czechoslovakia.

34. Large investments have been made in recent years to improve the transportation network – mainly to induce greater tourism. Expansion of air travel has been particularly rapid; airports have been or are being built near major population and tourist centers. Substantial roads and highway projects – financed in part by loans from the International Bank for Reconstruction and Development (IBRD) – also are being undertaken. Improvement of the rail network and development of Yugoslavia's maritime fleet and port facilities have proceeded more slowly. While a strengthening of the transportation network will undoubtedly contribute to a more efficiently operating economy, the investment programs, especially in air travel, require both large hard currency expenditures and a rather long gestation period. In the short run at least, it is doubtful that the investments will enable transportation earnings to offset much more of the hard currency trade deficit than the 10%-12% of recent years.

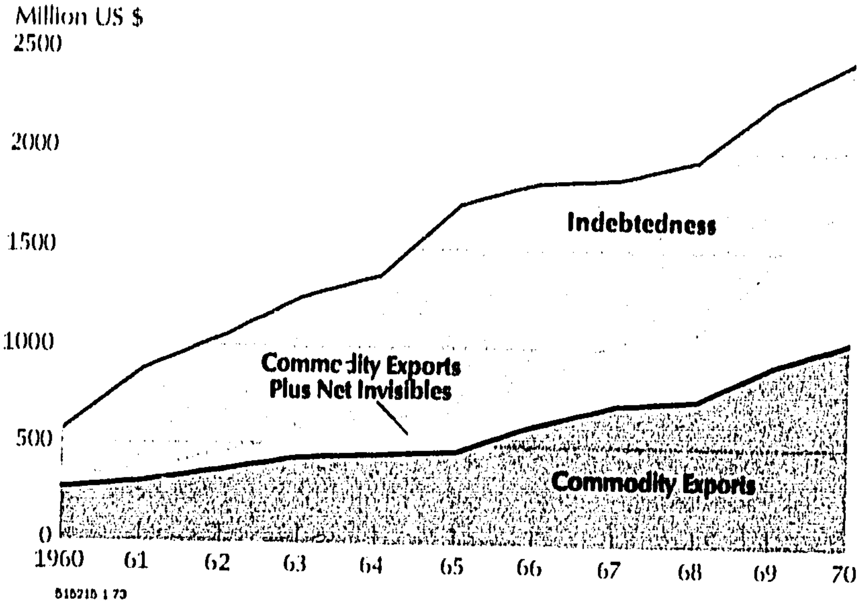
Rising Indebtedness

35. Financing required to cover the chronic balance-of-payments deficits, coupled with the need for new development capital, greatly expanded the volume of indebtedness during the 1960s. The Yugoslav debt

(including undisbursed credits) quadrupled from about $585 million in 1960 to nearly $2.5 billion at the end of the decade (see Figure 2). The largest increases in the debt were incurred to support the major economic reforms of 1961 and 1965 and to cover huge trade deficits after 1967.

Figure 2

Yugoslavia: Hard Currency Earnings and Indebtedness



36. Controlling the structure of Yugoslavia's external debt has proved to be as much of a problem as that of the overall volume. At least three times in the 1960s the excessively short-term structure of the debt – and its large servicing requirements – forced the government to appeal to major Western creditors for refinancing. The most recent round of rescheduling began late in 1970, after the regime realized it would be unable to finance its $1.2 billion hard currency trade deficit and at the same time meet the $670 million debt amortization falling due in 1971. Once again, Yugoslavia's major creditors – the United States, Italy, West Germany, France, and Japan – along with the IMF, agreed to bail out the Yugoslavs.

37. The IMF, in granting a $83.5 million standby credit, received assurances from the government that steps would be taken to check the volatile growth in credits guaranteed by Yugoslav business banks. The business banks had been permitted to engage in foreign borrowing as part of the 1967 foreign trade reform, and in retrospect it appears that the regime lacked the machinery to limit loan requests adequately. The result

was a credit explosion that played a major role in inflating the demand for hard currency imports. Credits guaranteed by the business banks – virtually all of which are suppliers' credits with a maturity range of 2 to 5 years – jumped from only $120 million in 1967 to more than $800 million by the end of 1970.

38. Under the terms of the IMF standby agreement, the National Bank introduced a tightened reporting system in July 1971 to curtail business bank borrowing. The new scheme gives the National Bank the authority to refuse to allow loans with excessive interest rates or other conditions it views as unfavorable. To help lengthen the term structure of credit requests, a non-interest-bearing deposit of 40% of the loan value for short-term credits to 20% for long-term credits must be made with the National Bank. So far, the credit restrictions have been effective – the increase in business bank guarantees during 1971 was only $90 million, a far cry from the increase of $300 million during 1970.

39. Medium-term suppliers' credits have become the major source of foreign capital, displacing official government loans and raising the average interest rate. During the first half of the 1960s, foreign government loans accounted for nearly 41% of the net long-term capital inflow; in the second half of the decade, only 13%. As shown in the following tabulation, the IBRD has emerged as the largest source of official long-term lending to Yugoslavia. Thus far, more than $585 million in 20 loans has been extended to develop power and water resources and for highway construction, industrial projects, and tourism.

	Million US $					
	1965	*1966*	*1967*	*1968*	*1969*	*1970*
Gross inflow	328	382	351	390	517	636
Repayments	165	178	200	225	264	367
Net inflow	163	204	151	165	253	269
Private capital[a]	73	71	160	154	201	278
Official capital	90	133	-9	11	52	-9
Of which:						
US	60	115	10	4	-19	-45
Other government	11	-8	-16	-19	-3	-24
CEMA	-19	7	-14	10	53	33
IBRD	35	19	11	16	22	27

a. Mostly financial and suppliers' credits.

40. The shift from long-term official loans to medium-term suppliers' and financial credits has led to a rapid increase in Yugoslavia's debt servicing obligations. The rise in repayments since 1967 has been so rapid that a doubling in annual gross borrowing – from \$351 million in 1967 to \$715 million in 1971 – added only about \$100 million to the net inflow of capital in 1971. The small increase in net capital inflow would have been even less except for extensive debt rescheduling carried out during the period. Even with the National Bank's squeeze on the shorter term dealings of the business bank, however, the repayment burden is a heavy one – of the \$800 million in suppliers' credits outstanding on 30 September 1971, \$500 million is scheduled to be amortized during 1972-73.

41. One measure of assessing the increase in the burden of Yugoslavia's hard currency debt over time is by comparing the ratio of repayments to hard currency inflows from services and exports. This debt service ratio – despite extensive rescheduling – rose from around 21% in 1967 to 24% in 1971 (see Table 5). Yugoslavia's ratio is slightly above

Table 5

Yugoslavia: Hard Currency Earnings and Debt Repayments

	1967	*1968*	*1969*	*1970*	*1971*
	Million US \$				
Commodity exports	715	738	922	1,033	1,080
Net revenue from invisibles (excluding interest)	366	422	578	836	1,100
Repayments (including interest)[a]	-229	-256	-320	-441	-522
	Percent				
Repayments and interest as a share of exports	32.0	34.7	34.7	42.7	48.3
Repayments and interest as a share of exports plus net invisibles	21.2	22.1	21.3	23.6	23.9

a. Excluding CCC loans.

average for Eastern Europe, but without Yugoslavia's extraordinary invisibles earnings the ratio of debt service to exports would climb to 48% – the highest in Eastern Europe. Rough projections of the Yugoslav debt indicate that the debt servicing ratio will remain at a high level until at least 1976. Indeed, the ratio – unless hard currency exports show more sustained growth than in the past – may rise again in 1974-75, when most of the rescheduled repayments to West Germany, Italy, France, and Japan fall due. Scheduled amortization in 1974-75 on the debt outstanding in 1971 will probably be at least $625 million to $650 million, assuming no major increase in borrowing and excluding IMF assistance. Maintaining the ratio of exports to debt service at about 45% would require hard currency exports to increase by about 13% annually. If a slowdown in invisibles receipts -- especially workers' remittances – were to take place by 1974, another round of rescheduling requests would probably be forthcoming.

42. As might be expected, most of Yugoslavia's indebtedness is owed to its major hard currency trading partners – the United States, West Germany, Italy, the United Kingdom, France, and Japan (see Table 6). As of 31 December 1970, the most recent date for which a country breakdown of external debt is available, the United States was Yugoslavia's largest creditor, with $622 million (including undisbursed), followed by West Germany ($465 million), Italy ($297 million), the United Kingdom ($171 million), and France ($134 million). Of the debt owed to the United States, $277 million stems from governmental sources – such as Commodity Credit Corporation (CCC) credits, and PL-480 loans repayable in dollars. Direct government assistance from the other major Western creditors, with the exception of Italy ($143 million), is a relatively small portion of the debt: most is owed in the form of suppliers' credits and bank loans.

43. Of the CEMA countries, the USSR and Czechoslovakia have provided the most assistance to Yugoslavia. On 31 December 1970 they were the largest CEMA creditors with $226 million and $136 million, respectively, in disbursed and undisbursed credits. During 1971 the USSR extended another $130 million for development of bauxite resources and the construction of an alumina plant in Bosnia-Hercegovina and agreed in early November 1972 to extend another $540 million for development of mineral and power resources mainly in the less developed republics. As Table 6 illustrates, past drawings on CEMA credits – unlike drawings on Western credits – have been slow. Of the $509 million which had been extended as of the end of 1970, only $213 million had been utilized. Large drawings on the most recent Soviet development credits will probably not begin until at least 1975.

Table 6

Yugoslavia: Indebtedness by Major Creditors as of the End of 1970

Million US $

	Disbursed	*Including Undisbursed*
Total[a]	**2,060.7**	**2,977.4**
Convertible currency	1,848.0	2,468.1
Of which:		
France	93.5	134.2
Suppliers' credits	82.0	120.4
Government loans	9.0	11.3
Other	2.5	2.5
Italy	207.1	297.0
Suppliers' credits	116.2	152.6
Government loans	89.6	143.1
Other	1.3	1.3
Japan	51.2	51.9
Suppliers' credits	47.7	48.4
Government loans	3.5	3.5
United Kingdom	82.5	170.6
Suppliers' credits	75.5	158.8
Government loans	2.2	2.2
Other	4.8	9.6
United States	553.2	621.7
Suppliers' credits	258.6	326.6
Government loans	276.2	276.7
Other[b]	18.4	18.4
West Germany	373.3	465.0
Suppliers' credits	215.6	284.2
Government loans	28.7	28.7
Other	129.0	152.1
Nonconvertible currency	212.8	509.3
USSR	70.4	226.4
Czechoslovakia	85.7	136.0
Poland	36.0	62.2
Other	20.7	84.7

a. Excluding dinar debts.
b. Including bank credits, publicly issued bonds, and the like.

Prospects

44. Without strong import controls and especially favorable export results, the surplus in 1972 could not have been achieved. If another surge in imports is to be avoided, the upcoming trade liberalization will have to be carefully managed. With inventories at low levels, enterprises are likely to exploit any easing of controls on imports of raw and intermediate materials. Because of rigid barter agreements and the delays involved in trade with the CEMA countries, most enterprises will probably turn to Western suppliers if given the chance. Lacking fiscal tools, the government must depend on monetary policy and selective controls to slow the economy's growth rate in 1973 and thus its intake of imports. Controls on consumer credits will be tightened, and measures to curb the investments of insolvent enterprises went into effect in January 1973. To reduce demand further, growth in the money supply will be slowed and workers in insolvent enterprises will receive 10% cuts in pay, while government employees' wages will remain frozen until June 1973. While it is too early to predict the outcome of this campaign to slow the economy's growth rate, past efforts at fine tuning have usually gone awry – monetary controls have either proved too strong and driven the economy into recession as in 1966-67 or too weak to slow down the growth rate as in 1969-70.

45. Even if the impending liberalization adds little to the import burden, it is unlikely that another surplus will be forthcoming in 1973. The necessity of increasing raw materials imports to rebuild inventory stocks, coupled with the mediocre 1972 harvest – a bellwether of large food imports and sluggish agricultural exports – dims the 1973 trade picture. Adding to the pessimistic trade outlook is a study published in September 1972 by the Ljubljana Economic Institute, headed by the well-known economist Alexander Bajt. According to Bajt's study, Yugoslav exports since October 1971 have been in a state of "phased out stagnation" and by last August had reached virtually a zero growth rate.

46. The real test for the Yugoslav economy will come after 1973. If economic instability is to be reduced, the regime must be willing to pursue and enforce moderate growth rates for a sustained period and to encourage a major structural overhaul of the economy. In the past the government has given in to pressures from the less developed republics for a fast growth policy with emphasis on heavy industry. The result has been the chronic economic difficulties of a less developed country – rapid inflation, structural bottlenecks, inefficiency, and excessive imports. Moreover, in 1974-75 rescheduled debts from Western creditors will again bulge. If the economy then is in another boom and invisibles earnings – especially from workers' remittances – have leveled off, policymakers can expect another round of refinancing requests from the Yugoslavs.

47. Over the longer run, the leadership has been banking on joint ventures and joint investment capital to pull Yugoslavia out of its credit bind and to aid in the development of the south - Bosnia-Hercegovina, Montenegro, Macedonia, and the Kosovo. Legislation permitting foreign investment was first passed in 1967 and considerably liberalized in 1971, with special treatment promised for investors going into poorer regions. Results thus far have been disappointing to Yugoslav policymakers. Not only has the capital inflow been small (around $90 million), but more than 90% of the funds has been invested in the more advanced republics of Slovenia, Croatia, and Serbia. Given chronic economic instability as well as the unsettled outlook for economic policy in a post-Tito Yugoslavia, the regime can realistically expect foreign investment capital to meet only a small fraction of its developmental needs in the foreseeable future.

48. Confronted with its huge debt and able to attract only token amounts of foreign investment capital, the regime has sought increased economic contacts with the Soviet Union. Major deals concluded since September 1971 include a $130 million credit for construction of an alumina plant at Zvornik in Bosnia-Hercegovina, a $100 million barter deal involving Yugoslavia's Fiat affiliate Crvena Zastava, and, more recently, the extension of a $540 million credit line to be used mainly for development of mineral and power resources in the less developed republics. While this upsurge in economic activity does not necessarily mark a major shift in Belgrade's Western-oriented trade policy, the Soviet credits considerably strengthen Moscow's economic leverage in the weaker republics and may, over the longer run, widen still further the gap between northern and southern views on economic policy. The Yugoslav balancing act could become even more precarious – with the south pushing for rapid growth and closer ties with CEMA, in conflict with northern demands for structural improvements in output, more efficient resource allocation, and greater trade with the West.