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Federal Republic of Yugoslavia: Membership and Request for Emergency Postconflict Assistance--Staff Report, and Press Release on the Executive Board Discussion

In the context of discussions with authorities of the Federal Republic of Yugoslavia on succession to membership in the IMF and request for emergency postconflict assistance, the following documents have been released and are included in this package:

- a staff report prepared by a staff team of the IMF, following discussions that ended on **November 21, 2000**, with the officials of **Federal Republic of Yugoslavia** on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on December 12, 2000.** The views expressed in the report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a Press Release summarizing the **views of the Executive Board as expressed during its December 20, 2000, discussion** of the staff report.

The document listed below has been or will be released separately also.

Statement of Economic Policies

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INTERNATIONAL MONETARY FUND

FEDERAL REPUBLIC OF YUGOSLAVIA

Membership and Use of Fund Resources—Request for Emergency Post-Conflict Assistance

Prepared by the European I and the Policy Development and Review Department

(In consultation with other Departments)

Approved by Jacques Artus and Shigeo Kashiwagi

December 12, 2000

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Appendices

I. Introduction

1. Following the overthrow of the Milosevic regime on October 5, 2000, the staff held discussions with the new authorities of the Federal Republic of Yugoslavia (FRY) to pave the way for FRY's succession to membership in the Fund.[1] The discussions focused on assessing recent economic developments, the external financing and technical assistance needs, and a short-term stabilization program covering the period through end-March 2001, which could form the basis for a post-conflict emergency purchase. Upon membership, the authorities intend to request such support on the basis of the Statement on Economic Policies contained in Appendix I.[2]

2. **The FRY was constituted in April 1992, as a federation of the republics of Serbia and Montenegro, after four other republics of the Socialist Federal Republic of Yugoslavia (SFRY) became independent states.** Montenegro accounts for 6 percent of the total population of about 10½ million, while the populations of Vojvodina and Kosovo, provinces of Serbia, each amount to about 2 million. The FRY constitution limits federal responsibilities to foreign relations, defense, monetary/exchange rate policy, and customs. At present, the federal government exercises these authorities only over the territories of Serbia proper and Vojvodina, as Kosovo is under UN administration,[3] and Montenegro has effectively taken over the responsibilities for foreign relations, monetary/exchange rate policy and customs.

3. **From its inception until recently, FRY was subject to sanctions and international isolation.** In May 1992, the UN Security Council imposed economic sanctions (embargoes on trade, travel, and transportation) on FRY for its involvement in the civil war in Bosnia and Herzegovina and Croatia, and tightened them in April 1993. Following the signing of the Dayton agreement—setting a framework for peace in Bosnia—the sanctions were suspended by the UN Security Council in November 1995 and lifted in October 1996. However, the U.S. and other countries maintained an "outer wall" of sanctions—affecting membership in

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[1] The staff teams that visited Belgrade during October 24–30 and November 14–21 consisted of Messrs. Zervoudakis, Tzanninis, Klyuev (October), Ms. Udovicki (November) (all EU1), Messrs. Szekely (FAD) and Mukhopadhyay (PDR), and Mrs. Ricasa (AA, EU1). Mr. Boese (TRE) joined the November team for several days. The staff met officials at the federal and republican levels: (a) at the federal level, Mr. Labus (Deputy Prime Minister and Minister of Foreign Economic Relations) and Mr. Dinkic (Governor of the National Bank of Yugoslavia, NBY); (b) in Serbia, Deputy Prime Minister Covic, and the three co-Ministers of Finance; and (c) in Montenegro, Prime Minister Vujanovic and Finance Minister Ivanisevic. The October mission worked closely with concurrently visiting delegations of the World Bank, the EBRD, the European Commission, and various bilateral donors.

[2] See Section II of this report on membership issues.

[3] United Nations Security Council Resolution No. 1244 of 1999.

international institutions—until the FRY authorities cooperated with the war crimes tribunal and addressed concerns about human rights in Kosovo. Owing to the escalation of tensions in Kosovo, in mid-1998 the U.S. and EU imposed bans on new foreign investment in FRY and on financial transactions by FRY entities, while the EU revoked the trade preferences that it had earlier granted. The confrontation over Kosovo culminated with a NATO bombing campaign in March–June 1999, at which time the EU and U.S. also imposed a ban on oil sales.

4. **The sanctions eventually started being lifted in October 2000, following important political changes in FRY.** Federal elections in September, followed by massive street protests, brought into power a reformist coalition (DOS) led by Mr. Kostunica, the new President of FRY. With the governing block in Montenegro having boycotted the September federal elections, DOS, which won a majority of the votes, formed a coalition government with the Montenegrin Socialists. In Serbia, the Socialist government resigned under popular pressure, early elections were scheduled for December 23, and an interim government was formed with representatives of the former regime and the reformist forces. The government of Montenegro has taken some steps toward independence, but has agreed to defer the resolution of its status until after the Serbian elections and FRY's integration into international institutions. The normalization of international relations has progressed speedily; to date, FRY has gained membership in the UN, OSCE and several regional organizations, and has established diplomatic relations with major countries. Talks regarding the establishment of diplomatic relations with all its neighbors are well under way. Membership in the World Bank will require, inter alia, agreement on a plan to clear some US$1.7 billion of arrears to the Bank, and discussions on this issue between the authorities and Bank staff are currently underway.

II. Fund Membership Issues

5. **Two conditions remain to be met for FRY to succeed to the former Yugoslavia's membership in the Fund:** (a) the clearance of about SDR 101.1 million of arrears to the Fund, equivalent to 21.6 percent of FRY's proposed 11th review quota of SDR 467.7 million, which will require a bridge loan that would be repaid from a purchase from the Fund to take place after FRY has succeeded to Fund membership, as explained in the next paragraph;[4] and (b) a finding by the Board that FRY is able to fulfill its obligations under the Articles of Agreement.[5] An additional step is for FRY to consent to its proposed 11th review quota and

[4] See "Yugoslavia—Cessation of Membership, Allocation of Assets and Liabilities, and Succession to Membership in the Fund", EBS/92/207, Supplement 1, 12/17/92, which contains the Executive Board's decision on the allocation of the quota of the former Socialist Federal Republic of Yugoslavia among its successors.

[5] FRY has already met two of the original four conditions specified in the Board's 1992 Decision. Specifically, it has (a) accepted its share in the assets and liabilities in the Fund, as of January 7, 1993; and (b) notified the Fund, on December 6, 2000, that it agrees to succeed

(continued...)

pay the increased subscription, which will require a bridge loan to facilitate the reserve asset subscription that would be repaid from a reserve tranche purchase. Appendix IV provides a detailed description of the sequence of steps that will be required. Proposed decisions pertaining to emergency assistance and the membership process will be provided to the Executive Board separately.

6. **Clearance of the Fund arrears is to be facilitated by a post-conflict emergency purchase.** Given FRY's very low external reserves, and the difficulty in securing other financing, the clearance of its arrears to the Fund will require a bridging loan from member countries which will be repaid by resources provided by a purchase from the Fund.[6] In the staff's view, FRY is eligible for a post-conflict emergency purchase of 25 percent of its proposed 11th review quota (SDR 117 million). This is because—largely owing to the sanctions and the international isolation of FRY over the past eight years—the authorities lack the institutional and administrative capacity to formulate and implement an upper credit tranche program, pending receipt of Technical Assistance from the Fund and others in the coming months (see Appendix V on FRY's eligibility for emergency post-conflict assistance).

III. Economic Background

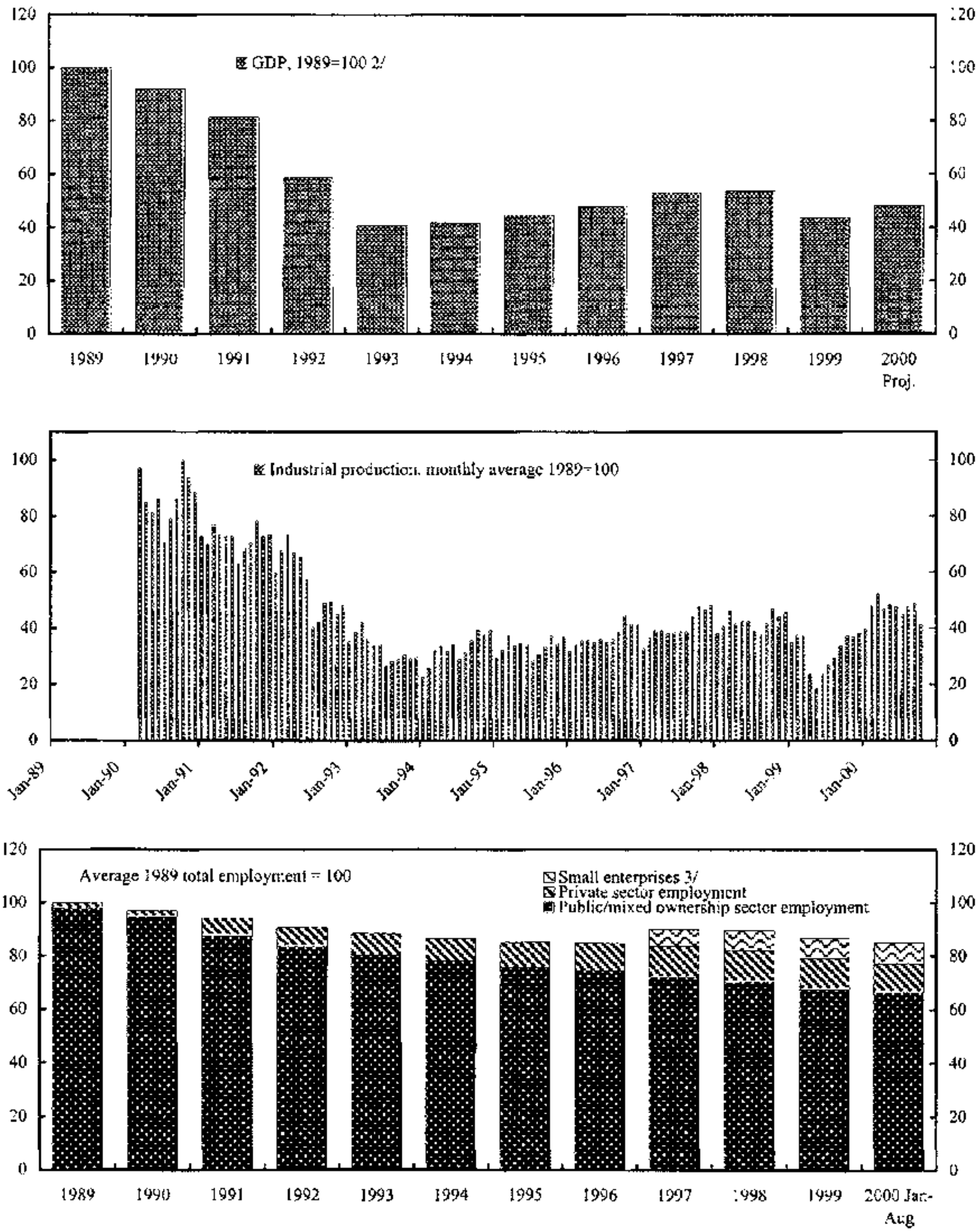
A. Overview of Developments in 1991–99

7. **In 1991-93, in the wake of the breakup of former Yugoslavia, economic mismanagement resulted in hyperinflation and a virtual collapse of the economy.** The regional war took an enormous toll on FRY's economy owing to the loss of markets, the interruption of long-established production relations, and the imposition of crippling sanctions. The effects of these developments on the economy were aggravated by macroeconomic mismanagement. With inflexible real government spending, in the face of eroding real revenue, the nominal fiscal deficit steadily rose to the equivalent of almost one third of GDP in 1993, fueling monetary expansion and inflation. Confidence in the banking system was further undermined by the freezing of large household foreign currency deposits and the collapse of a few private banks in 1992. By January 1994, monthly inflation reached more than 300 b*illion* percent, while industrial output collapsed to less than one third of its January 1991 level (see Figures 1–2).

to the former Yugoslavia's membership in the Fund under the terms and conditions of the 1992 Board decision and has taken all the necessary legal steps to do so.

[6] Norway and Switzerland have offered to extend such a loan.

Figure 1. Federal Republic of Yugoslavia: Selected Economic Activity Indicators, 1989-2000 1/



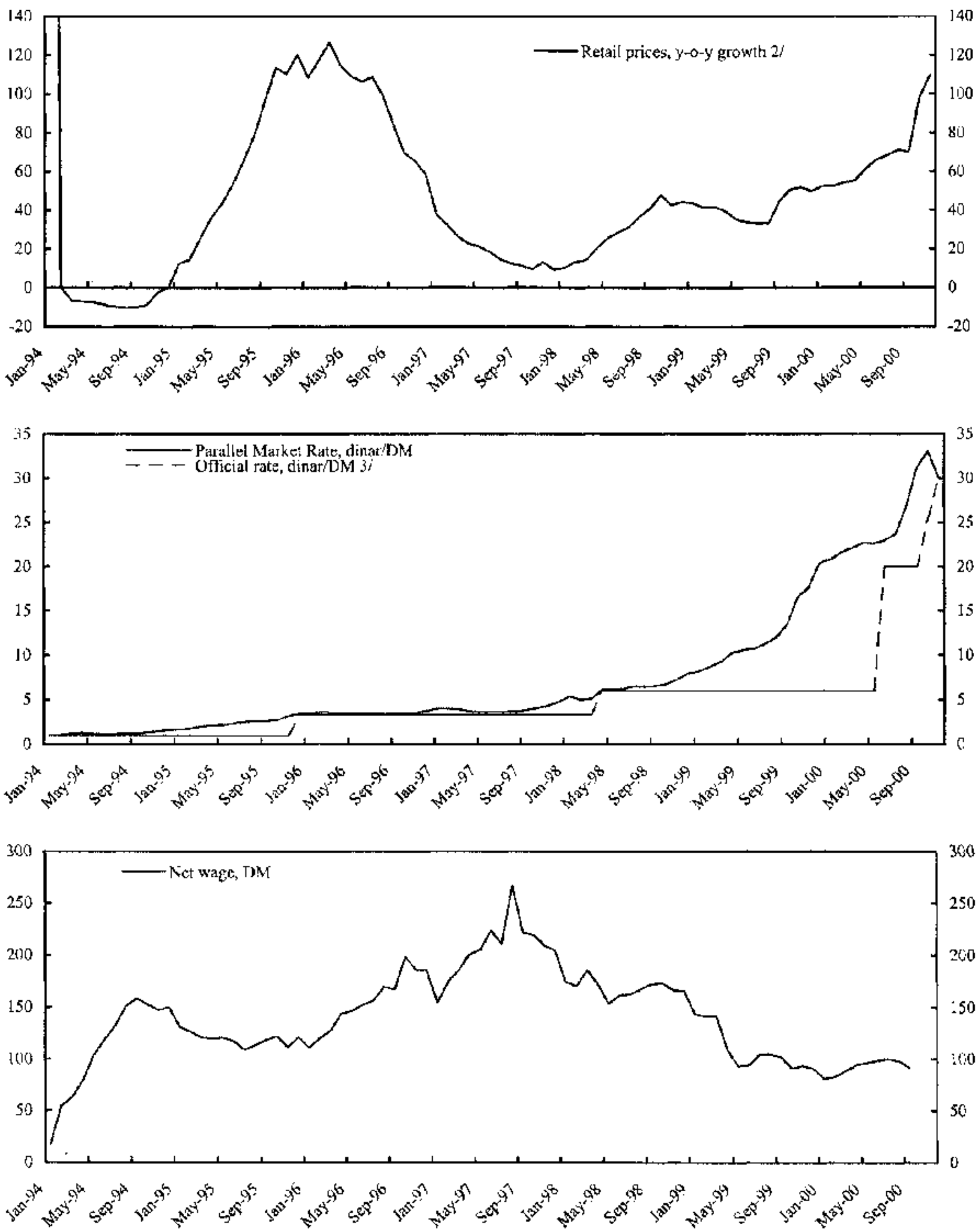
Sources: Federal Institute of Statistics and National Bank of Yugoslavia.

1/ Data before 1991 refer to the territory of the Republics of Serbia and Montenegro; after February 1999 indicators refer to the territory excluding Kosovo and Metohia.

2/ Growth rates for 1990-94 refer to Gross Social Product (GSP), which is about 15-20 percent smaller than GDP as it excludes public and other services.

3/ In 1997 the official statistics begun to track employment in small enterprises excluded from other surveys.

Figure 2. Federal Republic of Yugoslavia: Prices, Exchange Rates, and Wages, January 1994-November 2000 1/



Sources: Federal Institute of Statistics and National Bank of Yugoslavia.
1/ Data after February 1999 excludes Kosovo and Metohia.
2/ Retail prices in Serbia. In January 1994, monthly inflation peaked at 300 billion percent; figures for February 1994-January 1995 represent accumulated inflation relative to end-January 1994.
3/ Since May 2000 the official exchange rate includes a premium which was applied in most but not all official transactions.

8. Following the adoption of a stabilization program in January 1994, a degree of financial stability with some output growth was achieved in 1994–98. With a fresh memory of the hyperinflation, the authorities sought to maintain relatively tight macroeconomic policies during this period, even though a stop-and-go pattern of stabilization gradually eroded policy credibility. In 1997–98, output growth was sustained by large foreign exchange receipts from the sale of equity in Serbian Telecom to foreign investors (US$1.0 billion in mid-1997). Over the 1994–98 period, annual output growth and inflation averaged 6½ percent and 43 percent respectively.

9. **The Kosovo crisis, which culminated with the NATO bombing campaign in March–June 1999, erased the modest economic gains of the previous five years and lowered potential output.** Growth had already come to a halt in mid-1998 as mounting defense/security costs claimed the bulk of available resources and as international sanctions were tightened. The bombing campaign, however, led to a precipitous drop in output reducing real GDP in 1999 by 20 percent, to its lowest level in the decade. There is a paucity of estimates of the damage, but there is little doubt that they very substantially reduced the economy's potential output.[7] To keep inflation under control while ensuring adequate supplies of essential goods, the authorities put the economy on a war footing, relying on a combination of restrictive macroeconomic policy measures, price controls, rationing, special taxes, trade quotas and the confiscation of private assets by the state. Nevertheless, such measures were unable to offset the impact of the imbalances in the external sector. During 1997–98, the FDI inflow related to the sale of equity in Serbian Telecom was able to finance the large current account deficit.[8] However, from 1999 onwards the shortages of foreign exchange were reflected in the steadily widening spread between the official and the parallel market exchange rates. The general economic decline resulted in a sharp increase in the level of poverty; the UN estimates that the proportion of people living in poverty—defined as living on a total monthly income of US$60 or less—doubled to two-thirds during 1999.

[7] *G17 Plus*—a think-tank closely allied with the democratic opposition of Serbia—estimated the damage, shortly after the bombing, at US$3.8 billion (territory of Serbia excluding Kosovo). According to *G17 Plus*, damage was suffered by industrial facilities (US$2.7 billion—including two oil refineries, the largest automobile plant and substantial parts of the chemical, electrical and machine-building industries), infrastructure (US$0.8 billion—including 24 destroyed and 36 damaged bridges, parts of the power distribution and generation system, and transmission components of the telecommunications system), and non-economic civilian objects (US$0.3 billion).

[8] Balance of payments data in FRY are not reliable. As noted earlier, because of the sanctions a large volume of financial transactions bypassed official channels, while the wide-ranging administrative restrictions on the availability and usage of foreign exchange has created a strong incentive to under-invoice trade flows, particularly exports. This is reflected in the very large magnitude of the errors and omissions. The services account is similarly uninformative, with more than half of the receipts and expenditures being accounted for by "Unidentified Services".

B. Current Situation and Short-Term Outlook

10. **Ten years of regional conflicts, international isolation, and economic mismanagement have left a dire legacy**. Output, which has only partly recovered from the economic devastation caused by the Kosovo war, stands at about 40 percent of its 1989 level. Unemployment amounts to one half of the labor force.[9] The country's infrastructure is in disrepair following years of inadequate investment and the damage inflicted during the Kosovo war. About 900,000 refugees and internally displaced persons live in FRY under difficult conditions. Serious energy shortages are being somewhat alleviated with humanitarian assistance. The macroeconomic situation is very fragile. And with declining output, the ratio of external debt to GDP has risen to about 140 percent in the absence of debt servicing.

11. **The outlook for 2000 is for a modest output recovery and high inflation.** GDP is projected to rise by 10 percent in 2000, thus only partly recovering from the economic effects of the Kosovo war. Agricultural output is expected to decline by 17 percent owing to a severe drought. Following the liberalization of prices by the outgoing Serbia government this October, retail prices rose by a cumulative 48 percent in October-November, bringing the 12-month retail price inflation in November to 110 percent. This severely eroded real wages and pensions which presently stand on average at the equivalent of DM 90 per month at parallel market rates.

12. **Fiscal policy implementation has contributed remarkably little to the monetary expansion.** Indeed, notwithstanding a depressed and largely insolvent domestic economy, cash fiscal deficits have been kept at low levels through a compression of real spending and accumulation of arrears. General government revenue has declined sharply in real terms over the past two years, by a cumulative 40 percent (Box 1). While in 1999 this was the result of the dramatic decline in output, in 2000 it reflected a decision to lower the tax burden—through lower tax rates and tax exemptions, often on a selective basis—so as to stimulate economic activity. Keeping the cash deficits of the consolidated general government at low levels (0.2 percent of GDP in 2000) has entailed a severe compression of spending (with the notable exception of defense spending) and, to a smaller extent, accumulation of arrears. In recent months, the sharp acceleration of inflation has resulted in a further decline in real revenue and, hence, real expenditure. The fiscal deficit on an accrual basis has been higher—at least 3 percent of GDP, even excluding servicing of government debt of over 100 percent of GDP.[10] Moreover, the quasi-fiscal deficits of some of the large state enterprises have been sizable, although no reliable estimate is available. In Montenegro, the expected consolidated

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[9] Unemployment figures include workers on involuntary leave. As layoffs of redundant workers were effectively forbidden, total employment has declined by less than 10 percent between 1991 and 2000.

[10] Total nondebt-related arrears, including those from earlier years, are officially estimated at 7–8 percent of GDP as of end-October 2000.

general government deficit of DM 100 million, or 8 percent of its GDP in 2000, will be fully financed by grants from the U.S. and the EU.

Box 1. Structure of the General Government

The consolidated general government includes the federal government, the republican governments, the social security funds, the local governments and the special extrabudgetary programs. The main revenue sources of the general government are the shared sales tax and excises, personal and corporate income taxes, social security contributions, property tax, and several surcharge taxes.

- The federal budget finances the federal army and the federal administration, and pays for part of the pensions of war veterans. It collects customs duties and shares the sales tax and excises with the republics.

- The republican budgets finance the police, the republican administration, social programs other than those financed by the social security funds, and a large portion of the expenditure on education. They collect the shared sales tax and excises, personal and corporate income taxes, property tax, and several surcharge taxes.

- The social security funds are organized at the republican level, and thus each republic has its own funds. There are three pension funds (according to the type of employment), a health care fund, and an unemployment fund. The funds collect the social security contributions and surcharge taxes.

- In addition to the extrabudgetary funds, there are several extrabudgetary programs which are typically financed by surcharge taxes. Some of the surcharge taxes are earmarked to certain social programs in the republican budgets.

Montenegro has stopped contributing to the federal budget (customs duties, sales tax and excises that are collected in Montenegro are not transferred to the federal budget) and the federal budget has stopped contributing to the Montenegrin pension funds. Hence, the public finances of Montenegro are effectively separated from those of the rest of the FRY.

13. **Against the background of a demonetized economy and reduced aggregate supply, the inflation impulse has stemmed largely from the monetary financing of quasi-fiscal deficits.** Until recently, the banking system (including the NBY) had been used by the government to extend directed credits to state-owned companies and the agricultural sector, with a view to subsidizing their operations and keeping utility and food prices low. However, with reserve money being equivalent to less than 3 percent of GDP, there is little, if any, room for monetary financing of quasi-fiscal deficits. In these circumstances, a pickup in directed credits in the runup to the September elections led to a rise in the 12-month rate of growth in currency in circulation from 32 percent at end-June 2000 to 58 percent at end-September, thus fueling inflation.

IV. Report on Policies

14. **In light of the urgency of the macroeconomic situation, the policy discussions focused on a short-term strategy for stabilization.** Against the background of a sharp acceleration of inflation following the removal of price controls in October, and the imminent risk of inflation spiraling out of control, the discussions dealt with measures to stabilize the economy, while providing targeted support to the most vulnerable social groups, and strengthening institutional and administrative capacities.

15. **The short-term program would pave the way for a comprehensive economic program to be formulated once a new Serbian government is in place.** The limited responsibilities of the federal authorities in the economic area point to need for close coordination between the federal and the republican governments for effective program implementation. The FRY authorities believe that the prospects for this will be good in Serbia following the December 23 elections that are expected to be comfortably won by DOS. In particular, they envisage that the new Serbian government would elaborate a budget for the whole of 2001 as well as structural policies in close cooperation with the federal authorities. However, policy coordination between the federal and Montenegrin governments is likely to remain weak. The significance of this for the program nevertheless appears to be limited owing to Montenegro's currency arrangement (use of the DM as the sole legal tender) and its small size in relation to Serbia (less than 10 percent).

16. **As expected, the discussions were complicated by data weaknesses, but improvements in this area are envisaged through technical assistance in the coming months.** The fiscal accounts are complex and segmented owing in part to the federal structure of the government but also to a proliferation of extrabudgetary accounts with earmarked revenue; moreover, accounting practices differ considerably from internationally accepted norms, requiring considerable adjustments to the officially supplied data. Basic monetary accounts (a central bank balance sheet and a monetary survey) were compiled with great difficulty, and are subject to significant revisions.

A. Macroeconomic Policies

17. **The agreed program calls for tight fiscal and monetary policies and the introduction of a managed float with current account convertibility.** Apparently influenced by the experience of the 1993 hyperinflation, the authorities were convinced of the need to eschew monetary financing of the budget and strictly limit other NBY credit expansion, with a view to reducing monthly inflation to the low single-digits by early 2001.[11] However, they also stressed that additional external assistance, including cash budgetary

[11] The monthly inflation rate jumped from an average of 5½ percent in 2000Q3 to 26 percent in October and 17 percent in November as a result of an increase in monetary emission in the run-up to the elections and of price liberalization measures in mid-October, and is projected to decline to under 10 percent in December.

support, was needed to alleviate strong pressures on the budget, owing to a severe compression of wage and social spending in real terms.[12] With regard to exchange rate policy, the authorities opted for the adoption of a managed float and current account convertibility by January 1, 2001.

18. **Agreement was reached that there will be little or no general government recourse to bank financing through end-March 2001, in line with the policy objective for the entire year.** Specifically, the federal government as well as the republican governments (including the social security funds under their jurisdiction) will eschew any bank borrowing through end-March 2001, with the exception of a small amount by the Serbian budget in 2001 Q1 (500 million dinars or 0.1 percent of annual GDP) to address seasonal financing needs. In the case of Montenegro, bank financing is effectively ruled out by the use of the DM as the sole legal tender.

19. **The fiscal discussions also sought to reach understandings on the authorities' revenue and expenditure plans for next year:**

- At the federal level, the mission discussed the overall framework for the 2001 federal budget, which is consistent with the principle of no recourse to bank financing. While some savings were being planned in the area of defense spending (which is expected to reach 6.2 percent of GDP in 2000), the authorities noted that their pre-electoral objective of a major restructuring of the sector was rendered difficult by the security situation in the region, including the need to guard the Serbia-Kosovo administrative line against incursions by armed groups. In order to strengthen commitment control and avoid the accumulation of new arrears, the authorities would introduce new contingency mechanisms in the budget. As the authorities started the budget formulation for 2001 with a considerable delay, they were not in a position to present revenue projections and detailed plans for the allocation of expenditures, but agreed to consult with the staff when the details of the draft budget emerge.

- At the Serbian level, the caretaker government chose not to prepare a regular budget for 2001, but only a provisional budget for 2001 Q1 as stipulated in the budget system law. The staff reached agreement with the authorities on the revenue projections and the allocation of expenditures for the first three months of the year.[13]

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[12] In this regard, the staff estimated that external budgetary support in the amount of US$140 million or 3 percent of GDP would be needed to eliminate arrears incurred during 2000, principally with regard to wages and pensions, thereby limiting the real decline in those expenditure categories and alleviating social pressures.

[13] The Serbian government recently introduced revenue measures in line with staff recommendations, including increases in the excise duty (surcharge) rates and the regulated price of petrol. The yearly revenue yield of the measures is around 3 percent of GDP, shared between the different levels of government and the social security funds. At the same time,

(continued...)

- The Serbian social security funds have also started to formulate their financial plans, which require approval by the Serbian government. The projections suggest a small ex ante fiscal gap for the pension funds, and a rather sizable one for the health care fund. The financial position of the health care fund will be adversely affected by the elimination of the central bank financing of the quasi-fiscal deficit of the pharmaceutical companies and by the *de facto* devaluation of the domestic currency (until October 2000, payments for imports of medicines and medical equipment were made at the overvalued official exchange rate of 6 dinars per DM.)

- The Montenegrin republican budget for 2001 aims at a balanced overall cash position, but the total size of foreign grants is expected to reach 3½ percent of GDP, even though the budget does not include any debt service payments. The staff saw a clear need to improve the fiscal position. The underlying position of the pension fund is also very weak, with the fiscal gap closed by foreign grants.

20. **The discussions revealed the need for wide-ranging fiscal reform.** Numerous ad hoc revisions to the tax code over the last 10 years—in the form of specific tax exemptions and special surcharges—have aggravated the distortionary character of the tax system, while tax administration is weak. On the expenditure side, there was a need to strengthen control of expenditure commitments in general, and also to undertake a major reform of the pension and health care systems, in both Serbia and Montenegro, in order to restore their long-term sustainability.

21. **Recent pricing policy measures have sought to strike a balance between social and efficiency considerations.** The Serbian authorities have liberalized most prices of goods and, to cushion the effects of this measure on the most vulnerable groups, have subsidized the prices of bread and milk. Meanwhile, few, if any, adjustments have been made to public utility prices, public transportation fares, and rents, pending a review of the appropriateness of those prices in the coming months. The import regime is liberalized, although some export quotas still remain in effect (mainly to ensure adequate food supplies).

22. **In the area of monetary policy, it was agreed that the NBY should generally issue domestic currency only against purchases of foreign exchange.** Accordingly, the quantitative monetary program calls for (a) broadly unchanged NDA of the NBY for the period through end-2000, and only a small increase during the first quarter of next year (to accommodate the seasonal financing needs of the Serbian budget); and (b) a floor on the NFA of the NBY that implies no decline in NFA from the end-September 2000 level.

23. **The authorities' undertakings in the area of exchange rate policy include a move toward a managed float by January 1, 2001.** The authorities opted for a gradual move to

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the Serbian government has approved a 30 percent increase in public sector wages, the total cost of which in the remainder of the year roughly equals the additional revenue generated by these measures for the Serbian budget.

managed float because they were concerned that a free rate might generate fears of a free fall, and—pending the Serbian elections—they did not yet have all necessary policy means at their disposal should things go wrong. On October 14, the authorities effectively depreciated the exchange rate to the level of the prevailing gray market rate (from 20 dinars to 30 dinars per DM) and decided to discontinue foreign transactions at the official exchange rate of 6 dinars per DM (Figure 2).[14] On December 5, they unified the exchange rate at 30 dinars per DM (thereby eliminating the official exchange rate of 6 dinars per DM, which was still used for customs and balance sheet valuation purposes) and abolished exchange restrictions in the form of obligatory sales of foreign exchange by exporters and importers at the official exchange rate (10 percent of the value of exports and 5 percent of the value of imports). The authorities have undertaken to adopt a managed float by January 1, 2001 with current account convertibility, subject to the aforementioned floor on the NFA of the NBY. Pending the introduction of the managed float, the authorities would ensure—through monetary and exchange rate measures as needed—that the spread between the official exchange rate and the moving average of the gray market rate over the previous 5 working days does not exceed 5 percent.[15] The managed float would allow the exchange rate to find its equilibrium value.

B. Structural Policies

24. **The next Serbian government will face difficult challenges in the areas of enterprise and bank privatization.** Both the banking and enterprise sectors continue to be affected by former Yugoslavia's heritage of "social ownership," under which firms were owned collectively by their workers and governance was weak and highly politicized. Several privatization initiatives since 1992 have accomplished very little as they have failed to challenge the authority of managements and employees in social enterprises. The authorities expected that the new Serbian government would amend the existing Serbian privatization law with a view to addressing weaknesses in the present legislation. On this basis, agreement on the privatization of at least a few large state enterprises is likely to be concluded in the period through end-March, while the pace of privatization would pick up in the remainder of the year.

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[14] The effective depreciation of the exchange rate to 30 dinars per DM was implemented through an increase in the premium on the official exchange rate from 14 dinars (in effect since May 2000) to 24 dinars per DM.

[15] Since October 14, all foreign transactions have taken place at the exchange rate of 30 dinars per DM (which equals the gray market rate), while the NBY plays only a limited role in the interbank foreign exchange market owing to its low level of reserves. Were a significant premium on the official exchange rate to emerge in the gray market, indicating intensification of exchange restrictions, the authorities would respond with monetary tightening and/or exchange rate depreciation.

25. **The banking system is insolvent and unable to perform its intermediation functions, and in urgent need of comprehensive restructuring.** Thirty banks accounting for 70 percent of the banking system assets are insolvent according to their own reports. Moreover, the banks' reported capital is unreliable and probably overstated, owing in part to the common practice of reporting accrued interest on nonperforming loans as income. However, the fiscal cost of cleaning the banking system is likely to be relatively low, reflecting the magnitude of disintermediation. An MAE mission reached agreement on the fielding of a follow-up mission in the second half of December, in cooperation with the World Bank and bilateral donors, to pursue the formulation of a strategy to address major insolvency problems in the banking sector. The central bank and banking laws, including the Bank Rehabilitation and Deposit Insurance Laws, are relatively new and provide all the tools needed for monetary policy and bank supervision and resolution, but they are yet to be fully implemented.

C. External Financing Needs and Relations with Foreign Creditors

26. **FRY faces urgent humanitarian needs and, in the medium term, large reconstruction requirements, in the context of a crushing debt burden.** Grants from the EU (in the amount of €200 million) and some bilateral donors are addressing some of the humanitarian needs in energy, food, and medicines, in addition to providing limited budgetary support. While the authorities and the donors are still in the process of assessing FRY's reconstruction needs, these are expected to be very large, reflecting the under-investment and neglect of infrastructure over the past 10 years as well as the destruction associated with the Kosovo crisis. Especially in light of these needs, FRY's external debt which now stands at US$12.2 billion (140 percent of GDP) imposes an unsustainable burden on the economy. A full assessment of FRY's external financing needs will be a key part of the discussions with the authorities on a comprehensive economic program in early 2001.

27. **The authorities consider the normalization of relations with foreign creditors to be a policy priority, to be pursued soon after Fund membership is secured, and intend to seek an expeditious agreement with other successor republics on the division of the assets of former Yugoslavia.** The authorities intend to normalize relations with foreign creditors. An important step in this regard will be to reach agreement on a plan to clear some US$1.7 billion in arrears to the World Bank, which is a precondition for membership in the Bank. Thereafter, clearance of these arrears will be necessary for the World Bank to initiate lending operations. FRY also has arrears to other multilateral creditors (IFC and EIB). In general, a restructuring of FRY's external debt will be required in order for it to meet its obligations in a timely manner. The FRY authorities have begun reconciling their debt database in anticipation of forthcoming discussions with creditors. FRY's debt to Paris and London Club creditors is particularly large (US$4.6 billion and US$2.8 billion, respectively), and discussions with these creditors will also be an important step towards normalizing FRY's external relations. In this regard, the FRY authorities are aware that as a condition for restructuring its Paris Club debt, they will have to seek restructuring terms from other creditors that are at least as favorable as those granted by the Paris Club. Finally, the authorities indicated their intention to negotiate with other former Yugoslav republics with a view to reaching a fair and expeditious agreement on the division of the former Yugoslavia's

assets. In this regard, they noted that discussions had already started on the division of gold held with the BIS.

D. Technical Assistance

28. **The authorities have requested technical assistance in the core areas of fiscal and monetary policy, banking sector reform, and the strengthening of economic statistics.** A diagnostic MAE mission has already had preliminary discussions in the area of monetary policy and banking reform, and a follow-up visit is envisaged in mid-December, in collaboration with the World Bank and bilateral donors. The authorities have also requested a multi-topic mission from the Fiscal Affairs Department of the Fund, which is likely to visit FRY in early 2001. Based on the recommendation of this mission, a strategy for seeking technical assistance from several international organizations and donor agencies will be formulated. Moreover a STA mission on money and banking statistics could visit Belgrade in January-February 2001, with a multi-sector statistics mission scheduled for March-April 2001. The needs assessments are expected to be discussed during the Donor Coordination Meeting on December 12 in Brussels, and plans of financial support for such assistance are expected to be developed at that time. There are also plans for a pledging conference in the first half of 2001.

V. Staff Appraisal

29. The new FRY authorities are faced with the daunting task of stabilizing and reviving a devastated economy after many years of military conflicts, sanctions, and economic mismanagement. Their task is further complicated by a weakened institutional capacity and the still evolving political situation.

30. In these circumstances, the authorities have appropriately focused on a short-term macroeconomic strategy to bring inflation under control, while seeking to protect the most vulnerable groups of the population. The strategy envisages little or no bank financing of the budget; no NBY credit expansion for other purposes; a floor on the NFA of the NBY; and the introduction of a managed float with internal convertibility to allow the exchange rate to find its equilibrium value. Adherence to these credit limits would ensure that monetary expansion will be limited to net purchases of foreign exchange, help bring inflation down to the low single-digits by early 2001 as targeted, and stabilize the exchange rate.

31. In the area of fiscal policy, avoidance of bank financing needs to be accompanied by efforts to improve the underlying fiscal position and avoid the continued incurrence of expenditure arrears. This will require prioritization of expenditures, improvements in tax administration, and a widening of the tax base through elimination of tax exemptions and curtailment of the gray economy.

32. The staff welcomes the authorities' intention to adopt a comprehensive economic program of stabilization and reform that could be supported by the Fund under an upper credit tranche arrangement. This will need to be preceded by good progress in stabilization and enhancing the institutional and administrative capacity under the current program.

33. On the strength of the aforementioned policy undertakings by the FRY authorities, the staff considers that FRY deserves Fund support under the policy for post-conflict emergency assistance. The risks to the Fund are modest, as the outstanding use of Fund credit prior to arrears clearance is low and increases only slightly as a result of the proposed purchase. Moreover, the removal of all sanctions and the reintegration of FRY into the world economy should strengthen its external position. However, achievement of a viable balance of payments position will require much more, most importantly prudent macroeconomic policies and bold structural reforms, but also restructuring of its external debt on appropriate terms.

Table 1. Federal Republic of Yugoslavia (Serbia/Montenegro): Selected Economic and Financial Indicators, 1996-2000 1/

	1996	1997	1998	1999	2000 Jan.-Sep.
Real economy (change in percent)					
Real GDP	7.8	10.1	1.9	-19.0	10.7
Industrial production	7.6	9.5	3.6	-22.5	15.2 2/
Retail prices (annual average)	92.7	18.5	29.8	42.4	71.2 3/
Retail prices (end of period)	...	...	...	49.9	109.6 4/
Unemployment rate (in percent) 5/	25.8	25.8	25.1	26.5	27.3
General government finances (percent of GDP)					
Revenue	...	...	...	...	27.8 6/
Expenditure	...	...	...	...	28.2 6/
Cash balance	...	...	...	...	-0.4 6/
Commitment balance	...	...	...	...	-2.7 6/
Money supply (end-of-period, percent change)					
M1	68.8	66.5	17.1	49.8	60.1 7/
M2 8/	15.4	23.9	69.4	20.1	38.2 7/
Balance of payments (in billions of U.S. dollars)					
Merchandise exports	1.8	2.4	2.9	1.5	1.3
Merchandise imports	4.1	4.8	4.8	3.3	2.8
Trade balance	-2.3	-2.4	-2.0	-1.8	-1.5
Current account balance	-1.3	-1.8	-1.2	-1.3	-1.0
Foreign debt (year-end)	...	...	...	...	12.1 9/
Gross official reserves	...	...	...	...	0.4
(In months of imports of goods and services)	...	...	...	...	1.3
Fund position (SDR millions, as of November 30, 2000)					
Quota (Eleventh Review)	...	...	...	...	467.7
Overdue obligations	...	...	...	...	101.1

Sources: Federal Statistical Office; National Bank of Yugoslavia; Ministry of Finance of the Federal Republic; Ministry of Finance of the Republic of Serbia; and Fund staff estimates.

1/ With the exception of money supply, foreign debt, and Fund position, data for 1999 and 2000 exclude Kosovo.
2/ January-October 2000/January-October 1999.
3/ January-November 2000/January-November 1999.
4/ November 2000/November 1999.
5/ Excluding workers on "forced holiday" (about 20-25 percent of the labor force in recent years).
6/ January-October, expressed in terms of projected annual GDP; excludes arrears of the Federal Army and local governments.
7/ September 2000/September 1999.
8/ Includes foreign currency deposits valued at the official exchange rate.
9/ Includes arrears on unpaid imports of fuel and gas.

Table 2. Federal Republic of Yugoslavia: Balance of Payments, 1996-2000

	1996	1997	1998	1999	2000 Jan.-Sep.
	(In millions of U.S. dollars)				
Trade balance 1/	-2,260	-2,431	-1,991	-1,798	-1,494
Exports f.o.b.	1,842	2,368	2,858	1,498	1,289
Imports f.o.b.	-4,102	-4,799	-4,849	-3,296	-2,783
Services, net	411	456	493	228	241
Receipts	688	818	914	471	454
Expenditure	-277	-362	-421	-243	-213
Net factor income 2/	23	25	8	-41	-9
Unrequited transfers, net	156	105	252	190	190
Official	0	0	0	0	0
Private	156	105	252	190	190
Current account balance	-1,670	-1,845	-1,238	-1,421	-1,072
Foreign direct investment	0	740	113	112	0
Capital transfers	0	0	0	0	0
Foreign loans	66	283	-10	-25	81
Medium and long-term	8	54	25	12	96
Disbursements	8	128	50	29	96
Amortization 3/	0	-74	-25	-17	0
Short term, net	58	229	-35	-37	-15
Other capital inflows	353	8	58	31	25
Capital account balance	419	1,031	161	118	106
Errors and omissions 4/	1,297	594	876	1,104	988
Overall balance	46	-220	-201	-199	22
Financing	-46	220	201	199	-22
Net foreign assets (increase, -)	-46	18	115	73	-82
Arrears (reduction, -) 5/	0	202	86	126	60

Source: National Bank of Yugoslavia.

1/ For 1996 and 1997 includes net exports to Bosnia and Herzegovina (Republika Srpska) equivalent to US$151 million and US$164 million respectively, that was paid for in dinars.

2/ For 1999 and 2000, includes interest arrears accumulated on imports of oil and gas not paid for in 1991, and 1997-2000. Otherwise only includes paid interest.

3/ Only includes actual payments for amortization.

4/ The figures for 1996 and 1997 are understated because of the trade with Bosnia and Herzegovina that was conducted in dinars.

5/ Reflects the accumulation of arrears on unpaid imports of oil and gas. In 1999-2000 also includes arrears on unpaid interest.

Table 3. Federal Republic of Yugoslavia: Stock of External Debt at End-October 2000
(In millions of U.S. dollars)

Creditor	Total Debt	*Of which:* Arrears Principal	Interest	Late Interest
Total stock of outstanding debt	12,179	5,802	1,772	2,521
Multilateral creditors	2,495	1,253	419	588
IMF	127	78	49	0
IBRD	1,759	982	263	436
Eurofima	142	30	10	0
IFC	137	76	9	52
EIB	275	59	82	79
Other	55	28	6	21
Bilateral creditors	5,003	2,559	404	1,569
Paris Club	4,567	2,523	404	1,569
Pre-cutoff debt	3,520	1,975	304	1,208
Previously rescheduled	2,449	1,363	269	817
Previously not rescheduled	1,071	612	35	391
Post-cutoff debt	1,047	548	100	361
Other bilateral creditors	436	36	0	0
London Club	2,809	1,017	872	146
Other creditors	599	323	17	218
Debt incurred in non-convertible currencies	209	209	0	0
Official debt related to unpaid imports	501	441	60	0
Non-government debt	563	0	0	0

Source: National Bank of Yugoslavia.

Table 4A. Federal Republic of Yugoslavia: Consolidated General Government Fiscal Operations in 2000

	Consolidated General Government excluding Montenegro											Consolidated Gen. Govt incl. Montenegro		
	Jan.-Oct. Prel.	Nov.-Dec. Proj.	Jan.-Dec. Proj.	Jan.-Dec. Budget	Jan.-Oct. Prel.	Nov.-Dec. Proj.	Jan.-Dec. Proj.	Jan.-Dec. Budget	Jan.-Oct. Prel.	Nov.-Dec. Proj.	Jan.-Dec. Proj.	Jan.-Oct. Prel.	Jan.-Oct. Prel.	Jan.-Oct. Prel.
	(Billion dinars)				(Percent of GDP) 1/				(Million euros)			(Dinars bn)	(% of GDP) 1/ 2/	(Euro mn)
Revenues	79.3	24.8	104.1	97.9	24.1	7.5	31.5	38.5	2,485	423	2,908	86.8	26.4	2,721
Expenditures	79.9	27.5	107.4	97.9	24.3	8.4	32.6	38.5	2,503	469	2,972	89.7	27.2	2,810
Overall balance	**-0.6**	**-2.7**	**-3.2**	**0.0**	**-0.2**	**-0.8**	**-1.0**	**0.0**	**-18**	**-46**	**-63**	**-2.8**	**-0.9**	**-89**
Foreign grants	0.1	0.0	0.1	0.0	0.0	0.0	0.0	0.0	4	0	4	2.2		69
Overall balance including grants	**-0.4**	**-2.7**	**-3.1**	**0.0**	**-0.1**	**-0.8**	**-0.9**	**0.0**	**-14**	**-46**	**-59**	**-0.6**	**-0.2**	**-20**
Statistical discrepancy	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0	38	39	0.0	0.0	
Financing	**0.5**	**2.7**	**3.1**	**0.0**	**0.1**	**0.8**	**1.0**	**0.0**	**14**	**84**	**98**	**0.7**	**0.2**	**20**
Domestic financing	0.5	0.0	0.5	0.0	0.1	0.0	0.1	0.0	14	0	14	0.7	0.2	20
Bank financing	0.8	0.0	0.8	0.0	0.2	0.0	0.2	0.0	26	0	26	1.0	0.3	32
NBY	0.4	0.0	0.4	0.0	0.1	0.0	0.1	0.0	12	0	12	0.4	0.1	12
Commercial banks	0.4	0.0	0.4	0.0	0.1	0.0	0.1	0.0	14	0	14	0.6	0.2	20
Non-bank financing	-0.4	0.0	-0.4	0.0	-0.1	0.0	-0.1	0.0	-11	0	-11	-0.4	-0.1	-11
Foreign Financing	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0	0	0	0.0	0.0	0
Privatization receipts	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0	0	0	0.0	0.0	0
Unidentified financing		2.7	2.7		0.0	0.8	0.8	0.0	0	84	84	0.0	0.0	0
Accumulation of expenditure arrears	9.1	0.0	9.1	0.0	2.7	0.0	2.7	0.0	284	0	284	9.1	2.7	284
Overall commitment balance														
including foreign grants	-9.5	-2.7	-12.2	0.0	-2.9	0.8	-3.7	0.0	-297	-46	-343	-9.7	-2.9	-304
Required foreign assistance	...	9.6	...	...	...	2.9	...	...	...	164	.	...	...	...

Sources: Federal and Republic of Serbia Ministries of Finance; and Fund staff estimates.

1/ Expressed in terms of GDP of the FRY excluding Kosovo.

2/ Expressed in terms of annual GDP.

Table 4B. Federal Republic of Yugoslavia: Federal Government Fiscal Operations, 1997-2000

(In percent of GDP) 1/

	1997	1998	1999	2000		
	Jan.-Dec. Actual	Jan.-Dec. Actual	Jan.-Dec. Preliminary	Budget	Jan.-Oct. 2/ Preliminary	Jan.-Dec. Projections
A Total revenue and grants (1+2)	6.6	6.1	7.0	8.9	5.6	7.8
1 Total revenue (1.1+1.2)	6.6	6.1	7.0	8.9	5.6	7.8
1.1 Current revenue (1.1.1+1.1.2)	6.6	6.1	7.0	8.9	5.6	7.8
1.1.1 Tax revenue (1.1.1.1+1.1.1.2+1.1.1.3)	5.3	5.2	5.7	7.8	5.1	7.1
1.1.1.1 Turnover (retail sales) tax	2.1	2.4	2.5	3.6	1.8	2.4
1.1.1.2 Taxes on international trade and operations	2.7	2.3	2.3	3.5	1.9	2.6
1.1.1.3 Other taxes	0.5	0.4	0.3	0.7	0.1	0.3
1.1.1.4 Extrabudgetary taxes	0.0	0.0	0.6	0.0	1.4	1.8
1.1.2 Nontax revenue	1.4	0.9	1.2	1.1	0.5	0.7
1.2 Capital revenue	0.0	0.0	0.0	0.0	0.0	0.0
2 Grants	0.0	0.0	0.0	0.0	0.0	0.0
B Total expenditure and net lending (1+2)	6.6	6.1	7.0	8.6	5.5	7.7
1 Total expenditure (1.1+1.2)	6.6	6.1	7.0	8.6	5.5	7.7
1.1 Current expenditure (1.1.1+1.1.2)	6.6	6.1	7.0	8.6	5.5	7.7
1.1.1 Interest	0.0	0.0	0.0	0.0	0.0	0.0
1.1.2 Non-interest (1.1.2.1+1.1.2.2+1.1.2.3+1.1.2.4)	6.6	6.1	7.0	8.6	5.5	7.7
1.1.2.1 General Government Services	0.8	0.9	0.9	1.0	0.6	0.8
1.1.2.2 Defense	4.8	4.2	5.2	6.4	4.3	6.2
1.1.2.3 Social Insurance and Social Security Transfers	0.6	0.5	0.5	0.7	0.4	0.5
1.1.2.5 Other non-interest expenditure	0.4	0.4	0.4	0.5	0.2	0.3
1.2 Capital expenditure	0.0	0.0	0.0	0.0	0.0	0.0
2 Net lending	0.0	0.0	0.0	0.0	0.0	0.0
Overall budget balance (cash) (A-B)	0.0	0.0	0.0	0.2	0.1	0.1
Statistical discrepancy	0.0	0.0	0.0	0.0	0.0	0.0
Financing (1+2+3)	0.0	0.0	0.0	-0.2	-0.1	-0.1
1 Domestic financing (net) (1.1+1.2)	0.0	0.0	0.0	-0.2	-0.1	-0.1
1.1 Banking system (1.1.1+1.1.2)	0.0	0.0	0.0	0.0	0.0	0.0
1.1.1 National Bank of Yugoslavia	0.0	0.0	0.0	0.0	0.0	0.0
1.1.2 Commercial banks	0.0	0.0	0.0	0.0	0.0	0.0
1.2 Nonbank	0.0	0.0	0.0	-0.2	-0.1	-0.1
2 Foreign financing (net) (2.1-2.2)	0.0	0.0	0.0	0.0	0.0	0.0
2.1 Disbursements	0.0	0.0	0.0	0.0	0.0	0.0
2.2 Amortization	0.0	0.0	0.0	0.0	0.0	0.0
3 Privatization receipts	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:						
Nominal GDP (billion dinars)	112.3	154.6	188.0	254.4	329.2	329.2

Sources: Federal Ministry of Finance; and Fund staff estimates.

1/ Expressed in terms of GDP of the FRY excluding Kosovo.

2/ Expressed in terms of annual GDP of the FRY excluding Kosovo.

Table 4C. Serbia: Republican Government Fiscal Operations, 1997-2001
(In percent of GDP) 1/

	1997	1998	1999	2000			2001
	Jan.-Dec. Actual	Jan.-Dec. Actual	Jan.-Dec. Preliminary	Budget	Jan.-Oct. 2/ Preliminary	Jan.-Dec. Projections	Jan.-Mar. 2/ Projections
A Total revenue and grants (1+2)	**12.3**	**10.4**	**9.2**	**11.4**	**5.9**	**7.6**	**1.7**
1 Total revenue (1.1+1.2)	12.3	10.4	9.2	11.4	5.9	7.6	1.7
1.1 Current revenue (1.1.1+1.1.2)	12.3	10.4	9.2	11.4	5.9	7.6	1.7
1.1.1 Tax revenue (1.1.1.1+1.1.1.2+1.1.1.3+1.1.1.4+1.1.1.5)	12.3	10.4	9.2	11.4	5.9	7.6	1.7
1.1.1.1 Personal income	6.4	4.8	3.7	4.6	2.7	3.4	0.7
1.1.1.2 Turnover (retail sales) tax	3.6	3.1	3.1	3.7	2.0	2.5	0.5
1.1.1.3 Excises	1.0	0.8	0.5	1.3	0.2	0.3	0.1
1.1.1.4 Other taxes	1.3	1.7	1.8	1.8	1.0	1.3	0.3
1.1.1.5 Extrabudgetary taxes	0.0	0.0	0.0	0.0	0.0	0.1	0.1
1.1.2 Nontax revenue	0.0	0.0	0.0	0.0	0.0	0.1	0.0
1.2 Capital revenue	0.0	0.0	0.0	0.0	0.0	0.0	0.0
2 Grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0
B Total expenditure and net lending (1+2)	**...**	**10.9**	**9.4**	**11.4**	**6.8**	**8.7**	**1.8**
1 Total expenditure (1.1+1.2)	...	10.9	9.4	11.4	6.8	8.7	1.8
1.1 Current expenditure (1.1.1+1.1.2)	...	10.8	9.1	11.0	6.7	8.5	1.7
1.1.1 Interest	...	0.3	0.2	0.1	0.1	0.1	0.1
1.1.2 Non interest (1.1.2.1+1.1.2.2+1.1.2.3+1.1.2.4)	...	10.5	8.9	10.9	6.6	8.4	1.7
1.1.2.1 General Government Services	...	0.0	0.0	0.0	0.0	0.0	0.0
1.1.2.2 Internal security (police)	...	2.8	1.9	2.6	1.4	1.7	0.3
1.1.2.3 Social Insurance and Social Security Transfers	...	0.0	0.0	0.0	0.0	0.0	0.0
1.1.2.4 Other non-interest expenditure	...	7.7	7.0	8.3	5.3	6.6	1.4
1.2 Capital expenditure	...	0.1	0.3	0.4	0.1	0.2	0.0
2 Net lending	...	0.0	0.0	0.0	0.0	0.0	0.0
Overall budget balance (cash) (A-B)	**...**	**-0.5**	**-0.2**	**0.0**	**-0.9**	**-1.0**	**-0.1**
Statistical discrepancy	...	0.0	0.0	0.0	0.0	0.0	0.0
Financing (1+2+3)	**...**	**0.5**	**0.2**	**0.0**	**0.9**	**1.0**	**0.1**
1 Domestic financing (net) (1.1+1.2)	...	0.5	0.2	0.0	0.9	1.0	0.1
1.1 Banking system (1.1.1+1.1.2)	...	0.5	0.2	0.0	0.2	0.2	0.1
1.1.1 National Bank of Yugoslavia	...	0.1	0.2	0.0	0.1	0.1	0.1
1.1.2 Commercial banks	...	0.3	0.0	0.0	0.1	0.1	0.0
1.2 Nonbank	...	0.0	0.0	0.0	0.6	0.8	0.0
2 Foreign financing (net) (2.1-2.2)	...	0.0	0.0	0.0	0.0	0.0	0.0
2.1 Disbursements	...	0.0	0.0	0.0	0.0	0.0	0.0
2.2 Amortization	...	0.0	0.0	0.0	0.0	0.0	0.0
3 Privatization receipts	...	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:							
Nominal GDP (billion Dinars)	112.3	154.6	188.0	254.4	329.2	329.2	604.0
Arrears (end of period)	0.2	0.8	2.7	0.0	0.2	0.2	0.3

Sources: Federal Ministry of Finance of the Republic of Serbia; and Fund staff estimates.

1/ Expressed in terms of GDP of the FRY excluding Kosovo.
2/ Expressed in terms of annual GDP of the FRY excluding Kosovo.

Table 4D. Serbia: Pension Funds Fiscal Operations, 1997-2001
(In percent of GDP) 1/

	1997	1998	1999	2000			2001
	Jan.-Dec. Actual	Jan.-Dec. Actual	Jan.-Dec. Preliminary	Budget	Jan.-Oct. 2/ Preliminary	Jan.-Dec. Projections	Jan.-Mar. 2/ Projections
A Total revenue and grants (1+2)	**10.7**	**11.8**	**11.0**	**12.2**	**8.1**	**10.5**	**1.9**
1 Total revenue (1.1+1.2)	10.7	11.8	11.0	12.2	8.1	10.5	0.0
1.1 Current revenue (1.1.1+1.1.2)	10.7	11.8	11.0	12.2	8.1	10.5	0.0
1.1.1 Tax revenue (1.1.1.1+1.1.1.2)	10.7	11.8	11.0	12.2	8.1	10.5	0.0
1.1.1.1 Social security contributions	9.3	9.2	9.1	9.6	6.7	8.8	0.0
1.1.1.2 Other taxes	0.2	0.2	0.1	0.1	0.2	0.2	0.0
1.1.1.3 Extrabudgetary taxes	1.2	2.4	1.8	2.5	1.2	1.5	0.0
1.1.2 Nontax revenue	0.1	0.0	0.0	0.0	0.0	0.0	0.0
1.2 Capital revenue	0.0	0.0	0.0	0.0	0.0	0.0	0.0
2 Grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0
B Total expenditure and net lending (1+2)	**12.3**	**12.0**	**10.7**	**12.2**	**8.1**	**10.9**	**2.0**
1 Total expenditure (1.1+1.2)	12.3	12.0	10.7	12.2	...	...	...
1.1 Current expenditure (1.1.1+1.1.2)	12.3	12.0	10.7	12.2	...	...	...
1.1.1 Interest	0.3	0.3	0.3	0.2	...	...	...
1.1.2 Non-interest (1.1.2.1+1.1.2.2+1.1.2.3)	12.0	11.6	10.3	11.9	...	...	...
1.1.2.1 General Government Services	0.2	0.2	0.4	0.2	...	...	...
1.1.2.2 Social Insurance and Social Security Transfers	11.8	11.4	9.9	11.7	...	...	...
1.1.2.3 Other non-interest expenditure	0.0	0.0	0.0	0.0	...	...	...
1.2 Capital expenditure	0.0	0.0	0.0	0.0	..	...	...
2 Net lending	0.0	0.0	0.0	0.0	...	...	...
Overall budget balance (cash) (A-B-C)	**-1.5**	**-0.2**	**0.3**	**0.0**	**0.0**	**-0.4**	**-0.2**
Statistical discrepancy	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financing (1+2+3+4)	1.5	0.2	-0.3	0.0	0.0	0.4	0.2
1 Domestic financing (net) (1.1+1.2)	1.5	0.2	-0.3	0.0	0.0	0.0	0.0
1.1 Banking system (1.1.1+1.1.2)	1.5	0.2	-0.3	0.0	0.0	0.0	0.0
1.1.1 National Bank of Yugoslavia	1.5	0.2	-0.3	0.0	0.0	0.0	0.0
1.1.2 Commercial banks	0.0	0.0	0.0	0.0	0.0	0.0	0.0
1.2 Nonbank	0.0	0.0	0.0	0.0	0.0	0.0	0.0
2 Foreign financing (net) (2.1-2.2)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
2.1 Disbursements	0.0	0.0	0.0	0.0	0.0	0.0	0.0
2.2 Amortization	0.0	0.0	0.0	0.0	0.0	0.0	0.0
3 Privatization receipts	0.0	0.0	0.0	0.0	0.0	0.0	0.0
4 Unidentified financing	0.0	0.0	0.0	0.0	0.0	0.4	0.2
Memorandum items:							
Nominal GDP (billion Dinars)	112.3	154.6	188.0	254.4	329.2	329.2	604.0
Arrears (end of period)	2.3	3.5	3.3	0.0	2.4	0.0	0.0

Sources: Ministry of Finance of the Republic of Serbia; and Fund staff estimates.

1/ Expressed in terms of GDP of the FRY excluding Kosovo.
2/ Expressed in terms of annual GDP of the FRY excluding Kosovo

Table 5. Federal Republic of Yugoslavia: Balance Sheet of the National Bank of Yugoslavia and Program Targets, 1999-2001

(In millions of dinars; end of period)

	1999	2000				2001
	Dec.	Mar.	June	Sept.	Dec.	Mar.
Net foreign reserves	4,589.2	3,641.5	9,108.7	13,652.4	13,652.4 1/	13,652.4 1/
Gross foreign reserves 2/	11,940.6	11,723.0	17,404.3	24,491.1	....	....
Gross reserve liabilities (-) 3/	-7,351.4	-8,081.5	-8,295.6	-10,838.7	....	....
Net domestic assets	4,010.3	5,449.6	669.8	-1,446.4	-1,446.4 4/	-946.4 4/
Domestic credit	22,410.4	24,159.7	24,958.1	26,524.6	26,524.6	27,024.6
Net claims on government	1,758.3	3,078.4	2,793.2	3,347.3	3,347.3	3,847.3
Claims	2,610.8	3,888.8	4,247.6	4,385.1	....	....
Liabilities (-)	-852.5	-810.4	-1,454.4	-1,037.8	....	....
Net claims on banks	22,655.6	22,979.0	23,460.7	23,845.6	23,845.6	23,845.6
Claims	31,460.4	31,963.0	32,221.1	33,546.3	....	....
Liabilities (-)	-8,804.8	-8,984.0	-8,760.4	-9,700.7	....	....
Net claims on the rest of the economy	-2,003.5	-1,897.7	-1,295.8	-668.3	-668.3	-668.3
Claims	2,697.6	2,994.0	3,000.6	4,020.0	....	....
Liabilities (-)	-4,701.1	-4,891.7	-4,296.4	-4,688.3	....	....
Other assets (net) 5/	-18,400.1	-18,710.1	-24,288.3	-27,971.0	-27,971.0	-27,971.0
Reserve money	8,599.5	9,091.1	9,778.5	12,206.0	....	....
Currency in circulation	6,688.3	6,202.5	7,159.4	9,026.4	....	....
Reserve deposits	1,911.2	2,888.6	2,619.1	3,179.6	....	....
Required reserves	1,215.3	1,657.2	1,670.9	2,074.0	....	....
Excess reserves 6/	695.9	1,231.4	948.2	1,105.6	....	....

Sources: National Bank of Yugoslavia; and Fund staff estimates.

1/ Program floor.

2/ Defined as monetary gold, holdings of SDRs, any reserve position in the IMF, holdings of foreign exchange in convertible currencies by the NBY, and any short-term foreign exchange accounts held abroad. Excludes frozen assets of the FRY, undivided assets of the SFRY, long-term assets, NBY redeposits with the domestic commercial banks, any assets in nonconvertible currencies, encumbered reserve assets, reserve assets pledged as collateral for foreign loans, reserve assets pledged through forward contracts, and precious metals other than gold.

3/ Gross reserve liabilities are subject to revision. They are defined as any loan, deposit, swap (including any portion of the NBY gold that is collateralized), and forward liabilities of the NBY in convertible currencies to residents and nonresidents; IMF purchases; borrowing from international capital markets; and bridge loans from the BIS, foreign banks, foreign governments, or other financial institutions, irrespective of their maturity. Excludes long-term liabilities and any foreign liabilities not being serviced as of September 30, 2000.

4/ Program ceiling.

5/ Given the definition of net foreign reserves, gross foreign assets and liabilities excluded from net foreign reserves are captured in other assets (net). For end-September 2000, the items excluded represented net foreign liabilities totaling dinars 21,758.3 million.

6/ Comprises balances in giro accounts and cash in commercial bank vaults.

Federal Republic of Yugoslavia: Statement of Economic Policies

Introduction

1. The federal elections of September 2000 boosted democratic processes in the Federal Republic of Yugoslavia (FRY) and marked a turning point in the country's economic relations with the rest of the world. In this new environment, we now look forward to undertaking the challenging task of reintegrating FRY into the world economy with the support of the international community.

2. Our most immediate priority, though, is to address the acute shortages of food and energy facing us during the winter months. The emergency assistance from the European Union and other bilateral donors that we have already secured will go a long way to help us address those needs. We are also facing very difficult macroeconomic problems. To correct the situation, we have already adopted a strong adjustment program, are in the process of assessing our financial and technical assistance needs, and in the months ahead will prepare a comprehensive package of reform. We believe it is imperative that we secure for our endeavors the financial and technical support of international financial institutions. For this reason, we intend to complete all membership requirements expeditiously.

3. In this statement, we (a) describe recent economic developments in FRY, (b) outline our economic strategy and policies, focusing in particular on the period through end-March 2001, and (c) summarize our needs for external financial and technical assistance. We expect this statement to help form the basis for a purchase from the IMF under its policy on emergency post-conflict assistance, following the succession to membership in the IMF. We intend to move as quickly as possible thereafter, in step with the improvements in our technical capacity, to adopt a comprehensive economic program that could be supported by the Fund under a stand-by arrangement.

Background

4. A decade of conflict, years of isolation caused by economic sanctions, and lack of structural reform have severely damaged FRY's economy. In Serbia,[1] real GDP today is only 40 percent of its level in 1989, and in Montenegro only 53 percent of its 1989 level. Unemployment is rampant; by some estimates, nearly half the labor force is unemployed. Industrial production is beginning to recover from the economic devastation associated with the Kosovo conflict and the NATO bombing campaign. However, without considerable

[1] Data and policy commitments for Serbia do not include Kosovo. Under United Nations Resolution Number 1244, Kosovo remains under the temporary administration of the United Nations Mission in Kosovo.

investment the growth potential of the sector is likely to be strictly limited, because of severe infrastructural bottlenecks, outdated machinery, and the loss of business contacts during the economic isolation. Agricultural output in 2000 declined by some 17 percent, affected by a severe drought in the region that caused widespread deprivation and exacerbated the existing food shortages. In this situation, the outgoing Serbian government liberalized most prices in October, and the severe shortages were immediately manifested in a sharp acceleration of the 12-month inflation rate to nearly 100 percent by the end of the month. With virtually no savings to fall back upon, the bulk of which was wiped out by the hyperinflation of 1993, the recent upsurge of inflation deepened considerably the impoverishment of the population. In Montenegro, the DM has been adopted as the sole legal tender on its territory.

5. The Federal and Serbian budgets, as well as the social funds face grave difficulties in the period ahead. The revenues of the Federal government were adversely affected by the severe erosion of capacity in the customs administration, while Federal expenditure commitments did not decline commensurately. Revenue collections by the Serbian government have suffered because of the tax arrears accumulated by state-owned enterprises, the granting of tax exemptions and amnesties, a reduction in tax rates and the inability of the tax administration department to target effectively the proliferating gray economy. The Serbian government has attempted to contain expenditure commitments, but the decline in the real wages of many government employees and of social entitlements to very low levels as well as the large number of refugees and internally displaced persons (IDPs) have made significant adjustments very difficult to undertake. The fiscal position in Montenegro has also come under considerable pressure because of a sharp increase in public sector wages and the large number of refugees and IDPs. However, generous commitments of donor assistance are expected to cover the entire consolidated budget deficit of the Montenegrin government, that is now expected to reach 8 percent of GDP. Thus, the consolidated cash fiscal deficit for FRY as a whole, which has been held under ½ percent of GDP and has been associated with the accumulation of wage and pension arrears, is fully attributable to the Federal and general Serbian governments.[2] For these governments, the fiscal deficit at end-October on an accrual basis, even after excluding the servicing of government debt, was about 3 percent of GDP, and total non-debt related arrears, including those from earlier years, were estimated to be at least 7–8 percent of GDP. The fiscal situation is still graver when one considers FRY's external debt, which according to preliminary estimates stands at about 140 percent of GDP, with almost all of it in arrears.

6. Monetary developments in Serbia were significantly affected by the practice of extending credit to finance the large quasi-fiscal deficits accumulated by state-owned enterprises, credit from the National Bank of Yugoslavia (NBY) to insolvent commercial banks, and the monetization of cash fiscal deficits. Such practices spurred inflation and

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[2] Together these comprise the Federal, Serbian Republican and Serbian local governments, and the Serbian social security, and special extrabudgetary, funds.

intensified the pressures on the exchange rate that had persisted since the end of the Kosovo conflict; the parallel market exchange rate depreciated by about 100 percent over the 12 months ending in October 2000. Accordingly, the level of gross official reserves remained at a very low level and the use of the dinar for transactions purposes experienced a marked decline. The pressures were partly relieved when in late May the government introduced a foreign exchange premium that effectively devalued the exchange rate for most transactions from 6 dinars per DM to 20 dinars per DM, and thereafter in October to the parallel market rate of 30 dinars per DM. While these measures went a long way towards eliminating incentives to transact in the parallel market for foreign exchange, the modest sales of foreign exchange to the NBY since then underscores the still fragile state of confidence in the dinar. Given these circumstances, and the low level of reserve money to GDP (3 percent), there will be very little scope in the near term for non-inflationary monetary financing of the economy by the NBY.

7. The absence of structural reform in some key areas has also contributed to the emergence of macroeconomic imbalances. The economy remains dominated by inefficient state-owned enterprises, whose continued operation has, in recent years, depended crucially on the availability of credit from the banking system. This has contributed to large scale insolvency among commercial banks, and to prevent a collapse of the banking system, the NBY has often suspended the enforcement of prudential regulations for problem banks, and has also extended credit to such banks as needed. Until recently, the exchange system was characterized by several restrictions and multiple exchange rates, all of which were grossly overvalued. All of these have created a strong incentive to bypass official channels in favor of the parallel market, thus exacerbating the paucity of official reserves. Finally, for a set of diverse reasons, including notably, a very high tax burden, and until recently, pervasive price controls, a large gray economy has emerged in the country. This development, which has taken place at the same time as the decline in the capacity of the tax and customs administrations, has been an important contributor to the decline in the performance of government revenues.

Economic policies

8. Our economic reform strategy is to orient policies in the period immediately ahead toward promoting financial stability, while protecting the most vulnerable groups of the population. Thereafter, the focus will be on advancing the transition to a market economy and establishing the basis for sustainable growth. We are aware that efforts to address urgent social needs will have to be a prominent part of our program of economic reform, notably because impoverishment of the population in recent months has increased considerably.

9. With the termination of most economic sanctions, and the remainder to be lifted shortly, renewed possibilities for travel and transportation, and the initiation of reconstruction programs, we anticipate that real GDP growth will exceed 10 percent in the coming year. Monetary policy over the next 3–4 months will be geared to lowering monthly inflation to

the low single digits. We believe that because of renewed confidence in the economy and the already large depreciation of the exchange rate, such appropriately tight policies should help stabilize the nominal exchange rate. We are aware that supporting a monetary stance consistent with our inflation objective will require a marked turnaround in the underlying fiscal position together with improved fiscal management, and a discontinuation of the NBY's policy of directing credit to state-owned enterprises, various funds and commercial banks. We intend to immediately make the necessary changes to our policy framework, and to initiate steps to place the operations of state-owned enterprises and commercial banks on a more viable footing.

Exchange rate policy

10. We have moved swiftly to enhance the market orientation and efficiency of the exchange system. On October 14, we decided to depreciate effectively the exchange rate to the level of the prevailing gray market rate (30 dinars per DM) through an increased premium, and to discontinue transactions at the official exchange rate of 6 dinars per DM. On December 5, 2000 we unified the exchange rate at 30 dinars per DM and abolished exchange restrictions in the form of obligatory sales of foreign exchange to the NBY by exporters and importers. By January 1, 2001, when a proper institutional and policy framework will be in place, the NBY will adopt a managed floating exchange rate regime with current account convertibility, subject to a minimum target for net foreign reserves of the NBY. In the interim period, while preparations to move to the new regime are being made, we will ensure—through monetary and exchange rate measures as needed—that the spread between the official exchange rate and the moving average of the gray market rate over the previous 5 working days does not exceed 5 percent. We will also ensure that the net foreign reserves of the NBY in the period through end-March 2001 do not decline below the level prevailing at end-September 2000.

Monetary policy

11. In the period ahead, domestic credit from the NBY to the governments, state-owned enterprises, budgetary and extra-budgetary funds, and commercial banks will be strictly curtailed with a view to achieving the inflation target. Specifically, the outstanding amount of NBY net domestic credit to government, banks and the rest of the economy will not be allowed to increase between end-September and end-December 2000, and will be allowed to increase by up to 500 million dinars (4 percent of the monetary base) between end-December 2000 and end-March 2001, strictly to accommodate the seasonal financing requirements of the Serbian general government. We will support this credit policy stance by seeking to enforce prudential regulations for commercial banks, and in particular, ensure that the effective required reserve ratio of the commercial banks does not fall below its current level. This should, in turn, limit the ability of commercial banks to extend credit to the government or state-owned enterprises. With this set of policies we expect that the growth of the monetary base will be non-inflationary.

Fiscal policy

12. In view of our monetary strategy, we intend to contain the overall fiscal deficits of the Federal and general Republican governments during the period through end-March 2001 to the available amount of foreign grants and loans, with the exception of the aforementioned seasonal NBY credit to the Serbian government in the first quarter of 2001. Given the likely magnitudes of such assistance, we will implement measures to boost revenues and contain/re-prioritize expenditures to ensure that no additional borrowing from the banking system is required. At the Federal level we will seek to achieve this objective by lowering military spending. In Serbia, as regards revenues, we will restore excise duty rates on alcohol and tobacco to the levels that existed at the beginning of the year, and introduce an excise tax on the purchase of newly registered luxury cars. We will also seek to collect unpaid taxes of state-owned enterprises, rather than granting them a tax amnesty. We expect this package of measures to yield revenues of 400 million dinars in November–December 2000. The scope to undertake expenditure measures is rather limited in view of the small share of discretionary expenditures in the budget, and the already very low level of wages and entitlements. Nevertheless, we will seek to cut back spending on internal security, and temporarily suspend extrabudgetary programs that were initiated to finance the reconstruction efforts. Despite all of these measures, both revenue and expenditure, we anticipate that a fiscal financing gap equivalent to some 1½ percent of GDP will remain in 2000. We have already approached donors with requests for financial assistance to fill this gap and support budget execution in early 2001, and are hopeful that our requests will be viewed favorably. In Montenegro, the authorities intend to limit the increase of public sector wages and pension benefits to contain the budgets within the expected levels of real resources.

13. We are committed to pursuing prudent fiscal policies and shall take all the necessary steps to ensure orderly budget execution next year. In formulating the 2001 federal and Montenegrin budgets, the provisional Serbian budget for the first quarter of 2001, and the annual social security budget we shall aim at balanced budgets based on conservative revenue projections and shall introduce the necessary legislation to create properly designed and adequately sized contingency reserves and other related mechanisms in the budgets. Given the high degree of uncertainty surrounding the execution of the 2001 federal budget, we shall aim at including several contingency mechanisms in the budget, in the amount equivalent to 1–2 percent of GDP. Accordingly, we will consult with the Fund staff in the coming weeks on the technical modalities of such mechanisms.

Other policies

14. The decision to stop extending NBY credit to state-owned enterprises, budgetary and extra-budgetary funds, and commercial banks will have to be accompanied by measures that will allow them to continue operating in the new economic circumstances. In the recent past, the main recipients of credit from the NBY have been the parastatals in the energy sector, most notably the electricity company. In the period immediately ahead, the need to finance their operations from the banking system will be considerably reduced, as emergency assistance grants from the European Union and other bilateral donors will be mainly directed to financing energy imports and the operational costs of local heating utilities. Over time, electricity prices will be adjusted in a phased manner to better reflect costs. For the other parastatals, some of which still operate under conditions of administered prices for their output, we will attempt, to the extent possible, to adjust such prices upwards. In the medium term, the rehabilitation and restructuring of these enterprises will be an integral part of our reform agenda.

15. As regards banking sector reform, we intend to work closely with the IMF, the World Bank and other donors, to begin expeditiously the rehabilitation and restructuring of commercial banks. We anticipate launching this program early in 2001. We recognize that we face a formidable task in the banking sector, and intend to adopt a comprehensive approach to resolve the problems.

16. We have already indicated our desire to proceed quickly to a more comprehensive program of reform that could be supported by the Fund under a stand-by arrangement. We understand that to be eligible for such support we will need to enhance our ability to monitor and implement such a program, particularly through an improvement in the quality of data. This will require technical assistance, and our efforts to mobilize such support are described below.

17. As regards our external financial relations, we intend to engage in discussions with our external creditors, of which the largest are the World Bank, and Paris and London Club creditors. For the World Bank, a plan to clear such arrears is a precondition for Bank membership, and we will shortly begin discussions with their staff on the formulation of this plan. We have also begun to prepare an accurate assessment of our outstanding debt so as to ensure productive discussions with our other creditors. Finally, we intend to negotiate with other former Yugoslav republics with a view to reaching a fair and expeditious agreement on the division of the former Yugoslavia's assets.

Technical assistance

18. During the period of our long isolation the quality of our economic data has deteriorated considerably. Balance of payments statistics have been most seriously affected, since the economic sanctions forced international financial transactions to take place through irregular channels, and monetary statistics, which are key for program monitoring, also need improvement. To address all of these deficiencies we will require technical assistance. We will also need external technical assistance to help in the design and implementation of many aspects of macroeconomic policy and structural reform. However, there is a need to balance the requirement for rapid improvement with the difficulty of coordinating assistance from diverse sources. We will be working with the international community to establish mechanisms for the effective coordination of these efforts.

19. In the period immediately ahead we intend to rely on the IMF to take a lead role in the development of technical assistance strategies in the core areas of fiscal and monetary policy, banking sector reform, and the strengthening of economic statistics. We have already had preliminary discussions with a diagnostic mission from the Fund in the area of banking reform, and intend to continue these discussions during their next visit in December. We are also committed to formulating and carrying out a comprehensive reform of our public finances. To this end, we have requested a multi-topic mission from the Fiscal Affairs Department of the Fund, and expect one to visit FRY in early 2001. Based on the recommendation of this mission, we will formulate a strategy for seeking technical assistance from several international organizations and donor agencies. We expect the Fund to play a key role in coordinating technical assistance in this area. We are also hoping to receive a money and banking statistics mission from the Fund during December 2000, and a multi-sector statistics missions in early 2001.

20. Other donors are also engaged in assessing our technical assistance needs, and there have already been preliminary visits by some experts. The needs assessments are expected to be discussed during the Donor Coordination Meeting in mid-December, and plans of financial support for such assistance are expected to be developed at that time. We also expect the World Bank to become a key provider of technical assistance, once the membership process has been completed.

/s/
Miroljub Labus
Deputy Prime Minister
Federal Government
Federal Republic of Yugoslavia

/s/
Mladjan Dinkic
Governor
National Bank of Yugoslavia

Federal Republic of Yugoslavia: Fund Relations
As of November 30, 2000

I. **Membership Status:** The FRY is expected to fulfill the conditions for membership on the day of Executive Board consideration of the present document. Upon succession to membership and payment of its increase under the Ninth and Eleventh Review of Quota the quota of FRY will amount to SDR 467.7 million.

II.	**General Resources Account:**	SDR Million	%Quota
	Quota		
	Fund Holdings of Currency		
III.	**SDR Department:**	SDR Million	%Allocation
	Net cumulative allocation	56.66	100.0
	Holdings		
IV.	**Outstanding Purchases and Loans:**	SDR Million	%Quota
	Stand-by arrangements	55.64	
	First Credit Tranche		
V.	**Financial Arrangements:**	None	

VI. **Projected Obligations to Fund:** (SDR Million; based on existing use of resources and present holdings of SDRs):

	Overdue		Forthcoming			
	11/30/2000	2000	2001	2002	2003	2004
Principal	55.6					
Charges/Interest	45.5		7.1	7.1	7.1	7.1
Total	101.1		7.1	7.1	7.1	7.1

VII. **Exchange Arrangement**

The currency of FRY is the Yugoslav Dinar (YUD). FRY maintains a fixed exchange at YUD 30 = deutsche mark 1. Access to foreign exchange is not restricted, but enterprises and banks are subject to surrender requirements for foreign exchange.

VIII. **Last Article IV Consultation**

No consultation discussions have yet been held with FRY.

IX. Technical Assistance

Department	Timing	Purpose
MAE	November 2000	Diagnostic mission
MAE	December 2000	Diagnostic mission: Monetary policy instruments; Bank supervision; Payments system; Foreign exchange operations and reserves management; Development of money and securities markets.

Federal Republic of Yugoslavia: Relations with the World Bank

1. Based on a decision by the World Bank's Board of Directors, the Former Socialist Federal Republic of Yugoslavia (SFRY) ceased to be a member of the World Bank Group in February 1993, and as of now the Federal Republic of Yugoslavia (FRY) has not yet succeeded to SFRY's membership.

2. The conditions for FRY succession to membership are that FRY would: (i) become a member of the IMF; (ii) accept the Bank's Articles of Agreement and the terms and conditions of subscription to the shares of Bank capital to which it succeeds; (iii) make local currency payments as necessary with respect to shares to which it succeeds; (iv) enter into final agreement with the Bank on the loans of the SFRY it assumes; and (v) eliminate or agree with the Bank on a plan to eliminate the arrears in the servicing of the Bank loans it has assumed. Once all conditions for membership have been met, FRY's membership into the World Bank Group will be considered by the Bank's Board of Directors and, once all arrears have been cleared, the World Bank will be in a position to provide new financing to FRY. As of September 30, 2000, the stock of arrears of the SFRY to the International Bank for Reconstruction and Development (IBRD) amounted to US$1.7 billion.

3. The Government of the FRY has invited the World Bank to discuss its programs and policies with a view to reestablishing relationships with the World Bank Group. Because membership issues will take time to resolve, the Bank has designed at two-stage process that will enable it to be active even prior to membership. In a first pre-membership stage, the Bank will provide analytical and advisory support to FRY, in partnership with the European Commission, the IMF and others. This support would focus on preparing an economic recovery and transition program and mobilizing assistance for FRY in the near term. Formulating such a program will take time, careful study and substantial debate, as well as a close dialogue with the international donor community on issues of direction, speed and sequencing of reforms. As part of the mandate given by the international donor community, the European Commission and the World Bank will be reviewing the Government's evolving reform agenda with Yugoslav authorities. Based on this review, a report will be prepared that will be submitted to a donor pledging conference to take place as early as possible next year. During this phase, the Bank expects to administer bilateral trust funds which could be used to finance early projects in Yugoslavia or, alternatively, contribute to the clearance of FRY's arrears vis-à-vis the World Bank. In a second phase, once the conditions of membership of FRY in the Bank have been fulfilled and arrears are actually settled, the Bank would continue to provide advisory and aid coordination services and administering trust funds, but would also be able to provide loan financing, on either IDA or IBRD terms.

Federal Republic of Yugoslavia: Procedural Steps for the Succession to Membership and Consent to and Payment for Quota Increase

In order for the Federal Republic of Yugoslavia to succeed to membership in the Fund and become eligible for Fund assistance, a number of actions on the part of Yugoslavia and the Fund are needed. This annex summarizes the steps that are required in this context and need to be completed on December 20, 2000.

1. Yugoslavia must clear its arrears to the Fund, of SDR 101.1 million. It is expected that this will be accomplished through bridge finance to be provided by Norway and other members.

2. Following arrears clearance, the Executive Board must reach a finding that Yugoslavia can fulfill its obligations as a member of the Fund. The Executive Board will be requested to reach such a finding at the meeting on December 20, 2000.

3. Related to the membership process, the Executive Board will be asked to approve a representative rate for the Yugoslav dinar. A Board paper for that purpose will be issued shortly for approval at the meeting on December 20, 2000.

4. Having succeeded to membership, Yugoslavia will be able to consent to and pay for its quota increase under the Eleventh General Review of Quotas. It is expected that Yugoslavia's consent and payment will be made effective on December 20, 2000. Payment of the reserve asset portion of the quota increase will be facilitated through use of the same day SDR loan facility used by a number of other members with insufficient resources for quota payments.[1]

Following the above steps, the Executive Board will consider a request by Yugoslavia for a drawing under the Fund's policy for emergency assistance. The formal request will be presented to the Executive Board upon completion of the preceding steps on December 20, 2000. Proceeds from this purchase will be used to repay the bridge loan lenders on the same day.

[1] Payment of the quota increase results in a reserve tranche position for the member. The SDR loan is repaid immediately by the member purchasing its reserve tranche and paying the proceeds to the SDR lender.

Federal Republic of Yugoslavia: Eligibility for Emergency Post-Conflict Assistance

1. The conditions for qualifying for post-conflict emergency assistance are (i) that the country's administrative capacity has been disrupted as a result of the conflict so that the member is not yet able to develop and implement a comprehensive program that could be supported by a Fund arrangement; (ii) that there is nevertheless sufficient capacity for planning and policy implementation of a program, and demonstrated commitment on the part of the authorities; (iii) that there is an urgent balance of payments need to help rebuild reserves and meet essential external payments and a role for the Fund catalyzing support from other official sources; and (iv) that Fund support would be part of a concerted international effort to address the aftermath of the conflict situation in a comprehensive way. The member is also required to state its intention to move, within a relatively short timeframe, to an upper credit tranche Stand-By Arrangement, Extended Arrangement, or PRGF arrangement, and the use of emergency assistance is to be framed in a manner to pave the way toward the adoption of such a program. In support of a request for assistance, the member is to provide a statement of policies, including a quantified macroeconomic framework to the extent possible.

2. Because of the long period of economic isolation resulting from the sanctions related to the conflict imposed on FRY, the institutional capacity to administer a Fund program with upper credit tranche conditionality does not exist. The lack of interaction with international financial institutions and the absence of technical assistance has resulted in the compilation and presentation of monetary statistics that are economically not meaningful. In addition, the worsening conditions of banks have led to a gradual decline in the quality of raw monetary statistics and the emergence of irregular data reporting. The balance of payments statistics have also deteriorated, as the sanctions have encouraged the practice of conducting transactions outside domestic and foreign banks.

3. However, in their discussions with the staff, the authorities have demonstrated amply their commitment and capacity to plan and implement policies that will lead to short-term macroeconomic stabilization as well as a commitment to improve their statistical ability so as to manage Fund programs with upper credit tranche conditionality. In this regard, the authorities have made clear their intention to quickly adopt a program supported by a stand-by arrangement.

4. The authorities have been active in mobilizing the donor community to provide financial and technical support for their efforts towards economic transformation and reconstruction. These efforts have already led to some pledges of humanitarian assistance by donors. In addition, a Steering Group has been formed, chaired by the World Bank and the European Union, to coordinate donor efforts in FRY, and a Donor Coordination Meeting was held on December 12, 2000. An assessment of FRY's technical assistance requirements, and pledges to help meet those needs, will be an important part of the agenda at that meeting.

5. The Fund has an important role to play in supporting the FRY authorities. Balance of payments assistance from the Fund will help satisfy FRY's urgent requirements in the

coming winter months. It will also help the authorities to signal their commitment to reform, and thus act as a catalyst for financial support from the donor community. As FRY initiates its medium-term program of economic transformation, the Fund's role in coordinating technical assistance in its core areas of competency, namely fiscal and monetary policy, banking sector reform, and the strengthening of economic statistics will be critical.

INTERNATIONAL MONETARY FUND
EXTERNAL RELATIONS DEPARTMENT

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December 20, 2000

International Monetary Fund
Washington, D.C. 20431 USA

IMF Approves Membership of Federal Republic of Yugoslavia and US$151 Million in Emergency Post-Conflict Assistance

The Executive Board of the International Monetary Fund (IMF) today determined that the Federal Republic of Yugoslavia (FRY) has fulfilled the necessary conditions to succeed to the membership of the former Socialist Federal Republic of Yugoslavia (SFRY) in the IMF. The FRY's quota in the IMF will amount to SDR 467.7 million (about $604 million). With the succession of the FRY, effective December 14, 1992,[1] IMF membership now totals 183 countries.

The Board also approved a loan equivalent to SDR 116.9 million (about US$151 million) under the IMF's policy on emergency post-conflict assistance in support of a program to stabilize the FRY's economy and help rebuild administrative capacities. Of this amount, the authorities will draw SDR101.1 million (about US$130 million) to repay the bridge loans they received to eliminate arrears with the IMF.

Following the Executive Board discussion, Stanley Fischer, First Deputy Managing Director and Acting Chairman, said:

"Executive Directors welcomed FRY's succession to membership in the Fund as an important step in its reintegration into the world economy and the international community, which will be of considerable help to the country in addressing its difficult problems.

"The FRY authorities face the complicated task of stabilizing and reviving a devastated economy after years of regional conflicts, international isolation, and economic mismanagement. Against the background of a sharp acceleration of inflation in recent months, the authorities have appropriately focused on the need to prevent financial instability from adding to the difficulty of

[1] The decision adopted by the Executive Board on December 14, 1992 set out the conditions for succession of the Federal Republic of Yugoslavia to the membership of the Former Socialist Federal Republic of Yugoslavia in the Fund, which terminated as of the date of that decision. The 1992 decision has been extended on a regular basis since its adoption, pending a determination by the Fund that the conditions set out in the December 1992 decision have been met by the Federal Republic of Yugoslavia.

this task. Accordingly, the short-term macroeconomic strategy aims, through limiting the growth of credit, to bring inflation under control.

“Directors welcomed recent measures to streamline the exchange system as well as the authorities’ intention to introduce a managed float with current account convertibility by January 1, 2001, so as to allow the exchange rate to better reflect market conditions.

“Strengthening the underlying fiscal position and preventing a further accumulation of expenditure arrears will be critical in attaining and preserving financial stability. This will require prioritization of expenditures, improvements in tax administration, and a widening of the tax base by eliminating tax exemptions, as well as bringing the gray economy into the tax net.

“Directors welcomed the authorities’ intention to adopt a comprehensive program of stabilization and reform that could be supported by the Fund under an upper credit tranche program. This will need to be preceded by progress in stabilizing the economy and in strengthening the institutional and administrative capacities, under the current program. Technical assistance is expected to make a significant contribution to this process.

“Achievement of a viable balance of payments position will be a challenging task. In addition to prudent macroeconomic policies and bold structural reforms, it will require a restructuring of FRY’s external debt on appropriate terms, including early resolution of arrears to the World Bank, and substantial support, following the regularization of arrears, from external donors and creditors,” Mr. Fischer said.

ANNEX

Background

Ten years of regional conflicts, international isolation, and economic mismanagement have left a dire legacy in the Federal Republic of Yugoslavia. Output, which has only partly recovered from the economic devastation caused by the Kosovo war, stands at about 40 percent of its 1989 level. Unemployment amounts to one half of the labor force. The country's infrastructure is in disrepair following years of inadequate investment and the damage inflicted during the Kosovo war. About 900,000 refugees and internally displaced persons live in FRY under difficult conditions. Serious energy shortages are being somewhat alleviated with humanitarian assistance. The macroeconomic situation is very fragile, and with declining output, the ratio of external debt to GDP has risen to about 140 percent in the absence of debt servicing.

The year 2000 has seen only modest output recovery and high inflation. GDP is projected to expand by 10 percent in 2000, thus only partly recovering from the economic effects of the Kosovo war. Agricultural output is expected to decline by 17 percent owing to a severe drought. Following the liberalization of prices by the outgoing Serbia government this October, retail prices rose by a cumulative 48 percent in October-November, bringing the 12-month retail price inflation in November to 110 percent. This has severely eroded real wages and pensions which presently average the equivalent of DM 90 per month converted at parallel market rates.

The key source of inflationary pressures has been the monetary financing of quasi-fiscal deficits of state-owned enterprises. Cash fiscal deficits have been kept at low levels through a compression of real spending and accumulation of arrears. General government revenue has declined in real terms over the past two years by a cumulative 40 percent. In recent months, the sharp acceleration of inflation has resulted in a further decline in real revenue, and thus, in real expenditure. The fiscal deficit on an accrual basis has been higher—at least 3 percent of GDP, even excluding the servicing of government debt of over 100 percent of GDP.

The short-term stabilization program, which will focus on the period through end-March 2001, will pave the way for a comprehensive economic program to be formulated in early 2001. The stabilization program calls for tight fiscal and monetary policies and the introduction of a managed float with current account convertibility. In Montenegro, bank financing of the budget (except on a very short-term basis) is effectively ruled out by the use of the Deutsche mark as the sole legal tender.

There is an urgent need to implement wide-ranging fiscal reforms and undertake comprehensive restructuring of the enterprise and banking sectors. Both these sectors continue to be affected by former Yugoslavia's heritage of "social ownership", under which firms were owned collectively by their workers and governance was weak and highly politicized. Several privatization initiatives since 1992 have accomplished very little as they have failed to challenge the authority of managements and employees in social enterprises, and the banking system is insolvent and unable to perform its intermediation functions.

Federal Republic of Yugoslavia (Serbia/Montenegro): Selected Economic

and Financial Indicators, 1996-2000 1/

		1996	1997	1998	1999	2000 Jan.-Sep.
Real economy (change in percent)						
Real GDP	...	7.8	10.1	1.9	-19.0	10.7
Industrial production	...	7.6	9.5	3.6	-22.5	15.2 2/
Retail prices (annual average)	...	92.7	18.5	29.8	42.4	71.2 3/
Retail prices (end of period)	...	...	...	...	49.9	109.6 4/
Unemployment rate (in percent) 5/	...	25.8	25.8	25.1	26.5	27.3
General government finances (percent of GDP)						
Revenue	...	...	...	...	...	27.8 6/
Expenditure	...	...	...	...	...	28.2 6/
Cash balance	...	...	...	...	...	-0.4 6/
Commitment balance	...	...	...	...	...	-2.7 6/
Money supply (end-of-period, percent change)						
M1		68.8	66.5	17.1	49.8	60.1 7/
M2 8/		15.4	23.9	69.4	20.1	38.2 7/
Balance of payments (in billions of U.S. dollars)						
Merchandise exports		1.8	2.4	2.9	1.5	1.3
Merchandise imports		4.1	4.8	4.8	3.3	2.8
Trade balance		-2.3	-2.4	-2.0	-1.8	-1.5
Current account balance	...	-1.3	-1.8	-1.2	-1.3	-1.0
Foreign debt (year-end)	...	...	...	...	...	12.1 9/
Gross official reserves		...	...	...	...	0.4
(In months of imports of goods and services)		...	...	...	...	1.3
Fund position (SDR millions, as of November 30, 2000)						
Quota (Eleventh Review)		...	...	...	...	467.7
Overdue obligations		...	...	...	...	101.1

Sources: Federal Statistical Office; National Bank of Yugoslavia;
Ministry of Finance of the Federal Republic; Ministry of Finance
of the Republic of Serbia; and Fund staff estimates.

1/ With the exception of money supply, foreign debt, and Fund position, data for 1999 and 2000 exclude Kosovo.

2/ January-October 2000/January-October 1999.

3/ January-November 2000/January-November 1999.

4/ November 2000/November 1999.

5/ Excluding workers on "forced holiday" (about 20-25 percent of the labor force in recent years).

7/ September 2000/September 1999.

8/ Includes foreign currency deposits valued at the official exchange rate.

9/ Includes arrears on unpaid imports of fuel and gas.