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## INTELLIGENCE BRIEF

### YUGOSLAVIA'S PROSPECTIVE CURRENCY DEVALUATION

DIRECTORATE OF INTELLIGENCE

Office of Research and Reports

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YUGOSLAVIA'S PROSPECTIVE CURRENCY DEVALUATION

Yugoslavia may devalue its currency before the end of the year in order to ease the pressure on its balance of payments. The devaluation reportedly will increase the official rate of exchange from 750 dinars to US \$1 to between 1,000 and 1,200 dinars to US \$1, but the resulting increase in export revenues and import costs in dinars will be offset in part by selective cuts in export subsidies and import tariffs. Improvement in the balance of payments and relaxation of administrative interference in foreign trade are alternative ways of taking advantage of the devaluation. The Yugoslav government is likely to give priority to the balance of payments problem because the trade deficit has grown to unprecedented levels under the strong inflationary pressures of recent months. There also is strong interest in a further liberalization of economic controls to promote a more efficient allocation of Yugoslav resources and to qualify Yugoslavia for full membership in the General Agreement on Tariffs and Trade (GATT).

1. Details of the Rumored Change

Statements by Yugoslav officials and legislative bodies earlier this year indicate that Yugoslavia may soon devalue its currency. In April, for example, the Federal and Economic Chambers of Yugoslavia's Federal Assembly adopted a resolution that called for adjustment of "relations between domestic and foreign prices" so as to stimulate exports and bring about a more rational distribution of imports. In July, Ljubisa Milanovic, Director of the Office for International Organization Affairs of Yugoslavia's Federal Secretariat for Foreign Trade, reportedly stated that Yugoslavia planned to devalue its currency no later than the end of 1964. In late August, Mika Spiljak, President of the Croatian Executive Council, stated that devaluation was under consideration, although no final decision had yet been made.

According to these and other reports, the rate of exchange will be changed from 750 dinars to US \$1 to at least 1,000 and possibly as much as 1,200 dinars to US \$1.\* The dollar value of the dinar consequently

\* Devaluation would not necessarily affect the par value of the dinar, which has been pegged at the artificial level of 300 dinars to US \$1 since the beginning of 1952 and is used only for statistical purposes.

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is expected to be reduced by at least one-fourth (from US \$0.00133 to US \$0.001). Because of selected cuts in export subsidies and import tariffs, however, the average number of dinars actually paid to domestic producers or by domestic consumers for one dollar's worth of exports or imports probably would not increase as much as the rate of exchange. Milanovic stated that export subsidies, which are paid on about one-half of Yugoslavia's exports, are to be cut from their present rates of 10, 22, and 32 percent (depending on the product) to 5, 10, and 15 percent.

The present rate of exchange of 750 dinars to US \$1 has been in effect since the beginning of 1961. From 1954 until 1961 the basic rate of exchange was 632 dinars to US \$1. Various coefficients were applied to this basic rate, ranging at the end of the period from 0.5 to 3.0, depending on the product, so that there was in reality a multiplicity of rates of exchange. In the foreign trade reform of 1961 the new rate of 750 dinars to US \$1 was made applicable to all commodity transactions. However, wide differences between dinar prices and world market prices were preserved by means of a provisional system of import tariffs and export subsidies, and the average number of dinars actually paid per dollar of imports or received per dollar of exports changed little.

## 2. Benefits of a Devaluation

### a. Improvement of the Foreign Trade Balance

By permitting Yugoslav goods to be offered at lower prices abroad and by increasing the prices of imported goods in terms of dinars, devaluation in general would promote exports and discourage imports, thereby reducing the trade deficit. Yugoslavia has achieved its high rate of economic growth with the help of substantial trade deficits. The deficits amounted to US \$197 million in 1962 and US \$266 million in 1963, or 22 and 25 percent of total imports in the respective years. Yugoslavia is able to finance a sizable trade deficit with earnings from tourism, transportation, and other services and with credits from the US and Western Europe, but the deficit so far this year is uncomfortably large. By the end of October, imports exceeded exports by the unprecedented value of US \$407 million, or half again as much as in all of 1963.

Such an increase in the trade deficit raises special difficulties at this time because Yugoslavia is burdened with heavy external debt

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obligations arising from past assistance. By the end of 1963, external public debt (excluding accumulated interest) totaled about US \$1.15 billion, 90 percent of which was owed to hard currency countries. Debt repayment obligations will be particularly heavy during the next several years, probably averaging about one-sixth of the value of exports.

The growing trade deficit is largely the result of an expansion of imports. Heavy internal demand, spurred by Yugoslavia's present investment boom, pushed imports in the first 10 months of 1964 to 27 percent more than their value in the same period last year. Raw materials and semifinished goods have led the increase in imports, followed by machinery and transportation equipment.

A substantial increase in prices of imported goods in terms of dinars should do much to keep the growth of imports within bounds. Assuming devaluation to 1,000 dinars to US \$1 and no change in tariff rates, there would be an increase of 33 percent in the dinar prices of all imports. In practice the regime probably would hold the increase below that figure for some products by cutting tariffs. Tariff cuts might be desirable in order (1) to limit increases in dinar prices of imports essential to the economy, (2) to avoid excessive protection of "infant" industries, and (3) to use foreign competition to curb monopolistic tendencies in some Yugoslav industries.

Yugoslav exports have grown at a moderate pace, increasing 12 percent from the first 10 months of 1963 to the first 10 months of 1964. Nevertheless, the growth of exports is lagging seriously behind the growth of imports, is lower than in 1962-63, and has slackened in recent months. Both the ability and the willingness of Yugoslav producers to export have been weakened by rising costs and prices. From September 1963 to September 1964, there were increases of about 30 percent in average wages, 6 percent in industrial producers' prices, and 29 percent in agricultural producers' prices. As costs have gone up, some enterprises have found it more difficult to compete in foreign markets. Moreover, high prices and strong demand have made sales in the domestic market more profitable to producers, reducing their incentive to export.

A substantial devaluation, such as is rumored, would stimulate exports considerably by increasing the profitability of exporting goods that already are competitive abroad and by permitting other goods to be offered at more competitive prices. If export subsidy

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rates were cut as predicted by Milanovic, devaluation to 1,000 dinars to US \$1 would permit subsidized exporters to reduce their prices by 14 to 21 percent without reducing their proceeds in dinars for a given quantity of exports.

b. Reduction of State Control over Imports

The rise in dinar prices of imported goods resulting from a devaluation would reduce the extent of direct state controls necessary to keep imports within any given limits. However, the greater the reduction in direct controls, the smaller the improvement in the balance of payments, and, in view of the difficult current payments position, it is likely that the regime will give priority to improving the balance of payments.

Further liberalization of the economic system appears to be a major objective of state policy in Yugoslavia, and the government undoubtedly would like to reduce direct controls over imports, partly in order to qualify Yugoslavia for full membership in GATT. There are indications that Yugoslavia intends to use a program for trade liberalization as a justification for foreign assistance, while using the devaluation mainly to improve the balance of trade. Milanovic, for example, emphasized that Yugoslavia would require hard currency to carry out the devaluation and the subsequent reform of the system. The US and the International Monetary Fund would be the most likely targets of Yugoslav requests for assistance because Western European countries probably would not assist Yugoslavia in a competitive currency devaluation as they did in the foreign trade reform of 1961.

c. Rationalization of the Structure of Production

To the extent that a devaluation would be accompanied by a reduction in the level and differentiation of tariffs, export subsidies, and direct state controls, it would tend to bring about in the long run a more efficient allocation of Yugoslav resources. The present system of tariffs, subsidies, and direct controls discriminates against the more efficient producers and favors the less efficient producers. A reduction in discrimination would lead to greater emphasis on agriculture, raw materials, and light industries and to less emphasis on the manufacture of machinery and equipment. Even if the government gave greater scope to economic criteria and less to political considerations in the allocation of resources, it certainly would continue to give considerable advantages to some industries.

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3. Policy Alternatives

A substantial devaluation would ease, at least initially, Yugoslavia's pressing balance-of-payments problem. The only reasonable short-term alternative appears to be a considerable tightening of direct controls over foreign trade. Although such a solution is by no means out of the question, it would be inconsistent with the general line of Yugoslav policy, which points toward greater liberalization of the economy.

Whether or not the dinar is devalued soon, however, a lasting improvement in Yugoslavia's balance of payments and in the structure of production will require greater restraint than in the past in investment policy and more effective control over credit. In recent months the regime has taken several steps to ease inflationary pressures, including suspension of work on 266 investment projects, restrictions on construction of administrative buildings, increases in the compulsory budget reserves of local and regional units of government, and stricter control over credits for enterprise working capital and purchases of consumer durables. So far, however, these measures have had little effect on the growth of investment expenditures.

Unless inflationary pressures are greatly reduced, domestic prices might rise quickly enough to nullify the favorable effects of a devaluation on the balance of trade. To prevent this eventuality, the government probably would tighten its control over prices and thereby reduce the possibilities for adjustments in the structure of production. It is likely that the rate of growth of investments will be reduced considerably in the next several years, but investment policy involves many economic interests and consequently is politically sensitive.

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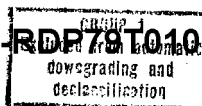
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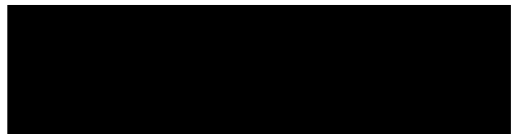
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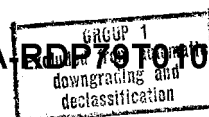
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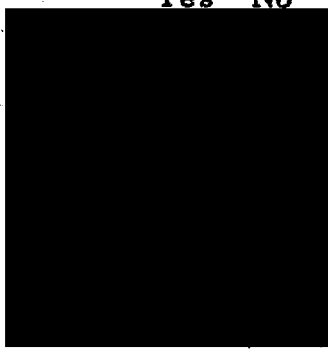
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