IMF conditionalities and debt conversion in the former Yugoslavia

by

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I. Introduction

Liquidity crises of an important country has the capability of disrupting the international financial system, and of leading to a breakdown of international financial markets, which was almost the case in 1982. A default of an important debtor country can have a devastating effect on the banking system in the industrialized countries. Körner (1984) points out that outstanding debts for developing countries from private creditors represented around two-thirds of all debts in 1982. In the same year 50 per cent of the total debt of indebted countries was owed to Western banks and the banks'assets in the developing countries were large relative to the banks' capital, therefore if a country defaulted a write-off of these assets would have resulted in a great loss of capital for the banks. Under the U.S. banking law, if debt income to banks is late 90 days, than the assets can be written off. A loss of one year's payments from three top debtor countries (Argentina, Mexico, Brazil) could have resulted in a 28 per cent loss of combined capital of the 9 largest banks in the U.S. This could have led to insolvency of the major banks. Commercial banks also played an important role in rescheduling packages to make sure that their assets in developing countries are performing and are in accordance with the International Monetary Fund's demands. Many banks felt that the IMF was increasing risk for them (Milivojevic 1985). There was a lot of concern that reliance on private loans would result in a delayed adjustment, undermining members' creditworthiness and destabilizing the banking system. Banks have been a major provider of loans to developing countries and most of the time the loans are not provided before the country enters into an arrangement with the IMF. In fact, in most contracts a default is eminent

when the country is no longer in "good standing" with the IMF. The IMF more than welcomes such parallel financing (Gold 1980).

Indebted countries violate a basic financial principle as they consume more than they earn. They use up their foreign exchange reserves and they build up debt. To be able to receive loans from the IMF, a member must first commit itself to pursue policies to deal with the balance of payment problem. These policies are called policies of adjustment or the stabilization program and they are referred to as conditionalities attached to IMF loans. What makes the IMF therefore so powerful is that its seal of approval signals the country's creditworthiness to the international financial markets. If a debtor country refuses to cooperate with the IMF its door to the international financial market is shut. To understand the severity of the debt problem Choussodovsky (1998) points out that the long term debt of developing countries was US$ 62 billion in 1970, a sevenfold increase of $481 billion in 1980 and more than $2 trillion in 1996, which is a 32-fold increase compared to 1970.

This paper will describe what is the Bretton Woods institutions' view on the problems in the developing countries and what their solution package in terms of restructuring the economy is. The Bretton Woods institutions supply loans to the developing countries and their aim is to restore financial and economic stability of countries to be able to repay back loans. The paper discusses some of the criticism of the IMF's conditionalities attached to the loans and their consequences on the economy. It analyzes the IMF's role in the former Yugoslavia, which was one of the most indebted countries in the 1980's and it shows that the consequences of the reforms in the 1980's and early 1990's, which had to be carried out under the IMF pressure in order to receive

loans were devastating and they plunged the country into an economic crisis, which contributed to the disintegration of the country. This paper shows that the conditionalities did not restore the financial health of the economy to pay back loans, in fact the country's indebtedness rose as more loans were needed just to cover interest payments on old loans. The final section of the paper focuses on debt conversions, whose use is what the IMF should have more extensively encouraged. The focus is mostly on debt swaps and debt buybacks and the analysis shows that despite its drawbacks, debt conversion was successful in reducing debt in Yugoslavia and it can be an important tool in the future in lessening the debt problem in other developing countries.

II. The IMF Solution package

1. IMF and World Bank's Aid Programs

The purpose of the Bretton Woods conference in 1944 was to establish international organizations that would be in charge of the international monetary system thereby lessening the competitive international financial policies of countries, which many believed contributed to the Depression and World War II. The IMF's role is to promote financial and economic cooperation among countries. The Fund plays a central role in the international monetary sphere. A crucial part of the role is financially assisting countries with actual and potential balance of payments problems in a way that ensures that the use of resources by countries is temporary and consistent with the goals of the institution. The proximate objectives of the IMF have been the attainment of a sustainable level of

aggregate demand to achieve financial stability, but the ultimate goal has been the attainment of supply potential and the IMF took a direct interest in the policies that encourage investment and savings, which were the base for expanding the supply potential. The Fund attaches conditionalities to loans or a so called "flexible body of policies and procedures" that support adjustment programs by encouraging the implementation of economic policies in the interest of the country and the Fund as a whole. Conditionalities were first included in the IMF's lending policies in 1952 in a world of relative economic stability. They came into existence without any reference to it in the IMF's original Articles (Gold 1980). The IMF has been responsible for balance of payments adjustment policies and the World Bank for development programs and project evaluation. However, their activities complement each other, especially with the World Bank undertaking a program of lending to countries with balance of payments problems that are in need of structural changes (Guitian 1981). In 1980 the World Bank created "structural adjustment loans," which also had conditionalities attached. By doing so, they entered the IMF's working area. Just like the IMF, the World Bank focuses on reducing trade restrictions, reduction of state intervention, abolition of price controls and price increases in public goods and services and stimulating production by devaluating the currency. Applying free market economic principles are of primary importance to both organizations (Körner 1984).

Financial aid is available to developing countries via a Stand By Arrangement. The procedure to obtain loans is as follows: After negotiations with the IMF "a letter of intent" is signed by the Ministry of Finance and/or the Central Bank, which explains the policies and plans of the country (Gold 1980). The managing director of the IMF then

recommends to the Executive Board to approve a member's request for funds when the government stabilization program is consistent with the conditionalities and sometimes corrective measures have to be taken even before the Stand By Arrangement is approved by the IMF (Guitian 1981). The IMF loan agreements do not have to be published because legally they are not international agreement. The amount on the loan is determined by quota. No conditionalities are attached to the first 25 per cent of the quota known as the Gold or Reserve Tranche as each member deposits an amount of foreign exchange equal to this sum. The Upper Credit Tranches, however, are conditioned upon a stabilization programme (Körner 1984). Performance criteria are included for loans beyond the first credit tranche, which have to be realized if the members want continued access to the resources (Guitian 1981). The credit tranche policy is a basic policy on the conditional use of funds and it consists of the first credit tranche and the upper credit tranche policy. "A purchase in the first credit tranche is a purchase that raises the Fund's holdings of the purchasing member's currency from an amount equal to its quota to no more than 125 per cent of quota" and in the upper credit tranches no more than 200 per cent. (Gold 1980). Countries with severe balance of payments problems can receive up to 150 per cent of quota each year and a cumulative limit of 600 per cent of quota within a three year period (External Debt Division 1981).

2. The Stabilization program

The IMF tries to help countries with balance of payment problems and according to the IMF " the balance of payments is a system of accounts covering a given period that is intended to record systematically (a) flows of real resources, including the services of the original factors of production, between the domestic economy of a country and the rest of the world, (b) changes in the country's foreign assets and liabilities that arise from economic transactions, and (c) unrequited transfers, which are the counterpart of real resources or financial claims provided to, or received from, the rest of the world without requital"(Payer 1974). A viable balance of payments position over a medium to long term needs a sustainable composition of balance, therefore a current account balance is an important policy objective as it measures the rate at which a country's assets or liabilities are accumulated vis-à-vis the rest of the world. To attain a sustainable relationship between aggregate demand and supply, it is crucial to focus on the gap between domestic investment and savings. Balance of payments is the economy's budget vis-à-vis the rest of the world (Guitian 1981). In the case of a deficit in the balance of payments, the government foreign exchange reserves are diminished due to attempts to bridge the gap by which the demand exceeds the supply for foreign exchange. The supply for foreign exchange is determined by the country's revenues from exports, loans and investments while the demand is determined by the price that the people are willing to pay for the imports and by what the country is sending out, i.e. capital outflow. The larger the country's foreign reserves are, the longer it can avoid adjusting a deficit. From the relationship between the imports and reserve holdings, the imminence of payment crisis

can be established. If there are enough reserves to pay only for a few weeks' imports, a crisis is on a horizon (Payer 1974).

The IMF assesses whether the balance of payments is a permanent or a temporary problem, if it is temporary regardless of internal or external origin, an adjustment program will be required to achieve a viable balance of payments by achieving a sustainable balance between the aggregate supply and demand of resources in the economy. Unsustainable expansion in the aggregate demand is characteristic of the imbalances in the economy. Aggregate demand and expenditure variations combined with relatively stable aggregate supply function are important sources of fluctuation in output prices and balance of payments. This is taken into consideration in the demand management approach to the stabilization policy. The Fund seeks to abide by a uniform treatment among members and at the same time it seeks flexibility to take into consideration different characteristics of the countries, but in no case is flexibility given to the extent that uniform treatment looses its meaning. The IMF urges all countries to establish reasonable price and exchange rate stability, high level of economic activity, a liberal system of multilateral payments and a viable balance of payments position (Guitian 1981). A uniform stabilization program consist of "abolition or liberalization of foreign exchange controls, devaluation of exchange rate, domestic anti-inflationary programmes, including: control of bank credit; higher interest rates and perhaps higher reserve requirements; control of the government deficit: curbs on spending; increases in taxes and in prices charged by public enterprises; abolition of consumer subsidies; control of wage rises, so far as within the government's power; dismantling of price controls, greater hospitality to foreign investment"(Payer 1974).To deal with the payment crisis

exchange controls, devaluation, import restrictions, deflationary monetary and fiscal policies are used.

Fiscal policy

Fiscal imbalances are often the proximate causes of unsustainable expansion in aggregate demand and therefore problems in the balance of payments. Measures to correct such imbalances demanded by the IMF are curtailing fiscal spending or raising revenues to limit the size of the public sector deficit (Guitian 1981). The following analysis will show why curtailing expenditures is important; If there is price stability and no seigniorage revenue, the government debt can be stated as follows:

$B_t = B_{t-1} + rB_{t-1} + X_t$

Where B is the government debt, r is the interest rate and X is the primary deficit, which is equal to government expenditure on goods and services minus tax revenue.

If both sides of the equation are divided by GDP, which increases at rate γ, the equation can be expressed as

$\Delta b = x + ((1+ r)/(1+ \gamma)-1)b$

where b is the ratio of the government debt to GDP and x is the primary deficit, which is expressed as a ratio to GDP. The above equation can also be expressed as

$db/dt = x + (r- \gamma)b$

where r is the continuously compounded real interest rate on government debt, and γ is the continuously compounded growth rate in the economy. The real interest rate equals the nominal interest rate i minus the expected inflation π^e. According to the theory of rational expectations, the actual inflation rate can be used as a substitution for the

expected inflation π^e. This equation shows that if the real interest rate r exceeds the real growth rate γ, the debt/GDP ratio will increase unless the government attains a surplus, i.e. x is negative. The government's budget constraint requires that the present value of tax revenue be greater than the present value of government spending plus the initial level of debt b_o, for debt not to explode. We can use the equation 2 on page 8 to show how the debt dynamics works. Assume that the GDP is $100 and debt is also $100 in year 0 with the interest rate 6 per cent and growth rate 4 per cent. In year 1, the government debt will increase to $106 as the government borrows $6 to pay off the interest. Meanwhile the GDP rises to $104 increasing the debt/GDP ratio to 101.9 in year 1, which is 1.9 per cent higher than in the year before. In year 1, the government borrows $6.36 to pay for the interest cost, therefore the debt rises to $112.6. If the government continues to finance the interest on debt only by borrowing, an explosive debt expansion will occur. Such behavior is called the archetypical Ponzi game where the borrower has no real interest of paying off the debt. Debt explodes with economic instability unless the government raises its revenues or limits its expenditures to stay solvent. The relationship between debt and deficit ratios depends on the growth rate and the real interest rate. The government can afford to increase its expenditures the higher the growth rate and the lower the interest rate. (Fry 1997).

Monetary policy

To limit the demand for foreign exchange indirectly, the government can practice deflationary monetary policy. To achieve financial balance, a deflationary monetary policy necessitates a limit on credit expansion by raising the interest rate banks charge or

on the required reserves they hold against their deposits (Payer 1974). Monetary policy has to be devised in terms of domestic credit expansion. Under the fixed exchange rate system, domestic credit policy is important to ensure that the demand for money is well-matched with the government demand for international reserves and under the flexible exchange rate system, domestic credit policy is needed to ensure that the public's demand for money and the government's objectives concerning exchange rate and price stability are satisfied. Such guidelines on domestic policy are a uniform characteristic of financial arrangements with the IMF. However, domestic credit policy is not enough to achieve a desired balance of payments position if in its formulation it ignores foreign borrowing, which is an alternative to the use of international reserves for financing. External debt and international reserve policies are important for the overall portfolio management strategy. Domestic credit and foreign credit are substitutes. By domestic borrowing the resources are transferred from surplus sectors to deficit sectors and without foreign borrowing output and growth depend on the propensity to save and investment efficiency. Foreign borrowing provides the economy with more resources (Guitian 1981). To "combat inflationary pressures", the government is often advised to practice a policy of tight restriction on money supply which necessitates real expenditure cuts, reduction of real wages and laying off workers in the public sector (Chussodovsky 1998). To deal with excessive demand the IMF advices to put a ceiling on domestic credit, to increase the interest rate and to control the money supply (Körner 1984). The debtor is requested to put a ceiling on the expansion of credit since balance of payments problems are often a result of excessive national spending and therefore it is crucial that aggregate demand is brought in line with output. Moreover, credit expansion ceilings increase effectiveness of

financial policies including channeling of resources to the private sector. If the policy on credit has a negative effect on employment and growth, the policy has to be formulated in a way to encourage savings and investment (Gold 1980).

Devaluation

Demand management policies are needed to hold aggregate demand to a level consistent with the global supply of resources. Financial stability encourages the mobilization of domestic savings and efficiency of investment (Guitian 1981). The IMF considers high inflation a result of "excessive demand" meaning the demand in terms of monetary units is greater than the available supply of goods and services, which puts the pressure on the balance of payments. High inflation also leads to an-overvalued currency because the decreasing purchasing power no longer corresponds to the official fixed rate of change. Because of the fixed exchange rate imports are relatively cheap. Devaluation's goal is to make imports more expensive and exports cheaper so as to stimulate exports, thereby improving the balance of payments. Overvalued currency results in an increase in imports and a decrease in exports causing the balance of payments deficit to rise. In many cases the IMF demands devaluation even before the loan agreements are signed. A viable balance of payments cannot be attained if the currency is overvalued, therefore devaluation is a necessary step (Körner 1984). Import restrictions such as tariffs and quotas make it harder to import despite the exchange being freely available. If exchange and import controls are lifted, devaluation has to occur to compensate for heavier demand for foreign exchange (Payer 1974) Devaluation is useful as by increasing the price of international goods relative to domestic goods, adjusting the exchange rate shifts the

demand from international to domestic goods. Moreover, devaluation reduces the real value of nominal assets therefore creating an excess demand for these assets; devaluation lowers the growth in the demand for goods and allows a shift in the flow of spending for restoration of balance in the market for nominal assets (Guitian 1981).

Exchange rate is a crucial instrument of macroeconomic reform and part of the IMF stabilization package. Currency devaluation, the unification of the exchange rate and the elimination of exchange controls affect the supply and demand in the economy. The exchange rate is a regulating mechanism for the real prices paid to producers and also the real value of salaries. The IMF's view is that the exchange rate in the indebted countries is overvalued (Chussodovsky 1998). Exchange rate is an important instrument as it is used to balance the external account and to monitor domestic absorption and it has an important role in the allocation of resources between domestic and external sectors (Guitian 1981). Multiple exchange rates could be imposed as devaluations affect the competitiveness of different goods differently and they recognize that increases in the prices of "indispensable" goods such as medicine has a negative effect on the economy (Körner 1984). However, the downside of exchange control system to restrict imports is that it is vulnerable to corruption (Payer 1974). Most of the points regarding the role of exchange rates apply to interest rates as they are important for attaining a viable balance of payments position and it is important to attain internationally competitive interest rates to retain domestic savings and to encourage investment. Moreover, most of the time domestic interest rates are a stimulant for the mobilization of domestic savings, which makes positive domestic rates attainable, which in turn influence the domestic savings-

investment process and therefore the current account of the balance of payments (Guitian 1981).

3. Criticism of the IMF conditionalities

All the above mentioned policies are imbedded in a package as conditionalities, which are crucial in gaining access to IMF's financial assistance and they have been an object of criticism within and outside of the Fund. Especially conditionalities in the upper credit tranches have often been labeled as strict by the critics since major changes are expected to take place in a short time. They have been criticized as being too standardized and based on market economies (Gold 1980). The policies that also have to be carried out besides the above mentioned are trade regulation, deregulation of the banking system, privatization of state enterprises and agricultural land, tax reform, poverty alleviation, etc. Critics argue that the same policies of devaluation, budgetary austerity, trade liberalization, privatization, etc. are imposed in more than one hundred indebted countries (Chussudovsky 1998). The IMF has been criticized for its reforms as they frequently call for cut backs in social programs, strict limitations on wage increases, extensive lay offs in the public sector and closing down of unprofitable enterprises. The IMF reforms lead to a high unemployment rate in the private and the public sector. Critics argue that since the balance of payments deficits are often a result of high import bills and high interest rate levels, inflation that is treated with "demand-reducing therapies", makes matters worse.

Much of criticism has been focused on devaluation as the IMF often demands devaluation prior to even starting loan negotiations. The criticism of devaluation is that it

leads to a decline in the purchasing power and that it lowers the demand for domestically produced goods. It leads to a contraction of the domestic market through a restriction on demand and a reduction in the supply. For example, imports become less expensive than the comparable domestic products and as a result the domestic production drops (Körner 1984). Devaluation in practice does not work as stated in theory. Imported products with high demand will be imported regardless of the new exchange rate as consumers may prefer the imported products. Moreover, devaluation triggers inflation and "dollarisation"of domestic prices (Chussodovsky 1998). If devaluation is successful in stimulating exports, then the price of domestic products will increase as less will be available for local consumption assuming there is no increase in production. Moreover, often exporters just extract a higher profit at the new exchange rate and do not really lower their export prices when devaluation occurs (Payer 1974).

Critics have also focused much of attention on tight monetary policy as it can worsen the debt problem as it raises the interest rates, increasing the debt service and the growth in debt, ceteris paribus. It also lowers the growth rate in the economy, increasing the debt/GDP ratio and reduces the surplus by decreasing economic activity causing the tax revenues to decrease (Dornbusch 1996).

The following analysis will show that in the case of former Yugoslavia, following the IMF induced reforms, all economic indicators worsened and the economy plunged into an economic crisis.

II. Debt problem in Yugoslavia

1. Background

Yugoslavia in 1982 was one of the most indebted countries in Europe and one of the major debtor countries in the world with GNP per capita of $ 2,800 and $ 881 of debt per capita (table 1). Table 2 lists the top 10 per cent of IMF's Members' of total Stand by Arrangements per year (1952-1984) without considering the length of membership. Yugoslavia was placed second. Moreover, table 3 shows that Yugoslavia was placed seventh with receiving 4.56 percent of total Bank funds between 1950 and 1980 (Assetto 1988). The country's survival was dependent on debt but the heavy burden of debt servicing and the implementation of the reforms to satisfy the IMF took a heavy toll on its economy and ultimately to its demise. Since Yugoslavia was a neutral country, the reasons for supplying the country with loans even though it was many times ineligible to receive them, was political as the West used financial aid to ensure that the country did not enter the Soviet Block. Table 4 shows that Yugoslavia had received an unusual amount of loans relative to countries with similar economic characteristics. In a regression exercise by the IMF, a Stand-by-Arrangement (SBA) loan was the dependent variable and for the World Bank, the amount of loans received form the World Bank was the dependent variable. Yugoslavia received eight SBA's and 25 World Bank loans between 1962 and 1984 amounting to $3.2 billion and $3.1 billion. As tables 4 and 5 show the Yugoslav SBA exceeded the excepted amount by at least 2.5 standard deviations from the mean, reaching over 13 standard deviations in 1981. The loans from the World Bank exceed 2.5 standard deviations only in the year 1967 and 1979. Assetto

points out the bank lending in 1970's continued even though Yugoslavia was ineligible to receive loans suggesting non-economic criteria playing a role in the lending (Assetto 1988).

Yugoslavia was a very complex country with many ethnicities, languages and religions. It came into existence as a Socialist Federal Republic of Yugoslavia in 1945 and it consisted of six republics (Slovenia, Croatia, Bosnia-Herzegovina, Serbia, Montenegro and Macedonia) and two autonomous provinces (Vojvodina, Kosovo).
It was reduced to a rubble during World War II but it boosted one of the fasted growing economies in the 1950's and in the 1970's it had one of the highest investment rates in the world. It was a nation with distinct economic and foreign policy as it did not enter either of the political blocks and its economy embarked on a road of market socialism and worker's management.

Under the unique system implemented in 1950's, the central government's role in economic decision making diminished as households and enterprises decision-making became increasingly based on market forces. Collectivization of farms had stopped and farms with no more than 25 acres were allowed to be legally private. In other sectors, private enterprises with no more than five people were allowed to be legally private. All enterprises with more than five employees were to stay socialist. All capital and natural resources were in the possession of the people. As opposed to the Soviet Union, the state did not order workers around. The idea was that the Yugoslav enterprises operated in a democratic and not in an autocratic manner. The ultimate authority was given to the workers. They were acting as trustees; they decided on the use of inputs, what products to produce and where to sell them and they decided on the price to charge. Moreover, they

decided what to do with their net revenue; how much to invest in innovations and the firm and what portion to invest in collective consumption such as housing for workers or how much to give it to workers as personal income payment (Kohler 1989).

The middle of 1950's was marked by high economic growth, in fact the country had one of the fastest growing growth rates in the world, a 13% an average (Payer 1974). In 1952 the unemployment rate was only 2.2 percent (Kohler 1989). From 1956 to 1964, the inflation, measured by producer prices, averaged 1.5 percent per year (Zimbalist 1984). In 1965 the IMF began its substantial support in the form of loans (Payer 1974). The country became a member of GATT in 1965 bringing trade and tariff regulation into accord with international practice. Moreover, in 1965 reforms were carried out under the IMF pressure. However, following the reforms the annual inflation rate during the period from 1965 to 1975 rose to 10.4 percent (Zimbalist 1984). Unemployment first became a real problem after the 1965 reforms, due to the recession that followed the reforms and due to the emphasis on efficiency accompanying the reforms (Schrenk 1979). The economic situation worsened and that combined with political problems necessitated further reforms and a change in the Constitution in 1974. Resource allocation was further decentralized and the main change was decentralization of self-management through creation of BOALs (Basic Organizations of Associated Labour) and a new system of contractual planning. An enterprise now became an association of independent BOALS and each BOAL was responsible for its assets and decisions. Such system required coordination between BOALS, which resulted in lengthy periods of negotiations and lack of speedy action due to different interests (Repe 1995).

2. Foreign exchange crisis

Yugoslavia had its first foreign exchange crisis in the 1950's and by 1961 its debt of $800 million was a heavy burden on the balance of payments. An increase in agricultural products was offset by manufactured imports and the trade deficit kept growing. More loans were needed and in 1965 only repayments amounted to $290 million (Payer 1974). In 1972 and 1973 the current account was in surplus of more than $400 million but by 1975 it was again in a deficit of $1 billion. More aid was needed and by 1976 the external debt amounted to $1 billion (Assetto 1988). Moreover, what worsened the foreign exchange crisis were interepublican strives as Croatian nationalists demanded that most of the foreign exchange stays in the republics and the 1974 Constitution imbedded this demand (Payer 1974).

In 1978 and 1979 Yugoslavia received new multilateral credits from the World Bank and the European Investment Bank. Monetary policy, which was the main instrument of demand management during the 1970's was ineffective, in fact it contributed to the rise in prices. According to OECD, at the time a policy of restraint was in place but at the same time the money supply increased at record levels. The trade balance hit a record deficit of a $7.2 billion in 1979, mostly due to oil price increases. The current deficit also reached record levels and external deficit and external debt increased from $6.6 billion in 1976 to $20 billion in 1982 (Assetto 1988). A cut was made in imports from $13 billion in 1979 to $11.8 billion in 1984 and the trade deficit was brought down from $6.4 billion in 1979 to $1.8 billion in 1984. The current account was in surplus of $800 million in

1985 and the official reserves were only 1 billion. (table 6) (Dyker 1990). From 1972 to 1982 debt grew by 400 percent and 89 percent of domestic investment funds used to increase growth came from loans (Cichock 1985). One of the factors that caused an increase in debt in the 1970's was commercial bank borrowing from abroad to be able to finance the expansion of credits. With high inflation, interest rates were negative and the government came under tremendous pressure to cover the bank losses by primary emission. Yugoslavia resorted to private borrowing as they wanted to avoid conditionalities all together (Dyker 1990).

3. IMF's role

Loans

Regarding Western help, since 1961 many arrangements were made and loans were given on conditional basis. In return the country had to liberalize trade, price regulations, etc. Many times Belgrade could not fulfil the requirements and "time and time again the international financial organizations forgave and forgot". The World Bank gave the country $2.2 billion for 1961-1982 infrastructural investment alone (Dyker 1990).

In the 1980's, unlike in the 1970's, loan conditions were made harsher with shorter maturities and floating interest rates. The interest rate in 1982 at which the country borrowed was 11 per cent for official creditors and 14.7 for private creditors. (table 7). In 1981 the IMF agreed on a $2.2 million three-year credit, which back then was considered as the IMF's biggest credit. Conditionalities were laid down by the IMF and Yugoslavia was expected to practice restrictive monetary and fiscal policy, reduce government

expenditures and it was expected to have realistic exchange and interest rates. In 1981 Yugoslavia's indebtedness to IMF was 400 per cent of the quota and the limit was 450 per cent. Yugoslavia could barely cover its current account deficit and in the end of 1981 the governor of the National Bank was again negotiating a loan from Western banks. The loans were approved and in 1982 the situation worsened as $5billion + of debt service was due in 1982. The country needed even more loans in order to cover its debt commitments to international creditors. The economy had serious liquidity problems and mismanagement of the situation became clear. One of the government officials stated that "we still today do not have exact data with respect to our foreign obligations" (Dyker 1990). Ironically Clausen, the president of the World Bank visited Yugoslavia in 1982 and complimented the government for the efficient use of funds and advised them to concentrate on exports promising in exchange for the adoption of World Bank policies even more credits. Some say that Clausen went "out of his way to speak smoothing words". In 1983 many banks refused to lend funds to Yugoslavia despite the IMF pressure. Again, the IMF came to "rescue" as it provided the country with new loans and additionally the World Bank gave $400 million as a structural adjustment loan (Milivojevic 1985). Meanwhile, $1.6 billion was lent in a largest ever SBA ever negotiated by the IMF in support of austerity and stabilization measures (Assetto 1988). In 1983 they were earning enough to pay all the interest and a bit of the principal (Dyker 1990). The government tried to reschedule its loans and in 1983 they arranged for a reschedulment of $5 billion (Linden 1986). Moreover, they implemented an austerity plan to show it was serious about meeting debts and consequently ready to receive loans for the following years (Assetto 1988). However the government kept engaging in a

Ponzi game as in July 1987 it could not meet its debt repayments, which were a result of 1983 emergency borrowing. $2 billion of repayments and $2 billion of interest payments had to be paid to creditors in 1987. The situation was worsened by the high rate of withdrawal of private citizens' bank accounts as they lost faith in the constantly depreciating dinar (Milivojevic 1985).

Stabilization program

To act in accordance with the IMF demands a Commission for Problems of Economic Stabilization was formed in 1982, which set the following targets and guidelines until the end of the century: affiliation with a stronger set of national priorities and basic proportions within decentralized planning which set in 1976; initial tightening of price controls and a tighter monetary policy followed by removal of controls; lowering the amount of subsidies and a promise to close down businesses operating with a loss; increase in interest rates to revitalize saving and to rationalize investment; a requirement was set for enterprises to use retained earnings to pay for part of any new investment project; a unified and realistic exchange rate was set to take place, and decentralization of the allocation process of foreign exchange borrowing rights between the republics; lowering the overall tax burden, and a transfer from indirect taxes, which were considered to be inflationary, to direct taxes on income was planned (Repe 1995). The policies were meant to deal with the growing debt problem.

IMF reforms in late 1980's

The reform package under Markovic's government in 1989 strengthened bankruptcy and liquidation laws. The state was not allowed to give any subsidies to loss making firms and banks and bankrupt firms could no longer receive bank loans. At the time of reforms approximately one third of the 27600 firms had losses and the debt of the banks was approximately $3 billion dollars (see internet reference 1 upinfo). The Financial Operations Act of 1989 was also enforced and it gave more power and rights to creditors in settlement and bankruptcy procedures. If the enterprise was bankrupt for 30 consecutive days or for 30 days within a 45-day period, it had to have a meeting with its creditors within 15 days to reach a settlement or deferment of payment. There were times when creditors, including banks converted their loans to controlling equities and the enterprises kept working. It was the creditors that were in charge of reaching a settlement not the government. If settlements were not achieved, the bankruptcy procedures continued in courts. Workers in bankrupt firms did not get any compensation payments. There was a dramatic increase in the unemployment and the most affected areas were Serbia and the southern republics. According to the World Bank most firms had a labour surplus and that amounted to 20-30 percent (WB 1991). Following the IMF program, in less than two years, 600 000 workers were left without a job out of a 2.7 million workforce and another 1.9 million workers were in surplus. Moreover, Enterprise law of 1989 was introduced, which demanded the transformation of BOALs into private firms with the Worker's Council being transformed into a "Social Board". The control of the

Social Board was to lie in the firms' owners and Western creditors. Furthermore, massive privatization was demanded (Chossudovsky 1998).

In 1988 the Foreign Investment Law was also enforced and it gave foreign capital unrestricted access in industry, banking, insurance and the service's sector. Moreover, a new banking law was passed, which liquidated socially owned Associated Banks, more than 50 percent of nation's banks were dismantled and the encouragement of 'independent profit-oriented institutions' was strong. The World Bank basically destroyed the entire three tier banking system which consisted of the National Bank of Yugoslavia, the national banks of six republics and two autonomous provinces and the commercial banks (Chossudovsky 1998).

With reforms in 1989 headed by Markovic's government the WTO's principle of national treatment was implemented into the system, which meant equal treatment of Yugoslav citizens and foreigners alike. Furthermore, the government denominated the dinar (four zeros were erased), pegged it to the deutsche mark and declared it a convertible currency. The reforms also demanded a freeze on personal incomes over a six-month period (Macesich 1993). In phase two of the reforms policy makers encouraged banks to keep interest rates down, and they tried to allow market forces to stimulate investment in the private sector. They reformed the tax policy to encourage investment and created an agency, which was in charge of the development of small and medium sized firms (1 upinfo).

1990 reforms

Under the IMF pressured 1990 reforms the IMF unabled the government to use monetary policy as the government was refused access to credit and therefore it was not able to fund economic and social programmes. Moreover, the deregulation of commercial credit decreased investment by socially owned firms. In order to transfer its revenues for repayment of debt, the government was forced by the IMF to freeze all transfer payments to the republics, fuelling succession. Furthermore, government expenditures had to be cut by 5 percent of the GDP. Even though the inflation was eating away salaries, the government was forced to freeze wages at their mid 1989 level. IMF also demanded full convertibility of the currency, liberalization of interest rates, and additional reductions of import quotas. With the deregulation of trade the country was flooded with imports, which were paid by loans, and a greater destabilization of domestic market followed (Chossudovsky 1989). The government was also forced to remove price controls on 85 percent of all commodities. Price controls remained only on essentials such as electricity, gasoline, oil, coal, some raw materials, railroad, postal and telephone services (1Upinfo).

4. Consequences of the IMF's intermediation

Early 80's

Debt crisis resulted in lower production levels, lower standard of living and a higher inflation. According to a Yugoslav economist Korosic two thirds of the population did not have salaries high enough to have a normal life (Dyker 1990). Moreover, in the beginning of 1980's the growth rate was only –1 to 2 percent each year (Kohler 1989).

From 1981 to 1985 the growth rate was close to ten times slower when compared to the period from 1976 to 1980 and also to the relation of the period from 1948 to 1985 (Franges 1987). Because of the difficulties surrounding the foreign debt, the National Bank declared a freeze on investment in 1982. Collective consumption fell from 42.2 percent of Gross Social Product in 1979 to 31.5 percent in 1984 (Dyker 1990). Inflation skyrocketed and unemployment increased. What contributed to high inflation rates was the devaluation of the currency dinar, growing international payment deficits and foreign debt. Yugoslavia's debt grew on average 10 percent per year, rising from $2 billion in 1970 to $15 billion at the end of the seventies. In 1983 the debt reached $21 billion (Zimbalist 1984). Many times the country could not break the vicious cycle of balance of payment deficits, which called for devaluation of dinar, which caused import costs to rise causing inflation and another round of balance of payment deficits (Gardner 1988). As a result of inflation Yugoslav export industries suffered as inflation raised the costs of Yugoslav products (Stuart 1985). Between 1975 and 1980 inflation was at an annual rate of 50 percent (1upinfo). In the 80's the National Bank of Yugoslavia's ability to control inflation was worsening due to extensive trade credits between enterprises. Even though the central bank lowered the growth of bank lending in the 80's, it could not do much about business lending. Between 1980 and 1985 the percentage of trade credits in enterprise liabilities increased from 37 to 46 percent and at the same time bank credits fell from 51 to 39 percent. Because debts had to be repaid, the government came under political pressure to use emergency measures and it injected new credit. Such practice occurred too often in the 80's and this led to uncontrolled growth in money supply and consequently inflation. The inflation rates were rising each year and by 1986 the inflation

reached 88 percent (Gardner 1988). In fact, in the 1980's Yugoslavia had the highest inflation rate in Europe and international indebtedness in Eastern Europe and from 1980 to 1981 the international value of dinar dropped by 50 percent (Repe 1995).

Period after the stabilization program

The stabilization program successfully tackled the balance of payment problem and in 1983 Yugoslavia had its first balance of payment surplus after seven years and this continued for a few years. Also, the external debt was kept stable until 1985. Since the government thought the balance of payments was under control, it practiced expansionary fiscal and monetary policy and it abandoned the target to close unprofitable enterprises. However, such measures did nothing to reduce unemployment and they actually caused inflation to rise and the reappearance of the international payment problem (Repe 1995). In 1983 the "first substantial effective" devaluation of dinar since 1960 occurred. However, in 1985 with high inflation export profitability was again in question and the dinar was considered overvalued throughout 1986. In the same year the black market rate for dinar against the dollar was 50-100 percent higher than the official. In May 1988 the IMF demanded the devaluation of dinar to the level of the black market rate. After 1983 the authorities tried to keep the rate of devaluation higher than the rate of inflation. As a result enterprises had little incentive to export. Exports were manufactured goods, ores and processed goods. One third were of exports were electrical goods, machinery and transportation equipment. To lower the debt an effort to increase exports was made and the government's slogan for trade policy became "Exports by Any Means". Exports did

increase and the prices of exports dropped. In 1986 the trade deficit with the EEC dropped to $1 billion from the 1980's level of $4 billion. (1upinfo).

Because of the debt service crisis in the 1980's the authorities imposed short-term emergency measures by cutting imports and for consumer goods such as petrol, sugar, detergent, coffee, rationing was imposed. Import restrictions hit hard consumption as well as production due to a shortage of imported raw materials. Construction output fell by about 50 percent throughout the 1980-1987 period (Dyker 1990). From 1980 to 1988 productivity came to a near halt and investment fell to an average annual rate of 5.7 %. Moreover, standard of living fell; consumption declined at 0.6 percent per year, disposable income per capita at 1.8 % and the real wage at 2.3 percent (Gapinski 1993). In 1986 a temporary ban on noneconomic investments was placed, price controls were tightened and additional devaluation of dinar followed. In 1987 the inflation rate reached 140 percent (Repe 1995). The government froze wages at the end of 1986 level. Workers were unsatisfied with this measure and more than 50000 of workers started protesting. In fact, in one of the biggest hospitals in Belgrade patients were left not cared for a day (Gardner 1988). The number of dissatisfied workers increased and 150 000 workers in 1000 enterprises demanded the resignation of Prime Minister Branko Mikulic (Kohler 1989). Consequently, the government had to abandon this measure and increase the salaries (Gardner 1988). The salaries compared to the end of seventies dropped by 24 percent in 1988. Only in 1988 approximately four million people protested against economic and political mismanagement (Cohen 1995). In 1989, 60 percent of workers lived at or below the minimum income level guaranteed by the government; the standard

of living fell by 40 percent since 1982 to the level of mid 1960's. Average salary in the social sector was 170 USD in 1989 (1upinfo).

In 1988 the inflation reached 200 percent and ethnic tensions reached a critical point (Kohler 1989). By 1989 the economic situation was even worst as inflation reached 250 percent (Repe 1995). The tax system was unified with a change in Constitution and the new taxes were higher as more money went to the Yugoslav National Army, which was politically backing up the government. At the end of 1989 the inflation reached 366 percent and many blamed the government as it had control over 80 percent of prices. Consequently, the government fell in 1989 and the country was on the brink of a break up (Nesovic/ Prunk 1993). Yugoslavia boosted the highest foreign debt in Europe and the IMF provided new loans in return for cutting inflation by limiting expansion of domestic bank credits and demanded from the government to relax foreign exchange controls and open an effective foreign exchange market (1upinfo). Following the agreement with the IMF inflation skyrocketed and the real interest rates stayed negative. The IMF demanded that Yugoslavia liberalizes and rationalizes its economic system. The overall situation got worst. By May 1988 after successive devaluations the official rate for dinar was equal with the black market rate (Dyker 163). Inflation in 1989 reached in March 368 percent, in April 441 percent, in the summer it reached almost 700 percent. The situation was so bad that the money brokers at the Austrian border measured the dinar in cubic meters. In September, the annual inflation rate reached 1188 percent, in November it was already 1900 percent, and in December the "super" dinar was introduced, which placed the decimal point four places to the left, twice as far as following the reforms in 1965.

The Philips curve inverse relationship between employment and inflation did exist in the 1960's and 1970's but in the 1980's it disappeared. "The post-debt shock trend is for employment to rise, and for inflation to go through the roof;" authorities in Yugoslavia had great difficulty controlling the supply of money (Dyker 1990).

The unemployment problem got worse and at the end of the 80's more firms declared bankruptcy and more people lost their jobs. For example, in only the first half of 1986 108 firms went bankrupt compared to 61 bankruptcies in the whole year of 1985 (Gardner 1988). In "fully employed" Slovenia which had 14,836 people unemployed at the end of 1985, there were still 100 000 surplus workers (Dyker 1990). In 1986 the unemployment rate was 13.9 percent and if it were to include the migrants who went to Western Europe, the rate would have been more than 20 percent. Tight monetary and fiscal policy unleashed to combat inflation and strengthen the balance of payments, contributed to high unemployment rates (Gardner 1988). At the end of the 1980's the Croatian power industry was closed to bankruptcy and the Yugoslav oil industry was near collapse. Unemployment rate increased from 14 percent in 1984 to almost 20 percent in 1989 (1Upinfo). Yet the Bretton Woods institutions demanded even more reforms in exchange for loans. In 1986, Yugoslavia broke its stand-by-arrangement due to the dissatisfaction over the IMF's policy and a s a consequence the World Bank declined its request for more loans but the agreement was agreed on a year later (Dyker 1990).

Period after 1990 reforms

In the beginning of 1990 the inflation rate reached 3282 percent (Gapinski 1993). Despite the pegging of the dinar to the deutschmark the prices were still raising. Real wages decreased by 41 percent in the first six months of 1990 (Chossudovsky 1998). However, the inflation rate in April 1990 was brought down to zero and the revaluation of dinar was credited with an export increase of 21 percent and an import increase of 32 percent and a $3 billion increase in foreign exchange reserves in the beginning of the 1990's. By the middle of 1990 there were 1200 new joint investment deals with foreign firms. However, productivity did fall by 8.7 percent because of extreme monetary controls to decrease the money supply and because so many of the loss making firms had to close down increasing the number of unemployed (1 upinfo). Meanwhile equipment production and consumables fell and their fall reached record levels (Gapinski 1993). In 1990 the annual growth of GDP was –7.5 percent, in 1991 decreasing by further 15 percent (Chossudovsky 1998).

Furthermore, regional development differences were not solved by the reforms and they continued being a major problem and a constant battle among the republics. The gap between the relatively rich north and poor south was widening and the resources, which had to be given to the less developed areas were a huge burden on the more developed areas. Slovenians who contributed 25 percent of Yugoslavia's hard currency export earnings to the Fund for underdeveloped regions were against the additional requirement to pay 20 percent of republic's income for subsidizing non productive firms in other parts of the country. This issue contributed to Slovenian secession. In 1990 the Slovenian

government reduced its contribution to the Fund and Croatia threatened similar actions. At the time economic autonomy and membership in the EEC (European Economic Community) became better alternatives for those two countries (1 upinfo). Despite all the quarrels however, at the end of the 1980's, the government of Ante Markovic was set on reforming the economy from a socialist to a capitalist. Markovic even managed to almost sign an association agreement with the European Community. More and more entrepreneurs were opening private businesses and the shops were full of goods. More advanced compared to other Eastern countries, it would have been relatively easy to carry out reforms had the republics not been involved in constant strife. The federal government's power was seemingly declining which was best seen in two events that took place. In 1989 Milosevic ordered the Serbs to boycott all Slovenian goods and in 1990 his government carried out one of the greatest bank frauds in modern financial history, thereby increasing the debt. Serbian bank balance sheets went up by about 1.5 billion dollars and the companies that supported Milosevic got the so-called grey dinars in the form of credit, which was used to buy hard currency. The Serbian government managed to pull this as even though they had not yet seized the control of the National Bank of Yugoslavia, they did control the National Bank of Serbia and Vojvodina. The scale of the Serbian fraud was one of the key events that made the death of Yugoslavia inevitable (Judah 1997). Indeed, on the 26th of June 1991 Slovenia and Croatia declared independence and the Socialist Federal Republic of Yugoslavia ceased existing.

It is obvious that IMF's conditionalities did not restore the health of the economy so it would have been able to pay back the interest and the principal. In fact, the conditionalities made the repayment impossible as the economic situation worsened and

the country needed more loans just to pay back the interest on old loans. What would have helped to alleviate the debt problem is the market based schemes, which could have provided an alternative to rescheduling and concerted lending. It is unlikely that debt repudiation would have been and would ever be implemented and even such scheme could damage the country's creditworthiness in the international financial markets for a long time. The most efficient market based schemes, which should have been implemented in the case of indebted countries are debt conversions such as equity debt swaps and debt buy back. Such schemes were used in Yugoslavia, however, not as widely as they should have been, in particular in the case of debt equity swaps. The analysis will show such schemes do not offer any magic solutions; however, they can make a significant contribution to reducing the debt problem.

III. Debt Conversion

Debt conversion is a technique to relief debt, which changes the original value of loans, allowing the debtor country to reduce its debt. Most commonly used debt relief techniques are: debt-equity swaps, securitization, capitalizations, debt-for-bonds swaps, debt-for-debt swaps, debt-for-assets swaps, etc. In addition there are informal debt conversions such as round tripping and local currency prepayments (UNITAR 2003)

The debt conversion program was successful as it reduced the Yugoslav debt by $1.8 million or 25 per cent of its commercial debt in 1989. In the first six months of 1990's the debt was further reduced by $376.8 million or 5 per cent of the total debt. Moreover,

savings in interest payments were $115 million in 1989 and in the first six months of 1990 by $120 million. This had a positive effect on the balance of payments. Debt conversion programs were different from those carried out in other developing countries as they were highly flexible, decentralized at the commercial bank level with few restrictions on participants. In contrast, in Chile and Argentina the conversions were made through a single intermediating institution. In 1986 the market price of the Yugoslav debt was 80 per cent of its nominal value making a 20 per cent discount, which was not favorable for debt conversions. However, the environment became more favorable in 1987 and in 1988 as the discount increased to 53 per cent. In 1988 the Federal Executive Council started issuing permits for debt conversions. The following types of debt conversions were used in Yugoslavia: debt-dinar conversion, debt-equity swaps, debt-export of products or service swap and debt-debt swaps. The most common form of debt conversions was debt-dinar conversions. Debt-equity swaps have represented the largest share of debt conversion programs in other countries; however, in Yugoslavia debt-for-exports conversions have been most extensively used. Table 8 shows the different types of conversions used in 1988 and in 1989. Debt-export conversions constituted 42.8 per cent, debt-re-export conversions 38.3 per cent and other types of conversions were less widely used adding up to only 20 per cent of retired debt. Debt exports had the largest share as producers were keen on capturing part of the discount and the economy had a good export potential despite its relative low level of exports. Debt re-export conversions were designed to reduce the surplus on the country's clearing account with countries from the Soviet Block. Debt re-exports were an important type of debt conversions as the surplus was one of the main contributors to inflation. In a period of

high inflation enterprises were keen on converting loans in foreign currency into dinar loans or to repay loans from their "own accumulation". A big obstacle to an increase in the volume of debt conversions was a short supply of dinars. Overall, debt conversions did not have an inflationary impact as the Law enforced that dinars for debt conversion came from real accumulation. Debt-export conversions, however, can have a negative effect on the balance of payments, which was the case in Yugoslavia in 1988 and because of the negative effect, the Central Bank made conditions for such transactions tighter (Mrak 1992). This is why I will focus on debt-equity swaps and debt buybacks, which despite their drawbacks should have been used earlier and more extensively .

1. Debt-equity swaps

Debt-equity swaps are a form of a debt relief technique and they involve the creditor foregoing a part of a debt in return for a part in the debtor's equity (UNITAR 2003).
The debt-equity swap market had emerged at the same time the 1982 debt crisis was prevalent, though there were some isolated uses of debt-equity swaps even earlier (Blackwell 1989). Debt-equity swaps are also a "useful tool" for diversifying banks' portfolios and they can be also used for banks entrance into markets of countries with high indebtedness without increasing their risk exposure (Mrak 1992). The use of debt-equity swaps depends more on the political climate of the country rather than an economic and financial consideration but it has had a significant impact on individual

countries. For example, in Chile in 1986, approximately $1 billion of debt was converted into equity; thereby a reduction of debt was about 5 per cent (Blackwell 1989). Debt-equity swaps were not as widely used in Yugoslavia despite the expectations as in 1988 and 1989 they retired only $57.3 million of the debt and the only project carried out on the basis of debt-equity conversion for which the Central Bank was willing to print money was the joint venture Hyatt Hotel in Belgrade. The reasons for a small volume of debt-equity swaps were high inflation; legislation, which allowed full foreign ownership came to existence only in 1989 and the tax and labor laws were not clearly defined. In the second half of 1990's political risk was discouraging foreign investment and thereby also creating unfavorable conditions for debt-equity swaps (Mrak 1992).

Effect on the balance of payments

The following analysis shows the impact of debt-equity swaps on the balance of payments. An assumption is made that the loan and equity conversion are carried out in the same period in the balance of payments. The transaction is recorded in the following way:

Debit: foreign exchange assets	$100 million
Credit: external liabilities	$100 million

At the second stage, the conversion of debt to equity takes place and no cash payments are required by the country for redeeming the debt. The transaction is as follows:

Debit: external liabilities:	$100 million
Credit:	$100 million

Furthermore, loan consolidation gives the following:

Credit: external liabilities:	0.0
Debit: foreign exchange assets	$100 million
Credit: direct investment	$100 million

The final result for a debtor is a reduction in its external liabilities, an equivocal increase in investments and an unchanged level of foreign exchange. But the net effect on the economy is also dependent on how the debtor finances the domestic corresponding item of converting debt into equity. The conversion can have an impact on the balance of payments via the overall cumulative effect on net factor payments. If the government does not restrict direct investment for instance with respect to repatriation of capital or remittance of dividends, than the payments abroad from equity investment would be higher than interest payments on the redeemed debt. But instead of paying off the debt at interest rates determined by the outside factors, the remission of dividends and profits by the debtor would be influenced by the profitability of the investment, thereby establishing a more direct link to its servicing capacity. In such case debt-swaps would lower the debt service burden (Blackwell 1989). However, if the external debt is surrendered in exchange for an amount of domestic currency equal to the face value and not the market value, there will be no debt reduction. To illustrate this, a $100 million of old debt is exchanged for $100 million worth of local currency, the creditor can buy the equivalent of $100 million worth of domestic equity but the debtor would have to borrow the equivalent of $100 million from a third party and there is no debt reduction (Dooley 1990).

The direct investment via debt equity swaps is often focused on export oriented industries, thereby they can contribute to more successful trade performance (Blackwell 1989). The "investment income" in the balance of payments represents a large debit in most indebted countries. Because payments for interest in amortization of foreign debt take up a large part of export earnings, making it hard to finance the level of imports, it becomes an important cause of the payment crisis and an object of change (Payer 1974). Moreover, if the government agrees not to impose penalties or taxes, repatriation of flight capital could help to alleviate foreign exchange problems. Since many countries have a capital stock large in relation to debt, the potential for equity sales in exchange from debt is significant (Corden 1989). The limitation of debt-swaps is that the debtor countries have to tackle the adverse affect of converting foreign debt into domestic currency and there are fears over too much foreign ownership (Blackwell 1989).

Direct investment would have benefited the country as successful investments contribute to a creation of new jobs, greater output, via the accelerator mechanism; they bring in tax revenues and increase productivity through the introduction of new technology and expertise. However, it is up to the country to have an appropriate political and economic climate to encourage foreign investments. In Yugoslavia there was another limitation as if the government swapped debt for equity in socially owned enterprises, it would have incurred a reduction in its future tax revenues but this fiscal problem could have been solved by privatization and the government would not only benefit from a reduction in debt due to debt-equity swaps, but also from increased efficiency and a lower burden to provide subsidies to enterprises. In that sense since only enterprises with up to five people were allowed to be private, a limit on the benefits of such scheme was a

result. This could have been solved by privatizing all socially owned enterprises but that was a threat to the social fabric of the country.

Effect on the money supply

To analyze the impact of debt-equity swaps on the money supply, Blackwell (1989) used the following equation:

$\Delta M \equiv G-T + \Delta NFA^{g} + \Delta DC^{nb} + \Delta NFA^{b}$

where M is the monetary aggregate, G-public spending, NFA^{g}-net foreign assets of the government , DC^{nb}-claims on the nonbanking sector, NFA^{b}-net foreign assets in the banking sector. To simplify the analysis we are assuming that the exchange rate ifs fixed at two units of domestic currency per dollar and it does not vary through time and the government's redemption of debt is the full face value of debt. When the government borrows, there is a decline in NFA^{g}, it transfers the profits to the banking system and an increase in NFA^{b} of let's say $200 million in domestic currency and an equivocal increase in M due to foreign financing of the government deficit. When debt is converted to equity, the government's external liabilities decrease by $200 million in domestic currency and the equity claims increase by $200 million. The effect on M will depend on the government's choice of financing the domestic transaction. If it chooses to finance it via the banking system, the domestic claims on the government will increase by $200 million and thereby a direct effect on M will occur. If however it chooses to finance it via nonbanking system by selling securities to the public, there will be no effect on the money supply. Especially if large volume of debt-swaps occurs, debt-equity swaps have a

significant impact on monetary and fiscal policies but if the private sector debt is converted into private sector equity, there will be no such effect. However, there might be an upward pressure on interest rates due to an increased demand on the domestic capital markets (Blackwell 1989). Currency issue will be inflationary, unless it is offset by domestic borrowing, which would mean a debt swap of foreign for domestic debt. (Krugman 1989).

2. Debt buybacks

Debt buybacks are a type of a debt conversion technique, which should have been used more extensively in Yugoslavia. In 1988, debt buybacks reduced the debt by US $128 million, in 1989 by $610 million, in 1990 by $1.5 billion and in 1991 by $554 million (WB Debt Division 1994). The table below shows how Yugoslavia could have benefited from a debt buyback. Using the methodology developed by Krugman (1989) I assumed the approximate level of debt of $20 billion as the country had in the 80's and the country's initial reserves of $7 billion. The debtor faces uncertain ability to fulfill its debt service obligations and an assumption is made that there is a "bad" state in which the debtor generates $8 billion and a "good" state in which it gets more than it owes, let's say $30 billion. The probability of a bad state is ¾ and a good one ¼. If there is no buyback the creditors collect $15 billion in the bad state and the whole amount of what the country owed, therefore $ 20 billion in a good state. It follows that the creditors are supposed to receive

15*3/4 + 20*1/4= 16.25

Not taking into account the risk, the price on debt on the secondary market will be 0.81.

To continue, an assumption is made that the debtor uses its foreign exchange reserves to buy back part of the debt and we assume that the buy back has no impact on the probability of a good outcome. Foreign exchange reserves can buy back $8.64 billion of debt at a market price of 0.81, thereby reducing the debt to $11.36 billion. The creditors who sell out receive $7 billion in any case. Those who do not sell out will receive $8 billion in a bad state as the foreign exchange no longer exists and $11.36 billion in a good state. The expected payments to creditors now will be $7 billion in any state + $8 billion in a bad state + $11.36 in a good state, giving creditors

7+8*3/4+11.36*1/4=15.84

	Bad state	Good state
Foreign exchange reserves	8	30
No buy back		
Payments to creditors	15	20
Residual benefit to country	0	17
Reserves used for debt buy back		
Payments to creditors who sell out	7	7
Payments to other creditors	8	11.36
Total payments	15	18.36
Residual benefit to country	0	18.64

Country is assumed initially to have 7 billion in reserves

Thereby, we can see that the buyback reduces total payments to the creditors. It reduces the price in the secondary market, making the debtor better off.

The drawback of debt buybacks is that they are limited in their use by the amount of foreign exchange available. However, investment banks came up with the idea of securitization to deal with the problem. The idea is that the debtor issues new debt in the form of bonds that are sold for cash with which a repurchase of debt on the secondary market can take place or the bonds can be directly exchanged for debt. The debt outstanding can be reduced without any decline in the foreign exchange reserves if the new bonds sell at a smaller discount than the existing debt. However, for this to work, the new debt has to be made senior to the existing debt if is not, it will sell at the same discount as if it is not senior it faces the same probability of default as the existing debt. Seniority is hard to achieve, however, it is possible to achieve de facto seniority as was the case in Mexico where de facto was established by new debt taking the form of bonds instead of loans (Krugman 1989).

The way the debt buyback is financed is crucial in determining by how much the debt reduction is successful. If the buy-back is paid with an extra cash grant from a third party that is not available if there is no debt-reduction initiative, the expected stream of debt service payments is not reduced, however the stock of contractual debt is. Therefore, a buyback which is financed with the grant from third party causes the price of debt to increase which is equiproportional to the reduction in the contractual value of the country's debt. If the buy back is paid by with funds which are borrowed at concessional rates, than the future payments to the creditors will be reduced and this could offset some of the effects of debt buy back scheme, as the increase in the price of debt will be smaller

than it could have been if the financing was done with the grant. To conclude if the debt buyback is financed with funds, which were raised at yields reflecting the market risk premium for the country, there will be no reduction and no change in the market price of the debt (Dooley 1990).

Some believe that debt buybacks can lead to an increase in efficiency in terms of greater financial stability and lower level of capital flight when the country possesses additional reserves. In 1989 Yugoslavia had additional reserves, thereby having a favourable environment for debt buybacks (Mrak 1992). A buyback scheme can increase investments and it raises the capacity to export, therefore it increases the country's debt service payment capabilities (Dooley 1990).

IV. Conclusion

A debt crisis can have a devastating effect on the banking system and on the international financial system as a whole. Debt crisis is accompanied by economic and financial instability in the debtor countries. The Bretton Woods institutions try to restore the economy's repayment capabilities by attaching conditionalities in the form of a stabilization program as in the case of Yugoslavia.

Yugoslavia had embarked on an unknown road of market socialism and workers' management. It had no country to learn from and yet it managed to be more successful than other Eastern European countries with a higher standard of living and open borders unlike the rest of Eastern Europe. However, IMF induced policies attempting to lessen the macroeconomic instability and regional differences were excerbated by

mismanagement and constant ethnic frictions. What made the country's demise inevitable was its heavy reliance on loans from international creditors, which imposed conditionalities on loans and they involved policies, which worsened the macroeconomic instability and caused the standard of living to decline. Inflation was rampant and hostile to foreign investors as it made investors returns and costs difficult to estimate. High inflation often destroys existing financial markets and prevents their development. The unemployment problem was also worsening leading to an atmosphere of social despair and frustration among the population causing ethnic hatred to reappear in all parts of the country.

The country had low productivity, a primitive technological base, and the exchange rate was artificially overvalued, thereby its products were not compatible on the world markets. Moreover, export profitability was endangered due to skyrocketing inflation and the real exchange rate bobbed around too much giving exporters little incentive to export and the world recession exacerbated the problems. However, even if the country boosted its exports, duties and other protective measures were put in place to deter their entry into the European Union market. Protectionism of the EU market created a problem for solving the debt crisis and due to the world wide recession in the 1980's the demand for the Yugoslav exports decreased, making it hard for the country to earn foreign exchange. Devaluation demanded by the IMF raised costs of imports for enterprises and the already accumulated debt. It was hard for enterprises to obtain loans to finance their operations with bank credits becoming increasingly difficult to obtain. As a result many enterprises went bankrupt and the number of unemployed increased. Moreover, due to the IMF's liberalization demand, enterprises were subjected to increased competition and many

were unable to survive. Before many state enterprises were inefficient as they were not exposed to competition. Nepotism and workers' council's management contributed to inefficiency.

The problem with the reforms was that there was no direct pressure by the international financial organizations to improve the resource allocation procedures. Moreover, IMF reforms placed too much emphasis on demand management measures. More emphasis should have been placed on measures that improve the allocation of resources and stimulate the growth of productivity and aggregate supply. The adjustment program should have sought to generate public sector savings to ensure that investment financing was available domestically on the required level. Moreover, the country's productive base should have been made stronger. The IMF should have given solutions to lean toward self sufficiency. An increase in production to decrease imports not to spend foreign exchange would have helped to lower the impact of the crises. Revenues were inadequate to meet the payments as state expenditures increased faster than revenues and deficits were financed by loans from domestic banks and by printing money, which resulted in inflation. If anti inflationary measures would not have been implemented, devaluation would have been larger or even more loans would have been needed to cover the deficit.

Increasing military spending and the fact that the Yugoslav government was plagued with mismanagement contributed to the rising debt problem. Without aid, expenditures would have to be cut, however the international creditors allowed the country to borrow too much. The federal government squandered loans on capital intensive projects instead

of using relatively low amounts of capital with appropriate technology. It was incapable of managing the economy with the foreign creditors' aid.

IMF had followed market based policy of imposing financial discipline and structural adjustments to deal with the balance of payments problems. However, policies that work in theory do not necessarily work in reality, especially in a unique economic system of market socialism. IMF too often contradicted itself as its demand to restrict imports, for example, is in contradiction with the Fund's aim. The conditionalities failed to take into account the specific country characteristics and they ignored the complex structure of the country causing conditionalities to fuel interrepublican strives and economic crisis, which gave rise to a political crisis. IMF should be more aware that its measures interfere not only in economic, but also in social and political spheres. It is true that the Yugoslav government was plagued with mismanagement but as far as reforms necessitated by the IMF, it was powerless to do much as the country's door to international creditors would have been closed and its creditworthiness forever damaged. Cutting loans could have plunged the country from a recession to a depression. Loans should have been given on a more favorable conditions with longer maturity periods and lower fixed and not floating interest rates. Since the loans were made in U.S dollars, devaluation required earning more in the national currency to pay off debt. Moreover, more pressure should have been put on increasing the efficient use of loans. If foreign loans were invested productively to earn foreign exchange, the profit from investment and the growth in GDP could have enabled the country to service its debt service obligations. The Fund should have been a lender of last resort.

Increasing debt service burden leads to inflation, uncertainty about exchange rates, uncertainty about credit markets, etc. and this has an effect on domestic investment, thus on growth. Not enough emphasis was placed on getting the country out of debt. To alleviate debt, debt relief reduction schemes should have been more extensively promoted by the IMF. An efficient technique is the use of debt-equity swaps and debt buybacks. Debt-swaps reduce external liabilities and savings in interest payments and have a positive effect on the balance of payments. The effect on the money supply depends on the government's choice of financing the domestic transaction. If it finances it via nonbanking system by selling securities to the public, there will be no effect on the money supply. Debt swaps also increase investment. Direct investment benefits the country by contributing to a creation of new jobs, greater output and increased productivity through the introduction of new technology and expertise. The use of debt swaps was limited in Yugoslavia due to high inflation, unfavorable legislation, fears of foreign ownership and political risk.

Another form of debt conversion, which should have been more extensively used are debt buybacks, which reduce payments to the creditors by reducing the price in the secondary market, making the debtor better off. Debt buybacks can increase investment and they can raise the capacity to export enabling the country to earn foreign exchange reserves. Debt reduction schemes can not solve the country's debt problems, but they can certainly lessen the problem. To lessen the debt problem coordination and cooperation between the Bretton Woods institutions and the debtor countries is crucial. Debtor countries have to show commitment to attain economic and financial stability and the

Bretton Woods institutions have to look at specific causes of the debt crisis and country characteristics when formulating policy.

Table 1: Principal debtor countries: vital statistics in 1982

	Debt outstanding ($m)	**Debt per capita** ($)	**GNP per capita** ($)
Brazil	91.6	722	2,240
Mexico	86.1	1,178	2,270
Argentina	43.6	1,536	2,520
South Korea	37.8	961	1,190
Venezuela	31.9	1,912	4,140
Poland	25.2	696	5,088
Philippines	24.3	480	820
Israel	22.2	5,561	5,090
Egypt	21.9	494	690
Yugoslavia	19.9	881	2,800
Turkey	19.7	423	1,370
Chile	17.3	1,509	2,210
Algeria	16.7	838	2,350
Greece	11.3	1,149	4,290
Ireland	10.6	3,029	5,150
Romania	9.4	418	4,370
Hungary	7.0	654	6,277

Source: World Bank, OECD and ECE statistics

Table 2: Highest 10 Percent of IMF's Members' Total SBA Receipts (in millions SDRs)

Rank	Country	Total SBA 1952-1984	Total SBA 1952-1980
1	United Kingdom	12,832.0	12,832.0
2	Yugoslavia	3,262.1	880.2
3	Turkey	2,927.6	1,047.5
4	Korea, Republic of	2,803.3	1,083.8
5	Argentina	2,587.3	1, 165.0
6	Italy	1,747.1	1,747.1
7	Peru	1,639.9	1.183.8
8	Philippines	1,392.7	562.7
9	France	1,378.7	1.378.7
10	Romania	1,287.3	184.8
11	Portugal	1,154.7	NA
12	Thailand	1,131.4	NA
13	Chile	1,048.1	NA
14	United States	1,000.0	1,000.0
15	Hungary	900.0	NA

NA---Not applicable, or does not appear in the top 10 percent
Source: The data from which this table is derived are contained in IMF, Annual Reports (Washington, D.C.: IMF).
SBA-Stand -by Agreements

Table 3: Top 10 Percent of Members' World Bank Receipts: Total Bank Loans, Percentage of Total Bank Loans, and per Years of Membership, 1950-1980
(in millions of U.S. dollars)

Rank	Country	Total Bank Loans 1950-1980	Percentage of Total Bank Loans	Total Bank Loans Per Years Member 1950-1980
1	Brazil	5,313.7	8.95	156.27
2	Mexico	4,113.6	6.93	117.53
3	Indonesia	3,056.0	5.14	117.53
4	Korea, Rep.of	2,948.5	4.96	117.94
5	India	2,770.6	4.66	79.16
6	Colombia	2,961.4	4.65	78.89
7	Yugoslavia	2,684.1	4.52	76.68
8	Turkey	2,407.4	4.05	72.95
9	Philippines	2,389.9	4.02	68.28
10	Thailand	1,960.0	3.30	63.23
11	Romania	1,502.8	2.53	187.85
12	Morocco	1, 437.3	2.42	65.33
13	Nigeria	1,380.7	2.32	72.66
14	Argentina	1,350.3	2.27	56.26
15	Iran	1,210.7	2.04	34.59

Source: The data from which this table is derived are contained in IBRD, Annual Reports (Washington, D.C.: IBRD).

Table 4: SBA Residuals: Yugoslavia, Romania, and Hungary, 1965-1984
(in millions of SDRs)

Year	Country	Actual SBA Loan	Residual from Regression	Standard Deviation from the Mean
1965	Yugoslavia	80.00	85.22	*
1967	Yugoslavia	45.00	30.73	2.84
1971	Yugoslavia	51.75	37.66	3.83
1972	Yugoslavia	83.50	71.68	7.22
1980	Yugoslavia	408.58	371.31	3.08
1981	Yugoslavia	1662.00	1624.48	13.50
1982	Romania	1102.50	1065.35	8.85
1983	Hungary	425.00	438.09	3.64
1984	Yugoslavia	370.00	312.86	2.60
1984	Hungary	425.00	400.48	3.32

*---denotes missing
Source: The data from which this table is derived are contained in IMF, Annual Reports (Washington, D.C.: IMF).
Regression exercise (IMF)
SBA- Stand-by Agreements

Table 5: World Bank Loan Residual: Yugoslavia, 1965-1984 (in millions of U.S. dollars)

Year	Actual WBL	Residual from Regression	Standard Deviation from the Mean
1965	70.0	-6.04	*
1967	10.0	-65.45	3.80
1968	60.5	-15.64	*
1969	46.0	-30.04	1.13
1970	98.5	22.57	*
1971	100.0	34.04	*
1972	75.0	-1.80	*
1973	90.4	19.06	*
1974	128.0	52.06	*
1975	263.0	180.71	2.36
1976	242.0	158.21	1.78
1977	240.0	158.20	1.73
1978	328.0	242.11	2.16
1979	385.0	431.58	3.49
1980	347.0	-34.00	*
1981	321.0	-41.00	*
1982	256.0	220.50	*
1983	520.0	148.00	*
1984	451.0	-5.00	*

*---denotes less than one standard deviation from the mean
Source: The data from which this table is derived are contained in IMF, Annual Reports (Washington, D.C.: IMF).
Regression exercise (IMF);

Table 6: The balance of Payments 1982-6, in millions of dollars[1]

	1982	1983	1984	1985	1986
Current account					
Trade balance	-1833	-1152	-770	-579	-598
Exports	9475	9273	9889	10461	9448
Imports	-11308	-10425	10659	-11041	-10046
Balance of services	919	794	825	905	850
Transport (net)	1308	805	883	937	1027
Travel (net)	-1895	-1599	-1790	-1857	-1648
Interest (net)	- 2928	-2005	-1940	-1814	-2043
Other services (net)	- 4428	-3157	-1792	-2409	-2413
Balance of goods and services	3998	3414	3259	3230	3351
Transfers (net)					
Remittances from emigrants and Yugoslavs working abroad	3792	3206	3090	3059	3180
Other	206	208	169	171	171
Balance of current transactions	-430	257	467	820	937
Capital account					
Errors and omissions	74	-279	201	82	295
Net new credits	-938	-323	-572	-744	-522
Long-term (net)	-84	880	-259	78	-1198
Short-term (net)	-854	-1112	- 313	-822	676
Change in reserves	1184	155	-238	118	-424

($ bn)

	1982	1983	1984	1985
Trade balance	-3.1	-2.1	-1.8	-1.6
Exports	10.2	9.7	10.1	10.6
Imports	13.2	11.8	11.9	12.2
Remittances from emigrants and Yugoslavs working abroad	1.9	1.6	1.7	1.6

Strictly in SDRs. The relevant exchange rates are (US dollars per SDR): 1982: 1.0401; 1983: 1.06900; 1984: 1.02501; 1985: 1.01534; 1986: 1.17317 (IMF, *International Financial Statistics*).
Source: IMF Balance of Payments Statistics Rpt in Dyker 129

Table 7: The terms on which Yugoslavia borrowed 1973-1982 (medium and long term guaranteed loans only)

	1972	1975	1978	1979	1980	1981	1982
Total loans (average terms)							
All creditors							
Interest %	6.7	8.5	6.8	5.8	15.1	12.6	13.8
Maturity (yrs)	12.0	15.0	15.9	16.6	8.9	11.7	11.1
Grace period (yrs)	3.5	4.2	3.5	3.2	3.3	4.1	3.9
Grant element (%)[1]	15.4	8.5	18.0	24.4	-19.5	-6.5	-16.4
Official creditors							
Interest (%)	6.3	8.9	6.8	5.8	11.6	10.9	11.1
Maturity (yrs)	13.1	16.2	15.9	16.7	11.8	13.1	16.5
Grace period (yrs)	3.7	4.0	3.5	3.2	3.7	4.3	5.8
Grant element (%)	17.8	6.7	18.0	24.5	-5.9	1.5	-7.9
Private creditors							
Interest (%)	7.3	7.5	-	8.7	17.6	18.7	14.7
Maturity (yrs)	10.4	11.9	-	8.9	6.7	7.0	9.1
Grace period (yrs)	3.2	4.9	-	1.9	2.9	3.0	3.3
Grant element (%)	12.0	13.4	-	5.0	-29.4	-34.4	-19.4
Variable interest Rate loans (% age of total disbursed debt)	6.8	7.9	7.5	5.3	23.9	35.0	37.7

[1] Grant element is defined as the face value of a loan commitment less discounted present value of the future flow of payments of principal and interest, expressed as a percentage of the face value. The discount rate used is 10 per cent, which is the conventional rate used by the OECD in assessing terms' (World Bank Annual Report 1984: 149)

Source: World Bank, *World Debt Tables*

Table 8: The structure of debt conversion, 1988-1989
(in million dollars, per cent)

Type of conversion	1988		1989	
	face value of retired debt	% of total	face value of retired debt	% of total
I. Debt/equity conversions	-	-	57.3	4.2
II. Debt/export conversions	10.9	8.1	585.4	42.8
III. Debt/debt conversions	29.9	22.1	157.5	11.5
IV. Debt/re-export conversions	64.6	47.8	523.8	38.3
V. Debt buy-back	29.7	22.2	44.5	3.2
TOTAL	135.1	100.0	1368.5	100.0

Source: National Bank of Yugoslavia (internal sources)

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