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Editorial

by Mladjan Dinkic

Is the year 2000 going to be a year of changes?

As in all New Year's greetings, the President self-confidently promised a year of economic prosperity. All grandiose works on the reconstruction of the country will be carried on. The Government will, as always, keep the exchange rate and the prices stable, while a two-digit industrial production growth rate was also promised. Hence, from the stand-point of the regime, changes are not at all necessary, as continuous growth of the standard of living will be secured, to guarantee nonchalance to the citizens and arm them with extra strength while they queue for bread, milk, cooking oil and sugar.

In reality, Serbia is in despair, and so are its citizens. Although people try to appear normal in daytime and before the external world, even with smiling faces, many cannot sleep at night. The number of funerals in January 2000 rose by 40% compared with the same period last year. Owing to the shortage of medicaments, caused by the policy of price controls, private pharmacies register a dramatic expansion in the sale of antidepressants, sold at free market prices. After neurosis of all sorts, contracted because of the break-up of the former Yugoslavia, years-long bloody and utterly futile civil wars, the NATO bombardment and catastrophic decline in the standard of living, what threatens to finish off the citizens of Serbia is the lack of prospects for economic and national revival. In the internationally isolated country, hopelessness and apathy of most of its citizens cannot be eliminated by ready-made promises given by some politicians who are also paranoid, as they try to persuade themselves as well as others that progress and prosperity are possible without cooperation with the developed West, drawing instead on the policy of self-reliance and the help of "friends" from Russia, Belarus, China, Iraq and Libya.

FRY: basic economic indicators

	1999	1998	1999. / 1998	XII '99	XII '99 / XI '99	XII '99 / XII '98
GDP (USD mill)	14.224[a)]	17.626[a)]	-19,3%			
Montenegro		1.103				
Serbia		16.523				
GDP per capita (USD)	1.699[a)]	2.100[a)]	-19,1%			
Montenegro		1.704				
Serbia		2.133				
Serbia proper		1.977				
Vojvodina		2.590				
Industrial production			-24,1%		3,8%	-14,8%
Montenegro			-7,6%		26,3%	-9,6%
Serbia			-25,6%		2,6%	-15,1%

Serbia proper			-24,5%		7,6%	-11,6%
Vojvodina			-28,2%		-7,5%	-22,5%
Average wage (DM)	107[b)]	156	-31,7%	93[b)]	6,3%	-38,1%
Montenegro	154	180	-14,1%	161	16,8%	-8,0%
Serbia	102[b)]	155	-33,8%	88[b)]	5,4%	-40,6%
Unemployment rate, Serbia	26,6%[c)]	24,7%[c)]	7,7%			
Export (USD mill)	1.498	2.820	-46,9%	123	-13,7%	-54,9%
Montenegro	123	129	-4,7%	6,5	-51,1%	-21,3%
Serbia	1.375	2.691	-48,9%	116,0	-9,8%	-55,9%
Import (USD mill)	3.296	4.732	-30,3%	305	6,9%	-9,8%
Montenegro	358	335	6,9%	21	-33,6%	-34,5%
Serbia	2.938	4.397	-33,2%	279	11,3%	-8,1%
Money supply M1 (Din billion), at the end of period	16,4	10,8	51,9%	16,4	3,9%	51,9%
Cash	6,7	5,0	34,0%	6,7	9,3%	34,0%
Deposits	9,7	5,8	67,2%	9,7	1,0%	67,2%
Real money supply (DM million), at the end of period	739	1.280	-42,3%	739	-5,7%	-42,3%
Market interest rate, monthly level	4,25%	6,95%	-38,8%	3,89%	-12,4%	-44,2%
Retail price			42,4%[a)]		0,8%[a)]	50,1%
Montenegro			60,1%		20,8%	128,4%
Serbia			41,1%[a)]		-0,7%[a)]	45,4%
Costs of living			44,9%[a)]		2,2%	53,9%
Montenegro			67,2%		23,2%	145,3%
Serbia			43,5%[a)]		0,2%[a)]	47,9%
Cost price			44,2%[a)]		3,0%	61,1%
Montenegro			63,7%		17,3%	131,2%
Serbia			43,2%[a)]		1,6%[a)]	58,3%
Black market exchange rate (din/DM)	12,6	6,7	88,1%	20,0	5,3%	150%

[1] Official statistics; without Kosovo; unreliable
[2] Estimates
[3] Official statistics, September 1999, Serbia without Kosovo; changed methodology includes the employed; unreliable

Even if the "promises of paradise" given by years-long liars came true would this mean anything to a nation which is literally dying out? Given that the industrial production in 1999 was 72% lower than ten years ago, not even a two-digit growth rate could do much to improve our miserable situation. Namely, even with the statistically significant growth of 10%, this year's production would only reach the level which is 70% lower than it was in 1989. We wonder whether the citizens of Serbia would feel a noteworthy improvement in the standard even if the last year's average salary of DM 88, rose by 20% due to "the extraordinary efforts of the Government", to a sum of full 106 German marks at the end of this year.

Temporary cyclic improvements at the bottom of the economic abyss, Serbia has been going through since 1993, are just not enough to incite the hope of citizens in a truly better life. There is no doubt that even the present government, incompetent and compromised as it is, can secure such minor economic progress. Let us recall that back in 1997, after the sale of the Serbian Telecom Company and the provision of one billion dollars from abroad, this government managed to secure temporary macroeconomic stability in the electoral year. Real incomes actually had a two-digit growth. However, immediately after the elections they suffered a two-digit fall. Taking into account that this year is also the electoral year, we assume that a similar scenario will be attempted again. But, as the EU sanctions are in effect, banning foreign investments in Serbia, the regime is forced to secure the foreign assets needed for temporary maintenance of the stability of the exchange rate in a completely different manner. Last year, after the alarming growth of the black market exchange rate of 150% (by the way, the government had the nerve to proclaim it a success in the policy of stabilization), which was the result of large money issue without the backing by official reserves of the National Bank of Yugoslavia, it was clear that the situation could have easily escaped control. Although back in 1993 the regime had already won the elections in the time of hyperinflation, knowing what happened in the meantime, it has decided not to play with the voters and their electoral will this time. In December last year it was announced that our government received a "gift" worth 300 million US$ from the government of China. Taking into account that the Chinese are not famous for their altruism, this is obviously the case of repatriation of a part of the money that was previously taken out from Serbia to Cyprus, Israel and Greece, and then after the EU financial sanctions had been introduced, partially transferred to the accounts of the Serbian political establishment in China, South Africa, Lebanon, etc. This money was already used to intervene at the foreign exchange market last December, in order to check the increase of the foreign exchange rate, resulting in its stabilization at a level of 20 dinars to 1 German mark (black market exchange rate) and 25 dinars to 1 German mark (giro exchange rate). According to our estimates and taking into account a relatively low level of the current economic activity, this unexpected inflow of foreign currency reserves should be sufficient to maintain the stability of foreign exchange rate at least by the end of May, 2000 providing that an adequate monetary policy is pursued. Hence, it would not come as a surprise if this regime decides to hold local elections even this spring.

However, short-term stability of the foreign exchange rate and a temporary increase in the real incomes of the population, which are objectively possible with a quick depletion of foreign currency reserves, do not guarantee that the current regime will win the elections this time. Contrary to the developed Western democracies, where the electoral results are, as a rule, proportional to the success of the government achieved in its economic and social policy, the experience of Serbia is quite the opposite. Namely, the ruling elite relatively easily won all elections held under conditions of extremely negative economic trends (hyperinflation, drastic decline of the standard of living, growth of unemployment), while during its pre-election campaigns it deliberately incited fear that the situation could become much worse and that only the regime was capable of preventing its further deterioration. In addition, national-political motives, such as "the struggle for the Serbian national interest" (never defined precisely), "the struggle to keep Serbian territories", the fear of spreading the war and the loss of closest family members, etc. at that time had a key role in determining the voters' behavior. Today, the situation is very much different. Almost all territories have been lost, many lost their lives in vain, the true patriots have been disgraced and the fake promoters of the Serbian national interest are still sitting in their armchairs. This time the economic and social motives will be decisive for the voters' behavior. In such circumstances, an illusion of economic recovery, that the regime might create in the first months of 2000, would only be another proof that things, objectively, could be better, and, contrary to the desire of the regime, an additional motive for the voters to vote for those capable of providing the progress much faster. Obviously, the ruling elite - unable even to obtain visas of other countries - stands no chance in such a race, as the latest results of public opinion polls show that the majority of the population is fully aware that genuine economic recovery of Serbia and initiation of the economic growth are possible only after Serbia becomes fully integrated into the international community.

Hence, economic and political analyses claim that democratic opposition should have an easy task at the elections this year. The authoritarian regime is also aware of that, as it draws increasingly uncontrolled moves. Since the repression against the free media and the destruction of the university and the judiciary have failed to provide sufficient guarantee to prolong their rule, certain members of the ruling coalition, have, of late, started hysterically inviting a conflict with Montenegro. Others attempt to publicly demonstrate their "power", by threatening with the return of our army to Kosovo by force, despite the fact that it has previously left it to NATO soldiers. We believe that a conflict with Montenegro is unlikely to occur. Bearing in mind the hitherto exceptionally clever political tactics of the Montenegrin authorities, we expect that a referendum on the independence of Montenegro, which might provoke a new conflict, will not be held in the first half of this year. Serbia broke off the payment transactions in November 1999, and Montenegro is *de facto* no longer within the economic and legal system of the FRY. On the other hand, an attack of the Serbian army units on NATO forces in Pristina could be organized only by those who wish a prompt arrival of NATO in Belgrade, and we are not sure that the regime, despite its patriotic vocabulary, is currently able to host the NATO officers.

To conclude, after everything that happened in our country over the past ten years, the key of the electoral victory and the chance for a "fresh start" in Serbia are finally in the hands of the democratic opposition. Of the entire arsenal of economic measures and political filth the regime will use to stay in power, only one can be effective - dividing the opposition which has become united at the beginning of the year, i.e. to corrupt some of its key leaders. However, if opposition remains united and goes to all elections (local, republican and federal) with one electoral list and with a single program platform, it will attract the majority of the voters who are currently indecisive and who make over 40% of the electorate. In that case, the opposition cannot lose under any electoral conditions. Time will show whether the opposition in Serbia truly wishes the victory that is now at arm's length.

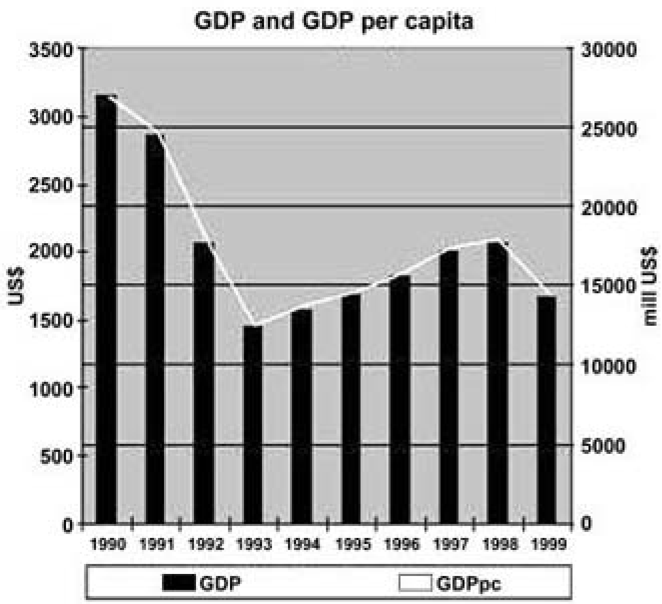
Analysis **by Branko Radulovic**

A decade of devastation

In the first issue of the Yugoslav Economic Monthly, we wish to introduce our readers to the origin and development of the economic situation in the FRY, i.e. in Serbia. In that purpose we shall present facts and developmental indicators that dominated the last decade. Factors that enabled such longevity of negative tendencies - a lack of growth and macroeconomic imbalance, will also be interpreted. Yugoslavia is certainly one of the countries whose economy requires a whole range of additional indicators to obtain full insight in its state and movements. They will not change primary conclusions, but they are necessary for understanding the real nature of the situation. Anyhow, with or without them, the state of economy in Yugoslavia is, mildly speaking, dramatic. It is obvious even at first glance and our duty here is to provide analytical verification.

It is rather easy to explain the reasons for the disastrous situation in Yugoslav economy by three factors. The first one is institutional by nature, as the current regime is unwilling to commence the necessary reforms. This reason, together with inadequate, sometimes destructive economic policy and frequent external blows - has led to the culmination of existing problems.

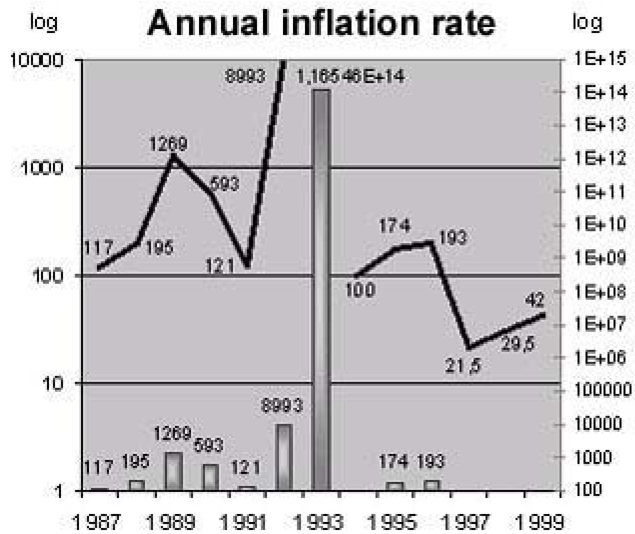
The above-mentioned factors have created a large difference between the potential and achieved GDP. Between 1990-1999, Yugoslav economy (without accounts for Kosovo) registered an average annual growth rate of around -7%, reducing the GDP in 1999 to the level of 50% of that in 1990[1]. In a hypothetical case of peaceful disintegration of the SFRY after Slovenia's separation, and assuming that the growth rates of Slovenian GDP were registered between 1990-1999, the FRY, without Kosovo, would cumulatively gain US$ 82 billion more than it actually achieved. It is slightly less than 6 GDPs for the same region in 1999. This figure was calculated on the basis of official statistics, so it is reasonable to assume that the lost GDP was even larger. There is no doubt that drastic growth of the lost GDP occured after the last year's war.[2]



Circulus vitiosus (low income-low savings-low investments-low productivity) is one of the main characteristics of Yugoslav economy. Chronic shortage of capital additionally expanded the existing problem in the respective period. Except for rare cases, Yugoslav economy had not only has access to the world capital market, but it also experienced immense capital flight, especially in the beginning of the 90's. This fact is very important in view of the "dependence" between Yugoslav economic development and the extent of foreign accumulation.

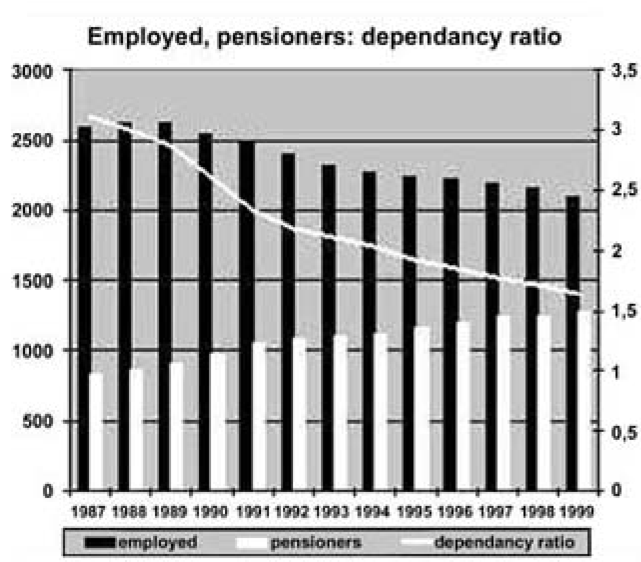
The industrial production accurately reproduces the GDP movement. Until 1999, many sectors in the industry reduced their production to several percents only, compared to 1989. During the respective period, the share of industry in the total GDP had been reduced at the expense of agriculture and only decent examples were the electric power industry and oil industry (until this year). Shortage of fresh capital, working assets and investments, together with a loss of markets and obsolete equipment, generate huge problems that deepen the recession and intensify the process of de-industrialization of Yugoslav economy.

In addition to the drastic drop of the production, Yugoslavia experienced extensive price instability. Between 1989-1994 the economy survived two hyperinflations. The second lasted over 20 months, reaching 3,31 x 108 at its peak in January 1994. Hyperinflation had both exogenous - disintegration of the state, war, transition of the economic system, external economic blows, and endogenous factors - deliberate incitement of hyperinflation by the political elite aimed at redistribution of wealth. Technically speaking, the second hyperinflation was caused by monetization of the deficit. It was halted in February 1994 by the implementation of an orthodox program which gained relative success in the first stage of its implementation - until October 1994, when, owing to the inconsistency in conducting the financial discipline, structural changes and privatization, negative tendencies emerged again.



Because of the enduring experience with hyperinflation and accented inflatory expectations, the economy formed a rather short time lag between the movements of money, prices and production. According to the official statistics in 1999 consumer price rose by 45%. This figure, like others from the same source, is doubtful not only because of the applied measuring method, but also because of the presence of repressed inflation as a consequence of extensive price control. The government uses monetary policy, subsidizing by selected credits and price control so as to reduce inflatory pressures and buy itself some time. The possibility of utilizing monetary policy reflects a low degree of the central bank personal and financial independence. Short-lived mandates, when there was no governor for some time, as well as high and frequent deviations from the planned movement of money supply, the approval of credits for quasi-budget activities (to social security funds, the electric power industry, etc.) illustrate this high degree of dependence.

Let us mention a few additional characteristics of Yugoslav economy. During the period between the program of monetary reconstruction and the bombardment (1994-1999), it experienced mild recovery, but important systematic changes failed to occur. It is still based on "social" property, state ownership and a questionable motivational system, and consequently on soft budget constraints. The process of privatization has not gone any further, but it has also been reversible.



Accumulation of debts created during the last two decades proceeded in the 90's as well. The problem of external debt has never been seriously resolved, so it grows by US$ 700-750 million at the annual level. The estimate of the total external debt is around US$ 12-12,5 billion, while there are no official data on its actual size. External debt is slightly higher than the estimated GDP and in the near future it will become the chief problem of Yugoslav economy.

According to the official statistics, the registered unemployment rate was constantly growing, but it did not correspond to other indicators. Although extremely high, such an unemployment rate is far from reality. The number of fictively employed is rather high, accounting for 30-40% of the total number of employed, according to estimates.

Apart from a significant decline of employment, resulting from the liberal regime of retirement - early retirement and disability pensioners, the number of pensioners has increased correspondingly. The annual rate is 3-4%. In such a manner, high pressure is exerted on the employed through contributions for social and pension insurance. During the whole respective period the dependency ratio between employed and pensioners had been deteriorating. It dropped under 2 for the first time in 1995. The problem lies in an actual “pay as you go” system in its late stage, with all the predicaments that accompany it. Inability to transfer the tax burden to other payers, i.e. financing through other taxes (for example, income tax) is a further disadvantage. Demographic movements can consequently initiate the fiscal deficit.

One of the dominant characteristics of Yugoslav economy is a chronic trade deficit reproduced in the balance of payments deficit. Cumulative trade deficit in the respective period was around US$ 15 billion. The question frequently asked is - how was it financed? Four elements answer this question.

Firstly, the current account deficit is much lower due to surplus in the service sector and net factor incomes.

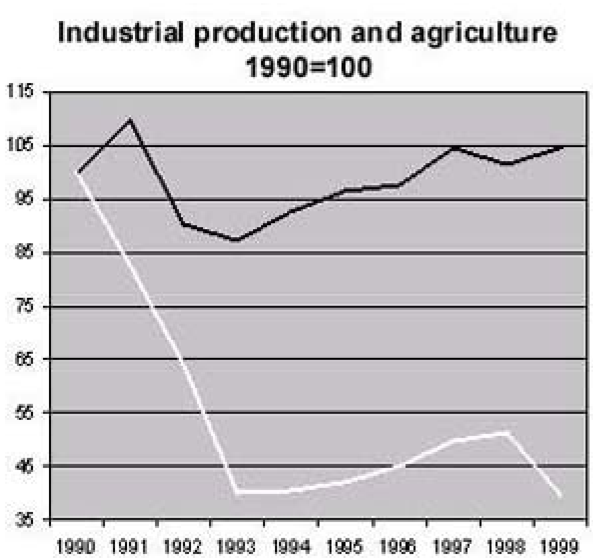
Secondly, the balance of payments deficit was covered out of assets deriving either from capital flight during the first years of the disintegration of the SFRY or from the sale of the Telecom Serbia. It is up to certain extent obvious from the balance of payments that net errors and omissions have a dominant role in making up the deficit. Advances and non-executed duties under the barter and other arrangements are behind this item, in addition to the capital inflow mentioned above. It should be stressed that the accounts where those assets were located have mostly been exhausted.

Thirdly, the data should not be taken for granted, since part of the trade transactions is not properly registered (export and import data are not realistic, so export and import are underestimated).[3] The purpose of an underestimation of export is capital flight, while the underestimation of import serves to avoid tariff obligations. In addition, transactions within the shadow economy are vastly related to the sale of imported consumer goods, which further distorts the picture. Those who had access to foreign currency reserves blew up their accounts and placed the capital abroad.

Fourthly, there are constant "specific" monetary and non-monetary mechanisms of foreign currency purchase from the population, used for financing necessary imports.

With regards to other small and open economies, the FRY has a closed economy with a foreign trade share of 40% of the GDP in the respective period. In 1999 there was further decline of export and import, but given the G17 estimates on the GDP decline in comparison with the last year and the existing data on import and export, this relation is again 40%.

During the whole decade the relation between price control and the government's administrative measures was present in foreign trade exchange as well. A complicated system of import permits and limited access to the trade of "strategic" goods for the privileged are also characteristic of the existing foreign trade regime.

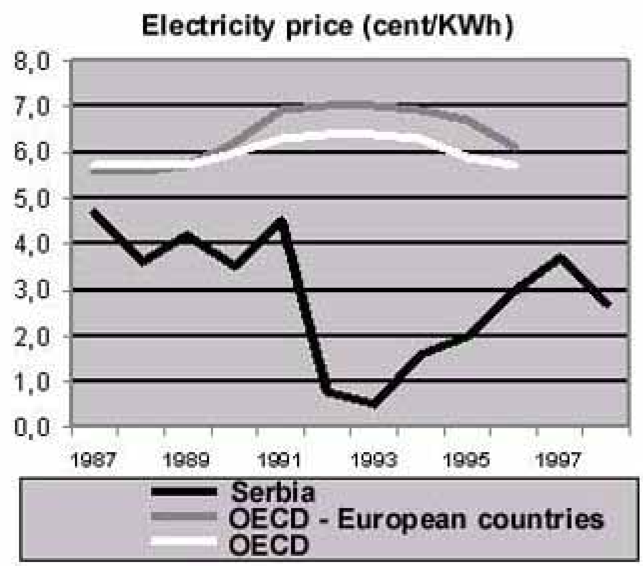


The banking sector operates with extremely problematic balances as the depositors have no confidence after their foreign currency savings were frozen and pyramidal schemes fell apart (around DM 6,7 billion in 1999).[4] The banking sector is concentrated, so only a few banks are important. After NATO bombing this process has gained a more apparent form.

According to the research conducted by *Transparency International*, Yugoslavia was the most corrupted country in Europe in 1999. There are two basic reasons for such a result - the first is related to the share of shadow economy, which includes tax evasion and corruption; the second reason is based on discreet rights of the authorities and it is related to the rentseeking tendencies.

There are some institutional problems worth mentioning. Legal and economic regulations either do not correspond to needs, or they are not implemented. Markets of capital, foreign currency and money either do not exist or have almost been transferred to the black market. Accumulated debts towards budgetary beneficiaries, with inadequate protection of property rights and contracts and with pronounced administrating are just few of the negative characteristics of Serbian economy.

Taking into account the above analysis, one wonders how the population of the FRY managed to hold back social dissatisfaction. Political reasons aside, there are few social shock absorbers used by the economic policy. Contrary to a catastrophic decline of industrial production, both agriculture and electric power industry register stagnation, rather than a larger drop (see the chart bellow). Products made in these sectors, supported by price control, have been filling up the scarce consumer basket of an average citizen.



Naturally, as there is no free lunch, the dilemma of whom the bill went to still remains. A partial answer is given in the chart showing the electric power price in Serbia as compared to the world price. As the price is excessively depressed and given that infrastructure wears down slowly, but repairs relatively slowly as well, the consumers will bear the costs and negative effects in the long run. Not only are those sectors under price control. It is estimated that around 20% of all goods are under direct control of the government, while 30% are under its indirect control.

In addition to the above-mentioned factors, an important role is played by the shadow economy. According to the estimates, it accounts for additional 35-50% of the GDP in the respective period. For most participants in the shadow economy, it is the economy of survival, so its exclusion from the analysis could lead to completely false deductions.

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[1] National statistics does not yet regularly publish the GDP accounted in accordance with the SNA methodology. During the last year the data on GDP were revised. In the Statistical Year Book for 1998, the following data were published (in US$ million): 1994-13862, 1995-14681, 1996-15548, 1997-17000, while in the Year Book for 1999, the GDP was as follows: 1994-14285, 1995-15825, 1996-16477, 1997-18158. Readers must be very careful due to inequality in the regional distribution and exclusion of the shadow economy. In addition, the problem of Kosovo's data was present during the whole respective period, as the official statistics included only a part of the activities in that region. Taking this into account, the GDP per capita for Serbia and Vojvodina between 1992-1999, should be increased by 400-600 US$, and a share of the shadow economy should be added.

[2] See: Methodological Supplement in "Economic Consequences of NATO Bombing: Estimate of the Damage and Finances Required for the Economic Reconstruction of Yugoslavia", Group 17, edited by Mladjan Dinkic.

[3] As FOB prices are used for export and CIF prices for import, it is realistic to expect a difference of 10% on the basis of inclusion of additional cost not included in the CIF price. Only differences above this rate can be indicated as doubtful. The example of foreign trade exchange with Greece is rather illustrative. According to the Greek statistics export to Yugoslavia (FOB) for 1996 and 1997 was 168,5 and 201,7 million US$ respectively, while the Yugoslav statistics registered import from

Greece under the CIF (higher) price of 147,7 and 180,3 million US$. According to the data from the Foreign Trade Statistics of the FRY and International Trade Statistics, it is easy to conclude that around 40 million US$ are missing.
[4] According to the Law on foreign currency savings and taking into account 2% of capitalizing in the last two years.

Macroeconomic Rewiew

by Mladjan Dinkic

Economic activity

In 1999 there was a drastic decline in economic activity as compared to the year before. Such a decline is the result of NATO bombing, EU economic sanctions and ill conduct of the internal economic policy.

According to official statistics, the real GDP, calculated in compliance with SNA methodology, was 19,3% lower than in 1998, amounting at US$ 14,2 billion. Meanwhile, the GDP per capita was reduced to the level of US$ 1,700, which is US$ 400 lesser than in 1998. This account does not include Kosovo, while figures differ a great deal from the figures hitherto published. It should be born in mind that Kosovo's share in the GDP of the FRY was around 5%, while its share in the total population was even 20% (GDP per capita in Kosovo in 1998 was only US$ 470). Consequently, the exclusion of Kosovo from the account increased the sum of GDP per capita for a "new territory" of the FRY. However, the above data should not be taken for granted, for two reasons: (1) official statistics, due to political reasons, systematically overestimates the GDP value; (2) the above GDP account does not include turnover data in the shadow economy, which currently accounts between 35%-50% of the total transactions in economy.

Industrial production in 1999 dropped by 24,1% in relation to 1998, and even 72% in relation to 1989, according to official sources. In addition to that, the last year's economic decline was much higher in Serbia (-25,6%) than in Montenegro (-7,6%), since the industrial capacities in Montenegro came through the war unscathed.

Industrial production significantly decreased in the second quarter of 1999, during NATO bombardment. The bottom was touched in May 1999, when production was reduced to 16% of that achieved in 1989, which was the lowest level in the history of the FRY. Afterwards, the production registered continuous growth, so it reached the level of the first quarter by the end of the year. After the usual seasonal drop in January 2000, a relatively high statistical growth of production could be anticipated in the months to come, while it should be taken into account an exceptionally low starting position in relation to which growth is accounted.

Wages

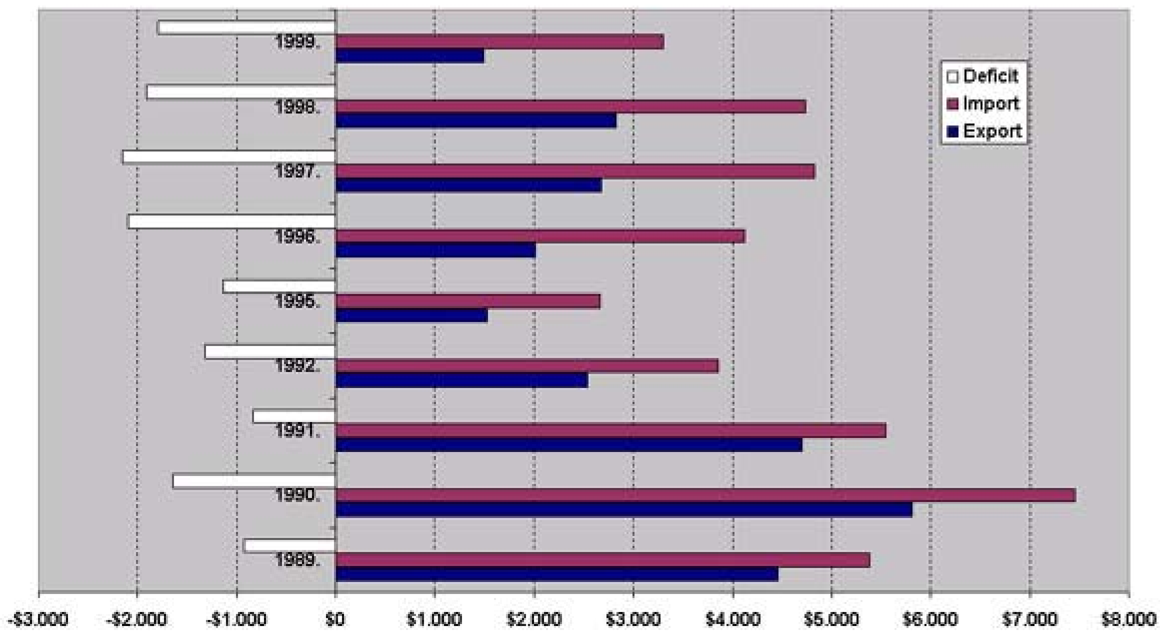
The decrease in economic activity was accompanied by a dramatic fall of real wages. The average wage in the FRY amounted at DM 107 in 1999, while it was much lower in Serbia (DM 102) than in Montenegro (DM 154). The average real wages in Serbia were by 34% lower than in 1998, while in December 1999 they were 41% lower than in December 1998. In the last quarter of 1999, the average wage in Serbia was reduced to the level bellow DM 90. As the year 2000 will be the electoral year, and given the experience from the electoral 1996/97 year, it could be anticipated that real wages would go up slowly in the next few months.

The gap between average wages in Serbia and Montenegro deepened during the last year. It amounted to DM 72 in favor of Montenegro. It should be born in mind that real wages in Serbia were higher than those in Montenegro until 1996, while in the former SFRY that difference was more explicit, since Montenegro used to be one of the least developed regions in the former state. Such a turn proves the depth of the crisis the Serbian economy confronts due to ill conduct.

Foreign Trade

Exports from Serbia in 1999 went down by 49% compared to the year before, while imports went down by one third (-33%), with the achieved foreign trade deficit of US$ 1.6 billion, which accounts for 11% of its GDP. As in the years before, the deficit was mostly financed from foreign accounts of the political establishment and by funds from numerous publicly unregistered state transactions, but also from the population (remittances from workers abroad). Contrary to Serbia, foreign trade of Montenegro registered no substantial deviations compared to the year before. The foreign trade deficit of Montenegro was slightly over US$ 200 million, accounting for 18% of its GDP.

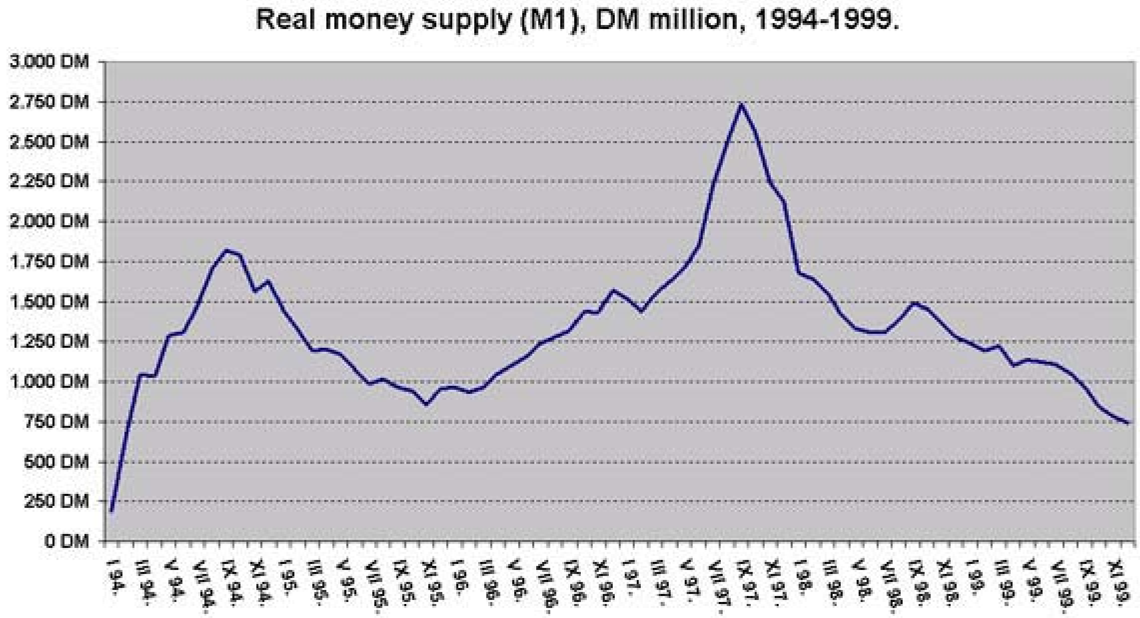
FRY: Foreign trade exchange (US$ mill), 1989-1999

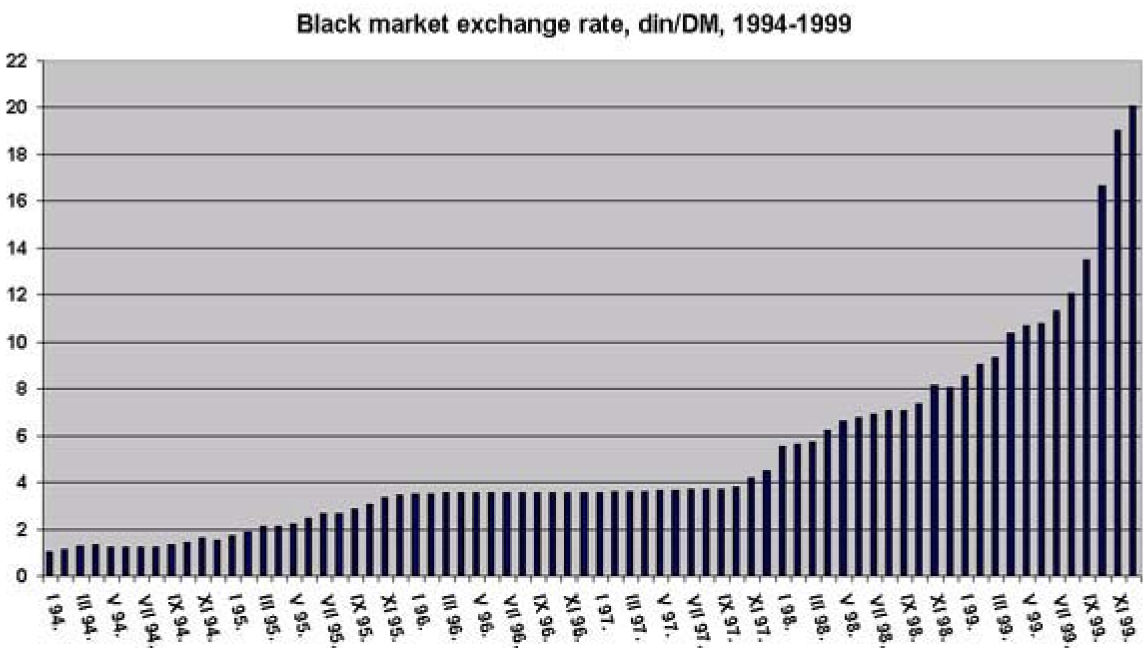


The main foreign trade partners of the FRY in 1999 were Republika Srpska, Germany, Italy, Macedonia, Russia, Switzerlad and Bulgaria. The main export commodities from Serbia were fruits (US$ 91 million), wood (US$ 90 million) and copper (US$ 79 million), while the chief import articles were oil derivatives (US$ 457), various machinery (US$ 263 million), cars (US$ 218 million), cotton (US$ 139 million) and plastic items (US$ 133 million). Aluminum accounted for 70% of Montenegrin export, and oil derivatives made one third of the total export.

Monetary Movements

In the first half of the last year, including the period of NATO bombing, the National Bank of Yugoslavia (NBJ) applied a relatively restrictive monetary policy, due to which money offer did not exceed the planned and officially proclaimed limits. However, after Serbian top officials had proclaimed the beginning of reconstruction works, monetary faucets were turned on and the NBJ started to finance higher and higher budgetary deficit by issuing the money without hard currency backing. A large portion of the monetary expansion the NBJ realized through direct investments from primary issue. Those "inflationary investments" rose by 135% in comparison with 1998. By the end of 1999, nominal money supply (M1) rose by 50% compared to that at the end of 1998. Such an inflationary financing of public expenditures and general economic depression resulted in sudden drop in real money demand. Consequently, real money supply, accounting for DM 2.7 billion in the second half of 1997, was reduced to the level of DM 740 million at the end of 1999.





To protect itself from the unrestrained monetary policy of the NBY, Montenegro introduced a dual currency system in November 1999, thus legalizing the German mark as a parallel tender on its territory. Serbia's reaction was very rough - it interrupted all payment transactions with Montenegro, which resulted in a speed withdrawal of dinars from Montenegro and its factual separation from the FRY's monetary system. Already in January 2000, around 2/3 of all transactions in Montenegro were conducted in German marks (money supply /M1/ in Montenegro is about DEM 65 million). It is certain that Serbia's rigid attitude against Montenegro will initiate further withdrawal of dinars, while Montenegro will implement the officially "dollarized" monetary system.

Exchange Rate and Prices

According to official statistics, the last year's inflation amounted at 42%, measured by retail price indices. Meanwhile, the annual exchange rate growth on the black market floated between 150% (black market exchange rate) and 170% (giro exchange rate). Such a disproportion between exchange rate growth and price growth is a consequence of: (1) administrative price control on large number of products; (2) considerable data forgery on price growth by official statistics, which was particularly noticeable in the last two months of 1999. Repressed inflation is characteristic for Serbia. Strong administrative price control, introduced for maintaining social peace and unrestricted monetary policy by the NBY, conducted in the second half of 1999, provoked a sudden growth of the black market exchange rate and shortages of all goods which prices were frozen (cooking oil, milk, sugar, bread, petrol, etc.).

In the forthcoming period official devaluation of the dinar can be anticipated. By the end of January 2000, the official exchange rate was even 3,3-4 times lower than the black market exchange rate. Bearing in mind that foreign currency reserves were significantly enlarged by a "Chinese gift" of US$ 300 million (before that the operational foreign currency reserves, without gold, amounted at US$ 130 million, according to our estimates), we can conclude that the National Bank of Yugoslavia currently has sufficient reserves to defend the newly established official exchange rate.