Understanding the Yugoslav "Bust": An Austrian Analysis of Global Economic Intervention in Yugoslavia

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Critics of the IMF and foreign intervention in the Balkans from both the left and the right have condemned the actions of Western powers in the breakup of Yugoslavia and the violent and unnecessary civil wars that followed. Pointing to changes in IMF and US policy in the area under the Reagan Doctrine, the shifting interests of the US after the fall of the Berlin Wall, and the expansionist hopes of the newly reunited Germany, many authors have explained the wars in the Former Yugoslavia as a result of foreign power plays. To a large extent they are correct—international political and military pressure made what could have been a peacefully resolved, albeit difficult situation into a conflict that has cost tens of thousands of lives and led to hundreds of thousands of displaced peoples. However, their analysis of the roll of the IMF and the financial crisis in Yugoslavia in the 80's is fundamentally flawed.

Using the Austrian School's unique insight into the business cycle and money theory, I hope to show in this paper that the bust of the 1980's in Yugoslavia was unavoidable (and possibly even beneficial), which resulted from decades of economic intervention in the region, a global movement towards unstable currencies and fractional reserve banking, and the myth of 'market socialism' as a viable system.

THE YUGOSLAV SYSTEM: Bad in Theory and in Practice

No one can deny that of all the communist economies of Eastern Europe the most free and prosperous was Yugoslavia. While still a fundamentally socialist society Yugoslavia was far more decentralized than the rest of communist Europe, which prevented the economy from suffering the full impacts of socialism. Though businesses in Yugoslavia were never as profitable as in many Western countries, by the end of the 1980 the average Yugoslav citizen was better off than those in Portugal, Spain, Turkey, and Greece.[1] This was especially true in both the northern republic of Slovenia and parts of Croatia, which had significant industry in place and persistently low unemployment. However, the fundamentals of the system as maintained by the government ensured that the economy would remain mutated, and fail to reach it full output potential.

Collective Ownership and the Elimination of the Capitalist

The defining feature of Yugoslav communism was the communal ownership of capital. While technically owned by the State, control of non-human capital was given to

[1] Gervasi, Sean. "Germany, U.S., and the Yugoslav Crisis." Covert Action Quarterly No. 43 (Winter 1992-1993).

worker boards, which made nearly all production decisions. Though first proposed in 1950 by Boris Kidric, it wasn't until economic reforms were under taken in 1957, 1961, and 1965 that "firms" gained effect rights of control.[2] One rather important feature of this system was the shift to the "net income system" that tied workers' incomes to the net income of the enterprise, essentially making them a residual claimant on the enterprise.[3] While developed to help alleviate the so-called "incentive problem", this measure had the unwelcome affect of fostering excessive capital consumption to increase income in the near-term, which limited the funds available to save for reinvestment.[4] However, this system allowed Yugoslav factories to *look* efficient, as they had incentive to maximize the price differential between inputs and outputs. Mistaking this price differential for profit is a major flaw in a good deal of analysis of the pre-1980 Yugoslav economy, which claim that the nation's industry was viable, and the dissolution of these enterprises was not necessary. A business can have a large price differential, but still not be profitable. The distinction between these two values however, is one that can only be identified in a capitalist system, because in order for there to be a profit, there must be other price differentials over a certain time horizon to evaluate the specific price differential against. In a system were capital cannot be shifted; this evaluation can't take place[5], which means the investment takes place "irrespective of the opportunity cost of capital".[6]

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[2] Dorn, James A. "Markets true and False: the Case of Yugoslavia." Journal of Libertarian Studies Vol. 2, No. 3. (1978) p.246

[3] Ibid. p. 248

[4] Tammen, Melanie S. "Fostering Aid Addiction in Eastern Europe." Perpetuating Poverty. Ed. Doug Bandow and Ian Vásquez . Washington: CATO Institute, 1994. p. 114

[5] Reference Ludwig von Mises. Economic Calculation in the Socialist Commonwealth. Auburn: Ludwig von Mises Institute, 1990. for more information on this argument.

[6] Dorn, p. 244

However, not all enterprises were collectively owned. Certain types of businesses, such as shops and groceries, were allowed to be privately run. Farmland was treated as privately held, meaning that agricultural production was allowed to be more market responsive. These businesses, however, were still stunted, since many opportunities to shift capital away or to these enterprises were limited.

Banks without Bankers

Among the rights afforded to these enterprises was the right to establish and maintain banks. Since these banks existed solely to serve the needs of the enterprises that created them, their basic objective was to provide their founder enterprises with low cost investment loans, regardless of banking profitability. This problem was exacerbated in 1977 with the introduction of the "redepositing" system by the National bank of Yugoslavia (NBY). This complicated system effectively shifted the exchange rate risk from the commercial banking system and transferred it to the NBY and later the federal budget.[7] This system made it even easier for communal banks to continue their decades-long practice of lending at extremely negative real rates of interest. In the eleven years the program existed, it created $12.2 billion in debt, the ultimate creditors of which were individual savers, who had unfortunately deposited so-called "hard currency" in the Yugoslav banking system.[8]

Running Virtual Printing Presses

The structure of the banking system threw the nation into an amazing inflationary cycle. The practice of fractional reserve banking (which is nearly inevitable with pure fiat currency) turned banks into virtual printing presses, allowing then to loan out money

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[7] Rant, Andrej. "Establishing Monetary Sovereignty." <u>Slovenia: From Yugoslavia to the European Union</u>. ed. Mojmir Mrak, Matija Rojec, and Carlos Silva-Jáuregui. Washington: The World Bank, 2004. p.85.
[8] Ibid. p. 86

that technically could still be claimed by savers. The effect of this was to multiply the "money supply" over and over, having the same effect as printing off mass quantities of cash. This was one cause of the inflation the plagued Yugoslavia in the 70's and 80's, which experienced an annualized inflation rate of 79 percent from 1971 to 1999; only Zaire and Brazil experienced more inflation over the same time period.[9]

This system then fed itself. The high inflation rates caused by excessive loaning made real interest rates fall into the negative double-digits, making loans even more attractive to the enterprises that borrowed from them and thus increasing demand. This in turn led to more lending which caused even greater inflation. By 1989, despite running a modest federal budget surplus, Yugoslavia experienced 2,795 percent inflation.[10]

Making Bad Business Worse: Malinvestment on Top of Calculation Impossibility

While inefficiently run, the community owned enterprises were not free from the threat of bankruptcy by law. Significant protections were in place: if an enterprise didn't earn enough income to cover minimum wage for all its employees, the difference would be taken out of the local commune's budget. In theory, if an enterprise was so poorly run that the commune couldn't finance it, it would go bankrupt and be dissolved.[11] The possibility of bankruptcy was also open for Yugoslavia's many privately owned enterprises—and such enterprises didn't have the security of a commune budget to fall back on.

However, the banking system made sure that even the most unprofitable of businesses managed to stay afloat. Not only did the system extend credit to businesses

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[9] Hanke, Steve H. "Yugoslavia Destroyed Its Own Economy." The Wall Street Journal 28 Apr. 1999.
[10] Tammen, p. 115
[11] Dorn, p.247

which not only would have failed without it, it also provided loans to enterprises that were clearly not credit worthy, financed the foreign exchange losses that borrower enterprises had made on overseas loans, and issued loans at a subsidized rate. By doing this the banks made the system even more unstable. But irresponsible banking was the least of Yugoslavia's problems. On top of the uncertainty caused by inflation, interest rate manipulation further weakened the prospects for true economization.

Previously I discussed how for there to be economizing action there must be comparable price differentials and the ability to move capital between different lines of production. In a capitalist society, the interest rate reflects the level which all price differentials would move to in an even rotating economy. The interest rate acts as a device for communicating consumer's time preference to producers, and allows them to evaluate what lines of production are most profitable.[12] When this rate is artificially lowered by the state producers invest in longer production processes while continuing to try to produce the same level of consumer goods. This period looks like a boom as employment increases and everyone seems to be wealthier. However, the '"boom" period can only be maintained so long, and the government must continue to pump more money into the economy to hold the interest rate down. The force of both political pressure (people calling for the end of inflationary practices) and physical limits (there is only so much capital that can be consumed) mean that this 'boom' period must end eventually.[13] This period in then followed by a 'bust'. It needs to be emphasized is that this is actually a readjustment period during which "the market reverts to its preferred

[12] Rothbard, Murray N. Man, Economy, and State. 4th ed. Auburn: Mises Institute, 2001. p. 855
[13] Ibid, p. 856

interest rate and eliminates the distortion caused by the credit expansion."[14] In other words, *it's a good thing*, however distasteful.

When viewed in this light, it becomes obvious that the seeming collapse of the Yugoslav system was indeed not unexpected or all together bad. If Western powers had not used the temporary destabilization as a means of asserting their influence in the region, this period might have allowed the Yugoslavia to emerge as much more efficient and prosperous nation.

THE IMF AND WORLD BANK: Delaying readjustment

Multiple authors, Susan Woodward and Michel Chossudovsky eminent among them, have emphasized the role of the IMF's changing policy towards the Balkans in the collapse of Yugoslavia. However, as analysis of the bust period reveals that perhaps more important than this period is the one preceding it, in which the stage was set for the eventual crumbling of the market socialist system and western intervention.

Yugoslavia had long been the IMF's "favorite son" in Eastern Europe. One of the charter members of the IMF, Yugoslavia only went three years without taking out IMF loans in the period from 1949 to 1989. As of 1991 Yugoslavia was allowed to borrow 5 billion dollars from the fund.[15] Not surprisingly, the World Bank also was very active in the area, extending 2.7 billion dollars in loans from 1950-1980 to fund state development projects.[16]

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[14] Idib, p. 859
[15] Tammen, p.114
[16] Assetto, Valerie J. The Soviet Bloc in the IMF and the IBRD. Boulder: Westview P, 1988. p. 46

Causing or Solving: Balance of Payments

Article V, section 3.b.ii, of the IMF's Articles of Agreement states:

> A member shall be entitled to purchase currencies of other member of the Fund […] subject to the condition [that] it has a need to make the purchase because of its balance of payments or its reserve position or development of its reserves.

This condition is then met if the reserves of a country's hard currency decline. Such a situation can easily be induced, either by decreasing the domestic component of the monetary base, or by revaluating the currency.[17] Neither of these situations is an economic emergency, indicating that even if one accepts the premise that international intervention is needed to adjust the balance of payments, the IMF's standard for evaluating situations in which such intervention is needed is not effective. However, the more devastating facet of IMF policy is that while there might not be a balance of payments issue when they intervene in a nation, they often manage to cause one to develop. By funding over-expansionary policies which artificially drive up demand, the IMF has an international track record of making balance of payment situations worse in the countries that they fund.[18] This was clearly the case in Yugoslavia, where domestic consumption, propped up by the policy of cheap (or more often free) credit, regularly exceeded domestic production.

Funding the Banks: Facilitating the Cycle

As mentioned earlier, in order for the "boom" period of a business cycle to continue, funds must continually pumped into the economy, holding the interest rate

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[17] Vaubel, Roland. "The Political Economy of the IMF: A Public Choice Analysis." Perpetuating Poverty. ed. Doug Bandow, and Ian Vasquez. Washington: CATO Institute, 1994. p. 39-40

[18] Ibid, p. 40

down and stopping it from moving back to the market preferred rate. In the case of the Yugoslav “boom” the funds which facilitated this action quite clearly came from the IMF and World Bank, which from 1981 to the collapse of the federation funneled 700 million dollars into the government’s nine regional banking groups.[19] (Of course, the Bank knew full well how the system operated. An internal report from the World Bank in 1989 estimated a 50 percent collectability ratio on problem loans.) The natural result of this extension of the “boom” period was that the misallocations that it caused were so entrenched, and capital was so depleted, that when the ‘bust’ came, consumers were sure to drastically affected.

Justifying the Intervention

It would have seemed that the role of the IMF, after the collapse of the Bretton Woods system it had been created to maintain, would have diminished in the early 70’s (if not completely abolished). However, this was not that case. One obvious reason for continued IMF intervention in Yugoslavia in particular was that it was of strategic importance to the United States, which sought to maintain their power in the region. To this end the IMF played as a smoke screen, facilitating the desires of policy makers without linking them directly to the intervention, which ensured that they could continue to take such action without worrying about being help public accountable for it. Few people dispute the fact that the US directed much of the policy of the IMF. Unlike direct aid, the IMF gathered its funds from all of its member nations. This made it cheaper to provide loans through the IMF than any other method of aid which in turn made the use of the IMF even more attractive..[20] Additionally, like other inherently unstable systems

[19] Tammen, p. 114
[20] Vaubel, p. 45

created in Yugoslavia, the extension of the boom period secured Tito's power in the short term, in line with his policy of "Apres Moi Le Deluge."

THE COLLASPE: Crisis and Readjustment

The Foreign Debt Crisis: Impetus for Change and Collapse

In 1982, when the "foreign debt crisis" broke out (though its roots really can be traced back to 1978, when US banks started to cease lending to certain foreign governments), it sent a shock to the Yugoslav economy, which had relied on massive foreign debt as one of the many ways it propped up its banking system. Author Susan Woodward described the situation as such:

> The problem was shortage of foreign currency, although experts blamed distortions in the economic system. The immediate solution was to seek short-term coverage (through IMF credits)… Terms negotiated with the IMF [were] railroaded through a tumultuous federal parliament… This project was completed by 1985, when the second stage of the debt crisis program began. The second stage was to legislate economics reforms on the basis of a "long-term program for economic stabilization" created by *external creditors* and an ad hoc commission of economists and politicians…[21]

While Chossudovsky acknowledges this, he emphasizes the role of the Reagan administration and the National Security Decision Directive (NSDD 133), entitled "United States Policy towards Yugoslavia" which came out in 1985, and a similar 1982 directive (NSDD 54) which sought to facilitate 'quiet revolutions' in the communist

[21] Balkan Tragedy. Washington: The Brookings Institute, 1995. p. 50-51 & 57 (emphasis added)

nations of Eastern Europe.[22] This sentiment had a great deal to do the final layout of the IMF directives, and the role of economic imperialism on the behalf of the United States cannot be denied. However, if these two authors are to be believed, and the implosion of the Yugoslav economy was caused solely by the IMF and external powers, the dates of these measures and the crisis that followed seem to be inconsistent.

The first round of IMF conditions was initiated in 1980, and had been under negotiation since 1979, well before Reagan came to office and NSDD 54 was issued.[23] Indeed, while it *was* action on the part of the United States which fueled this undertaking, the role of a third party must accounted for: the US banking lobby. By 1979, the government of Yugoslavia had foreign debt amounting to nearly $20 billion which it could not service because of the inefficacy of its banking and economic systems. Aside from the IMF and World Bank, the largest lender to the Yugoslav government was a group of major American banks. When these banks found the security of their loans in danger, they lobbied to the U.S. treasury department to induce the IMF to act in the areas where their debt was most likely to be compromised.[24]

Readjustment: More (mis)Management

While the collapse of the Yugoslav system was inevitable, it is also very clear that it could have occurred in a much swifter manner than it did. Both the struggle by the Yugoslav government to maintain power and the later efforts by the German and US governments to exert their force in the region by breaking up the federation and installing puppet governments meant that while a 'bust' was needed, it would not be allowed to take its natural course.

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[22] The Globalization of Poverty. Atlantic Highlands: Zed Books Ltd., 1997. p. 244
[23] Gervasi.
[24] Vaubel, p. 45

The first stage in the process of austerity was a response to debt and foreign illiquidity. To facilitate this, the federal government tried to reduce domestic consumption at all costs. Some of the actions taken by the Yugoslav government were true marketizing reforms, such as removing subsides on food, fuel, and transportation, which when done alone would have done long term good for the economy, and would have stabilized the economy. However, the Yugoslav government, under pressure to pull as much hard currency into government banks as it could as quickly as possible, instituted many polices which made the situation worse. This swung the country from one extreme to the other, and prevented the readjustment process that was necessary to bring economic security to the nation. Instead of allowing wages to fall, the government forced firms showing losses to fire workers. Instead of letting imports settle to a lower level and allowing firms to choose to sell domestically or export, they were strictly regulated, causing shortages of staple items like meat, sugar, and soap.[25] This was a sharp contrast to the situation most Yugoslav citizens were used to, especially in Slovenia and Croatia, where consumers had grown accustomed to stores that were well stocked with a large variety of consumer goods.

The result of this process was predictable. Far from curing the account balance ills that it had been hoping to eradicate, the measures actually decreased the country's ability to produce significantly, falling from 7% growth in 1979 to -1.3% growth in 1983.[26] This, of course, in not at all an unexpected outcome if one looks at how these measures would affect economic calculation. Just as not allowing capitalists to move capital from one production process to another impedes economizing, restricting imports

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[25] Woodward, p. 51
[26] Ibid. p.55

to only what the government thinks is necessary for production greatly limits the firm's ability to choose inputs and economize between production methods. The result would be an obvious decline in production, one much greater and long lasting than the one that would have occurred had the economy been allowed stabilize through market processes.[27]

The Spilt

There is no doubt that these "reforms" paved the way for the dissolution of Yugoslavia. Strong differences between pre-1979 policies and conditions among the republics meant that the actions taken by the Federal government had widely varying affects. For example, during the 80's unemployment in Slovenia never rose above 5 percent, whereas in the Serbian province of Kosovo, it reached levels of nearly 60 percent. Croatia and Slovenia, oriented well because of historical and geographical proximity to the West, were best able to withstand the austerity measures and even benefited (on the short term) from some of the polices. These differences drove an early divide in the federation, creating conflict over the domestic law and constitutional reform, which would eventually lead to the break-up of the nation and the wars of Yugoslav secession.

CONCLUSION

The point of this paper has not been to discount the role of international power politics in the breakup of Yugoslavia. Rather, I have attempted to show that the demise of the Yugoslav economy cannot solely be blamed on international issues. If it had not been for the rigging of the banking system, the elimination of the vital role of the capitalist, and the monetary irresponsibility that comes with fiat currency, Yugoslavia could have placed itself in a much stronger position for resisting international pressure.

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[27] Rothbard, p. 787

Instead, the system imposed made it necessary for there to be an economic ‘bust’ for the nation’s long term economic health. Saying that this economic readjustment was inevitable, or even good, is very different from justifying the actions of western powers to use this crisis as a cover for their bids to establish their power in the region. In the end, like far too many other tragedies in the world, the conflict was a result of the state system, which subjugated the co-operative power of the market to national and personal interests.