International Monetary Fund

Serbia and the IMF

Press Release:
IMF Executive Board Concludes 2014 Article IV Consultation with the Republic of Serbia
March 28, 2014

Serbia: Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding

February 6, 2015

The following item is a Letter of Intent of the government of Serbia, which describes the policies that Serbia intends to implement in the context of its request for financial support from the IMF. The document, which is the property of Serbia, is being made available on the IMF website by agreement with the member as a service to users of the IMF website.

Country's Policy Intentions Documents

Republic of Serbia: Letter of Intent

Ms. Christine Lagarde
Managing Director
International Monetary Fund
Washington, D.C., 20431
U.S.A.

Belgrade, February 6, 2015

Dear Ms. Lagarde:

In the past few years, Serbia has accumulated internal and external economic imbalances. The government appointed in April 2014 has recognized the challenges associated with these imbalances and is strongly committed to address them. While the global financial crisis seems to have abated, downside risks to our exports and external funding sources, particularly with regard to EU countries, remain elevated. To insure against such risks and better anchor our policy framework, we request that the Fund support our new economic program through a precautionary Stand-By Arrangement (SBA) for a period of 36 months in the amount of SDR 935.4 million (200 percent of quota).

The attached Memorandum of Economic and Financial Policies (MEFP) outlines the economic policies that the Government of the Republic of Serbia and the National Bank of Serbia (NBS) intend to implement under the new SBA. Our program has the full support of all coalition partners in the present government. In view of Serbia's comfortable international reserve position and continued access to external financing, we aim to treat the arrangement as precautionary. Therefore, we do not intend to make the purchases under the requested arrangement when they become available upon its approval and after observance of its performance criteria and completion of its reviews.

The implementation of our program will be monitored through prior actions, quantitative performance criteria, indicative targets, structural benchmarks, and an inflation consultation clause, as described in the attached MEFP and Technical Memorandum of Understanding (TMU). There will be twelve reviews of the arrangement by the Fund, scheduled to be completed on a quarterly basis to assess progress in implementing the program and reach understandings on any additional measures that may be needed to achieve its objectives.

We believe that the policies set forth in the attached memorandum are adequate to achieve the objectives of our economic program, but we will take any further measures that may become appropriate for this purpose. We will consult with the Fund on the adoption of these measures and in advance of revisions to the policies contained in the MEFP, in accordance with the Fund's policies on such consultations. And we will provide all information requested by the Fund to assess implementation of the program.

We wish to make this letter available to the public, along with the attached MEFP and TMU, as well as the IMF staff report on the 2014 Article IV consultation and the request for a three-year SBA. We therefore authorize their publication and posting on the IMF website, subject to Executive Board approval. These documents will also be posted on the official website of the Serbian government.

Sincerely,

/s/
Aleksandar Vučić
Prime Minister

/s/
Jorgovanka Tabaković
Governor of the National Bank of Serbia

/s/
Dušan Vujović
Minister of Finance

Attachments: Memorandum on Economic and Financial Policies
Technical Memorandum of Understanding

Attachment I. Memorandum of Economic and Financial Policies

1. This memorandum sets out our economic program for 2015–2017 that will address short-term as well as medium-term economic challenges that Serbia is facing. The economic program has three main objectives:

- First, address macroeconomic imbalances and vulnerabilities, most notably by placing public sector debt on a sustainable path.
- Second, bolster resilience of the financial sector and improve its intermediation function necessary to support economic growth.
- Third, improve competitiveness and reduce key growth bottlenecks through vigorous implementation of comprehensive structural and SOE reforms.

These goals are compatible with our aspirations to become an EU member after having started the accession process in January 2014. Implementing this program would allow Serbia to realize the significant potential for convergence towards EU income levels.

RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

2. We recognize that Serbia's economy is facing a number of challenges. In 2014, the economy fell into recession for the third time in six years, partially due to the devastating floods in May, 2014. Unemployment in excess of 18 percent of working age labor force poses a major social concern. A combination of falling domestic demand, a good agricultural outcome in 2013 and 2014, and low growth of regulated prices in 2014 have pushed inflation below target. Public debt has risen sharply and is estimated to have reached about 70 percent of GDP in 2014, while the fiscal deficit in 2014 was close to 7½ percent of GDP. A scenario without comprehensive policy changes is untenable, with likely economic stagnation and unsustainable public debt dynamics.

3. We will consistently implement policy actions and reforms envisaged under this economic program. We expect that this will give rise to a virtuous cycle of boosting confidence, improving growth and private sector vibrancy. We envisage the following macroeconomic scenario under the program:

- **Real GDP** is expected to contract by ½ percent in 2015 due to sizeable fiscal consolidation. Growth will gradually accelerate over the medium term on account of smaller fiscal adjustment, recovering market confidence and credit growth, and positive effects of structural reforms.

- **Headline CPI inflation** is projected to return close to the inflation target of 4 percent by the end of 2015 and stay within the inflation tolerance band (4 percent±1.5 percent), supported by the inflation targeting regime.
- **The current account deficit** is expected to adjust to about 4¾ percent of GDP this year and decrease to close to 3¾ percent of GDP over the medium term. External financing will rely mostly on FDI, eurobond issuance, and project loans.

4. **The program scenario is subject to downside exogenous risks, but the Serbian economy has considerable buffers to withstand them.** In light of the close trade and financial links with the EU, a protracted period of slow growth in trading partners would have a negative impact on Serbia. Continued deleveraging by foreign bank subsidiaries, which dominate our financial sector, could pose challenges. However, as the first line of defense we have large foreign exchange reserves and a well-capitalized and liquid banking system. The Fund arrangement would provide an additional buffer to help us cope with negative shocks, and we are prepared to further adjust policies as necessary.

ECONOMIC POLICIES

A. Fiscal Policies

5. **We are committed to implementing a set of fiscal consolidation policies that will reverse the rise in public debt by 2017 and put it firmly on a downward path thereafter.** We believe that a credible three-year adjustment requires significant front-loading. To this end, we identified gross fiscal measures amounting to 4¾ percent of GDP during 2015–17, of which over half has already been implemented or will be implemented this year. The measures focus primarily on containing public expenditures, namely on scaling down public sector wage and pension bills and reducing state aid to state-owned enterprises (SOEs).

6. **We have already initiated fiscal consolidation with the introduction of expenditure measures in 2014.** In order to contain the growth of the public wage bill, the original 2014 budget imposed a solidarity tax on wages higher than 60,000 dinars in the public sector (general government and SOEs) and introduced a 5:1 attrition rule for general government employment. The supplementary 2014 budget approved in October 2014 created additional net savings by replacing the solidarity tax with an across-the-board 10 percent nominal wage cut, protecting wages below 25,000 dinars per month and introducing a progressive cut in nominal pensions (22 percent for pensions between 25,000 and 40,000 dinars per month and 25 percent for higher pensions).

7. **In order to put the public pension system on a more sustainable footing, we have introduced a comprehensive parametric pension reform in July 2014**. We have legislated a new Pension Law which includes the following changes: (i) increasing the statutory retirement age for women from 60 to 65 years by 2032 (6 months per year by 2020, and 2 months per year

afterwards); (ii) increasing the minimum retirement age from 58 to 60 years by 2024, and (iii) introducing actuarial penalties of 4 percent per year for early retirement.

8. We will continue with fiscal consolidation in 2015. As a prior action, we have adopted the 2015 budget with the accompanying legislation as indicated below. This introduces additional fiscal measures that will reduce the augmented deficit of the general government to about 6 percent of GDP this year (performance criterion):

- We will reduce general government employment by 5 percent, through the continued application of the attrition rule and targeted separations in mid-2015, by preparing wage bill envelopes for individual public institutions in the 2015 budget. Severance payments will be determined in line with the current legislation. To support this, we extended the attrition rule through 2015 by amending the Budget System Law in December 2014.

- We will suspend the indexation of public sector wages in years in which the share of general government salaries (excluding severance payments) is expected to exceed 7 percent of GDP. We will suspend indexation of pensions in years in which the share of pensions is expected to be above 11 percent of GDP. We have modified the Budget System Law and Pension Insurance Law accordingly in December 2014.

- We have initiated a comprehensive public wage system reform to improve quality and efficiency by aligning base wages, unifying pay grades across comparable jobs, streamlining the structure of coefficients, and integrating other elements of pay into base wages across all general government sector entities. A single Law on Wages of State Employees will replace a battery of laws setting the key principles and parameters of the new system for most sectors (but not public enterprises), including the principle of same pay for generic jobs across all sectors. The new Law will be submitted to the National Assembly by June 2015. Implementing regulations will be adopted by end-October 2015, mapping every existing job into a new classification and specifying non-linear wage adjustment rules that will enable the introduction of new wage grades while respecting the financial envelope set by this program. The transition period to the new wage system will be determined in the course of 2015.

- We will reduce spending on goods and services by lowering the mark up on procurement from domestic suppliers from 15 percent to 5 percent in 2015, and eventually eliminating it by 2018, for which we have amended the Procurement Law in early February 2015. This will also reduce the cost of capital spending.

- We have eliminated agricultural subsidies for land over 20 hectares and for land leased from the Government of Serbia. We have modified the Law on Agriculture accordingly in December 2014.

- We will reduce state aid to SOEs, including subsidies, net lending, and payments from the budget for guaranteed and nonguaranteed debt of the SOEs. We have adjusted network fees on natural gas distributed by Srbijagas to generate €60 million on an annual basis, effective from February 1, 2015 until the government finds alternative measures with the same revenue effects, in consultation with the IMF staff. This additional revenue will enable Srbijagas to pay a part of its debt obligations, and will correspondingly reduce the payments of its called guarantees from the budget. We will reduce the operating costs of Serbia Railways, and reduce subsidies accordingly. We will introduce an excise tax on electricity to reduce inefficiency of consumption.

- We will reduce subsidies to public broadcasting companies in 2015 and will eliminate them in 2016.
- To ensure proper protection of the vulnerable segments of the population, the existing social safety net will be maintained.

9. We will implement additional fiscal measures during 2016-17. Our primary focus will be on the continued reduction of mandatory expenditures through the following measures:

- We will continue reducing the cost and increasing the efficiency of general government, through its organizational and functional restructuring, in accordance with the new Public Administration Reform Strategy, adopted by the government in January 2014. By end-March 2015, we will conduct an analytical overview of the public administration system with a view to identifying sectors with the highest potential for efficiency gains and employment reduction. These will then undergo in depth functional reviews, producing estimates of additional savings to be attained through restructuring by end-October 2015, in time for incorporation in the 2016 budget. Throughout 2015 we will also advance the data and legal infrastructure necessary to accomplish additional savings in 2016 and 2017 by introducing e-government. We are thus committed to attaining a further reduction of the general government wage bill and other labor associated costs budgeted under goods and services by 5 percent in both 2016 and 2017.
- We will amend the Local Government Financing Law, which will rationalize transfers and the revenue sharing mechanism to local governments and provide incentives to raise their own revenues. This law will be amended by June 2015 (structural benchmark), and will be implemented as of January 1, 2016.
- We will introduce an excise tax on non-alcoholic drinks (excluding water).

10. We will aim to reduce fiscal risks and will prepare contingency measures. In this regard, we will not rely on short-term external debt financing (performance criterion), and we will not accumulate public sector external debt payment arrears (performance criterion). We will also refrain from accumulating domestic payment arrears (indicative target). Our efforts to reduce public spending will be monitored through a ceiling on the current augmented primary expenditure excluding capital spending and interest payments of the Serbian Republican

Budget (quantitative performance criterion). If revenues are reduced due to an exogenous shock, we will consider contingency measures, such as raising the VAT rate and gasoline excise tax. On the other hand, if the revenue collection exceeds the projected amounts in 2015, the gains would be used to repay public debt in 2015. If the revenue gains are sustainable, a portion could be also used, in consultation with the Fund, for high priority infrastructure projects in future years.

B. Structural Fiscal Policies

11. To underpin the fiscal consolidation, limit risks and strengthen institutions, we will pursue the following structural policies in the fiscal area:

- To increase fiscal transparency, we classified as "spending above the line" all payments for guarantees serviced by the government, repayment of debt taken over, payments for arrears, and costs related to resolution of financial institutions in the 2015 Budget.

- We will review and clearly define the coverage of general government to be compatible with European System of Accounts (ESA) 2010, and will include social security funds with all health fund indirect beneficiaries, road and corridor funds, and own-source revenue and expenditures of indirect budget beneficiaries (excluding education and local governments) within the 2016 budget documentation. We will include education and local governments in the budget documentation by end-2016. In parallel, we will include all Indirect Budget Beneficiaries of the central government in the Financial Management Information System gradually by end-2016, taking into account their technical and technological capacity.

- We are committed to performing a fiscal impact analysis of all new legislative initiatives under the "pay-as-you-go" rule of Article 48 of the Budget System Law. For this, we will issue an instruction to line ministries on how to calculate and report the estimated fiscal impact by end March 2015.

- The National Assembly approved in the 2015 Budget Law the overall three-year expenditure ceilings of the Republican budget (without Indirect Budget Beneficiaries) that are aligned with the general government expenditures, as specified in the program and the Fiscal Strategy for 2015-17, which is to be adopted in early February 2015. We will also improve the planning of the contingency reserve to support the credibility of the ceilings.

- We will strengthen cash management by re-establishing a Liquidity Committee in February 2015 including, but not limited to, representatives of the Treasury, Tax Administration, Public Debt Administration, Budget Preparation Department, Macro-Fiscal and Analysis Department, and the NBS.

- To strengthen the control of the public sector wage bill, we have made significant progress in setting up a comprehensive registry of public sector employees. We will finalize and validate this registry by adopting the legal framework necessary to ensure full coverage of the public sector employees—all employees at the republican and local government levels, in public agencies and institutions, and SOEs—by end-June 2015 (structural benchmark). We will amend Article 93 of the Budget System Law to specify the necessary data submissions and all responsible agencies.

- We will ensure that a full assessment of all proposed Public-Private Partnerships (PPPs) is reviewed by the Ministry of Finance (MOF), including the PPPs' key financing features, cost-benefit analysis, and risk sharing arrangements with the government. We will also include a fiscal risk statement on all PPPs from the 2016 budget onwards. In this regard, we will set up a special fiscal risks management unit at the MOF by March 2015. Furthermore, to improve control of fiscal implications and risks, we will amend the existing Law on PPPs by June 2015 to mandate that all PPPs are submitted to the government for consideration only with prior approval by the MOF.

- We will implement recommendations of the World Bank and IMF TA missions on Public Debt Administration organizational structure and changes in the Law on Public Debt, including setting up a department for asset management.

12. To secure savings from the corporate and financial restructuring of major SOEs, we will introduce a number of public financial management changes.

- We will create a strong and stable institutional framework for monitoring SOEs. As a first step, we will adopt a government decree that will regulate the roles and responsibilities of the MOF, Ministry of Economy (MOE), and line ministries with respect to monitoring, supporting best governance practices, financial reporting, and transparency of SOEs, by March 2015 (structural benchmark). We will ensure quarterly provision of financial statements of SOEs to both the MOE and MOF from January 2015. We will strengthen the SOE monitoring unit in the MOE which will focus, in collaboration with the relevant line ministries, on corporate strategy and governance, and operational efficiency of SOEs. In agreement with the MOE, the SOE financial monitoring function will be created in the fiscal risks management unit in the MOF, which will focus on reviewing and compiling the financial reports and statements of SOEs and evaluate the fiscal implications.

- To enhance the payment discipline between public sector entities, we will broaden the scope of the Law on Payments in Commercial Transactions, to include transactions between public entities (including SOEs), in consultation with the IMF, by June 2015 (structural benchmark). This law will define monitoring and enforcement mechanisms for improving payment discipline in the public sector, to be implemented from January 2016. We will also modify the Decree (see TMU) that regulates the conditions under which transfers from the budget can be reduced.

- We will strictly limit issuance of state guarantees from January 1, 2015. In this regard, we will not issue any new state guarantees for liquidity support (continuous PC). We have reflected this in the Budget Law for 2015 and will modify the Public Debt Law accordingly by June 2015. Furthermore, we will set limits on issuance of new state guarantees for viable project loans (quarterly PC) in annual budgets, in line with the overarching debt sustainability objective, and consult the Fund staff before authorizing the issuance of guarantees. To avoid any misuse of guaranteed project loans, the fiscal risks unit at the MOF will monitor their implementation.

- We changed the Law on Development Fund in January 2015 to remove the article which stipulates that all guarantees issued by the Development Fund (DF) are backed by the Republic of Serbia (prior action). We will establish an indicative ceiling on the below-the-line lending by the Republican Government. In addition, we will only provide such loans to public entities with high probability of repayment. We will also proceed with the diagnostic analysis of the DF, followed by proposals to improve governance and operational procedures of the DF by end-2015.

13. In order to raise the efficiency of revenue collection, we are committed to improving tax administration based on recommendations of the September 2014 IMF technical assistance mission. We will appoint the Director of Serbia's Tax Administration with an appropriate skill set in February 2015 and we will transfer responsibility for investigation of economic crime cases to a relevant agency by end-March 2015. We will adopt and implement by end-March 2015 the *Tax Administration Transformation Program 2014–19* developed by the MOF as the official medium-term reform program (structural benchmark). Our priorities are to (i) strengthen the tax administration's governance, (ii) streamline organizational structures of headquarters and field offices, including by reallocating employees to facilitate compliance efforts, (iii) phase in a modern compliance risk management approach, (iv) strengthen arrears management, including write off procedures, (v) modernize information technology systems and business processes, and (vii) improve coordination and information exchange with other government agencies.

C. Monetary and Exchange Rate Policies

14. We see the current inflation targeting framework as the most viable option for maintaining stable inflation and protecting the economy against external shocks. We remain committed to the objective of keeping inflation within the inflation tolerance band (4±1½ percent). Inflation developments will be monitored via a consultation clause with consultation bands set symmetrically around the central projection of headline CPI (Table 1). As the fiscal adjustment takes hold and external financing conditions stabilize, we see room for rebalancing the policy mix towards looser monetary policy, in line with the inflation outlook and financial stability. This easing, however, will be gradual and will depend on external financing conditions.

15. We will maintain the existing managed float exchange rate regime in line with the inflation targeting framework. We believe that exchange rate flexibility provides a needed buffer against external shocks. In light of this, foreign exchange interventions will be limited to smoothing excessive exchange rate volatility without targeting a specific level or path for the exchange rate, while considering the implications for financial sector stability and meeting the inflation target. The current level of gross international reserves is above the levels determined by most reserve metrics and we will maintain adequate coverage throughout the program, which will be monitored by a floor on net international reserves (performance criterion).

16. In order to reduce risks to macroeconomic stability, we will continue capital account liberalization in a gradual way. Many of the capital account transactions, such as FDI and long-term flows, have already been liberalized, with the remaining restrictions related broadly to short-term capital and deposit flows. In order to limit balance of payments pressures under the program, the capital account liberalization required in the context of EU accession will be gradual, particularly in removing restrictions on short-term foreign inflows to domestic securities and the ability of residents to open deposit accounts abroad.

17. During the period of the SBA we will not, without Fund approval, impose or intensify restrictions on the making of payments and transfers for current international transactions, nor introduce or modify any multiple currency practices or conclude any bilateral payment agreements that are inconsistent with Article VIII of the IMF's Articles of Agreement. Moreover, we will not impose or intensify import restrictions for balance of payments reasons.

D. Financial Sector Policies

18. Our policies will support financial sector stability and the banking sector's ability to cope with shocks, while improving financial intermediation. We will put priority on the following: (i) further strengthening the supervisory and regulatory framework; (ii) improving the bank resolution framework and enhancing our crisis preparedness; (iii) stepping up efforts to address the high stock of non-performing loans (NPLs); and (iv) implementing a strategy for publicly-owned banks. These policies will follow the ongoing harmonization of the financial sector legislation with EU standards.

19. We will enhance the supervisory and regulatory framework. The NBS implemented the Basel II framework in late 2011 and is planning to introduce the Basel III framework in the medium term. In preparation, the NBS will benchmark its prudential standards against the EU's CRD IV package, with proposals for further reform to be finalized by end-December 2015. In doing so, the NBS will, inter alia, aim to introduce additional capital requirements for banks deemed systemically important reflecting the EU's CRD IV package. Meanwhile, the NBS stands ready to take necessary measures to ensure that banks maintain sufficient capital and liquidity. The NBS aims to intensify its supervisory cycle, ensuring that systemically important banks and institutions with the highest risk rating are subjected to on-site inspections on an annual basis. Finally, we will enhance our framework for macro prudential policy, leveraging international best practices.

20. In view of the current uncertain economic environment, we are undertaking a program of special diagnostic studies of banks operating in the Republic of Serbia, in line with similar initiatives in many EU countries.

- The diagnostic studies, to be completed by end-September 2015 (structural benchmark) with the help of external consultants, will be based on terms of reference that will be agreed with IMF staff by end-March 2015.
- The diagnostic studies will be guided, to the extent possible, by strengthened collateral valuation standards and minimum requirements for appraisers, to be finalized in consultation with IMF staff.
- The NBS will use the studies to foster conservative implementation of IFRS accounting standards and disclosure practices. Moreover, it will use the experiences obtained to strengthen its prudential framework and supervisory approach, in particular the Decision on the Classification of Bank Balance Sheet Assets and Off-Balance Sheet Items.

21. We have undertaken several legislative changes to strengthen the bank resolution and financial safety net frameworks. We legislated comprehensive revisions of the bank resolution framework—comprising amendments to the Law on Banks, Law on NBS, Law on Deposit Insurance, Law on Deposit Insurance Agency and Law on Bankruptcy and Liquidation of Banks and Insurance Companies, as well as abrogation of the Law on the Assumption of Assets and Liabilities of Banks for the purposes of safeguarding stability of the financial system of the Republic of Serbia—in early February 2015 (prior action), and the new framework will be effective from April 1, 2015. Our broad objective is to develop a general, flexible resolution framework for banks, giving the possibility to calibrate resolution strategies for institutions whose failure could trigger systemic disruptions. In making these proposals, we have relied on recent IMF technical assistance. In view of Serbia's ongoing EU accession process, the new framework is broadly guided by the Bank Recovery and Resolution Directive (BRRD). The main changes are as follows:

- Clarifying principles and objectives of resolution in legislation and introducing a single administrative resolution proceeding;
- Expanding NBS's resolution mandate while separating supervision and resolution functions within the NBS. The NBS will take on the responsibility for designing resolution strategy, including for gone concern banks. The mandate of the Deposit Insurance Agency (DIA) will be refocused on the deposit insurance function;
- Broadening the resolution toolkit to allow for the orderly resolution of all banks without severe systemic disruption and without exposing taxpayers to loss, while enhancing crisis preparedness. For this, we will develop the recovery and resolution plans for banks whose failure could trigger systemic disruption;

- Enhancing the safety net framework. We will strengthen the financial and institutional capacity of the DIA, to enable it to meet its deposit insurance obligations and serve as a core part of the financial sector safety net. We have increased insurance premiums for 2014-15 to replenish the Deposit Insurance Fund (DIF). In addition, we have obtained a €145.3 million loan from the World Bank as seed funding for the DIF, and secured a €200 million credit line from the EBRD. The DIA's operational capacity will be enhanced by (i) improving governance, (ii) strengthening the asset recovery process, and (iii) increasing information sharing between the NBS and the DIA.

22. We will launch a comprehensive strategy to address the NPL overhang. The high level of NPLs poses risks to financial stability and constrains financial intermediation. We will develop a comprehensive strategy for NPL resolution, in collaboration with the IMF, WB, and EBRD by end-June 2015. The strategy will include the following elements:

- Review and strengthen banks' capacity for dealing with NPLs. The planned diagnostic studies will provide an initial insight into banks' policies and procedures for working out distressed loans. We will issue guidance for banks' management of NPLs, including the creation of specialized workout units within banks, the implementation of which will take into account the findings of the special diagnostic studies.

- Remove obstacles to write-offs and asset sales. We will identify and eliminate impediments to loan write-offs by banks and asset sales to private investors. As difficulties with collateral valuations hinder NPL market development, we will legislate valuation standards and minimum criteria governing the activities of collateral appraisers. We will create the framework for licensing private professional valuators according to international best practices.

- Strengthen the in-court corporate insolvency regime and introduce a personal insolvency framework. Our objective is to make corporate and household debt resolution more efficient and timely. We will amend the Law on Corporate Bankruptcy to remove bottlenecks for in-court corporate debt resolution which need to be identified through further analysis, and establish a law on personal insolvency.

- Promote out-of-court corporate debt restructuring. We established the framework for voluntary corporate debt restructuring in 2011, yet this mechanism remains underutilized. We will review the effectiveness of the existing legal framework and will develop policy measures to address obstacles to effective debt restructuring. In order to improve out of court foreclosure and better align incentives for debt restructuring, we are revising the Mortgage Law to allow purchases of collateral property free from lower-ranked liens. We will conduct workshops to promote awareness by market participants and disseminate best practices.

23. We will strengthen state-owned banks. We will continue to implement the comprehensive strategy for state-owned banks which was adopted in May 2014. In particular, we will bolster institutions that fulfill a strategic function in the Serbian banking system, while selling or winding down in an orderly fashion other state-owned institutions, including via asset and liability transfers. Where necessary, we will strengthen banks' corporate governance and risk control frameworks, in accordance with international best practices.

24. We will continue to implement our dinarization strategy. This strategy is based on three pillars: (i) maintaining overall macroeconomic stability; (ii) creating favorable conditions for developing the dinar bond market; and (iii) promoting hedging instruments. In this regard, since November 2013 we have liberalized borrowing in dinars by the IFIs, and further increased maturity of dinar-denominated securities in the local market by successfully placing a 10-year dinar denominated T-bond.

25. We will support credit to SMEs. Given the importance of SMEs for Serbia's economy and the limited access to credit by this sector, we will support lending to SMEs through EIB's credit lines ("Apex loans"). We will streamline loan approval procedures.

E. Structural Policies

26. We will implement a comprehensive structural reform agenda to attract investment, support growth, and rebalance the economy on its path towards EU integration. We will focus on specific policies that (i) sustain job creation, (ii) reform state-owned enterprises, and (iii) improve the overall business environment.

27. Job creation is a central element of our economic policies. In July 2014, we made legislative changes to support labor market flexibility and job creation. Specifically, we enacted amendments to the Labor Law that rationalized severance payments by linking them to the length of current employment, limited the blanket extension of collective bargaining agreements, increased the duration of short-term contracts from one to two years, and clarified separation rules. In September 2014, we adopted (as part of the National Employment Strategy for the period from 2011 to 2020) a comprehensive National Employment Action Plan for 2015 (NEAP 2015), which sets out well-defined priorities to support employment. It includes specific programs that offer job matching services, career counseling and training for both pre-redundancy and the unemployed, employer subsidies targeting disadvantaged job seekers, employee subsidies, self-employment support, public works, active measures for employees with disabilities and co-financing of active labor market policies. Many of these programs will continue to be developed in close consultation with the World Bank and EU partners. Going forward, to support implementation of the Action Plan we will take the following actions:

- We will amend the Law on Employment by end-March 2015 to better align the disbursement of social benefits for the unemployed with specific training programs.

- Given that collective agreements are essential for the implementation of the Labor Law, and that all collective agreements concluded before the amendments of the Labor Law will expire by end-January, 2015, we have prepared new collective agreements where appropriate.

- Further, with the aim of improving the social dialogue, we will adopt a new Law on Social Partnership and Collective Bargaining by end-2016.

28. We are committed to wide-ranging reforms of socially-owned and state-owned enterprises to improve their operational viability and limit fiscal risks. A clear priority is to significantly reduce state aid to SOEs through (i) curtailed direct or indirect subsidies, (ii) limited issuance of new guarantees, and (iii) enhanced accountability, transparency and monitoring of these enterprises. We will implement strategies for two broad categories of state-owned companies: (i) companies in the portfolio of the Privatization Agency, some of which are currently protected under a bankruptcy moratorium; and (ii) other large SOEs including the electricity, gas, railways, and road companies.

29. We will ensure the resolution of over 500 enterprises in the portfolio of the Privatization Agency through either privatization or bankruptcy, in accordance with the recently revised Privatization Law. Since August 2014, we have collected letters of interest for these companies, and we have adopted an action plan for bankruptcy procedures for 188 companies in early February 2015. On the basis of agreement with the World Bank, we will initiate bankruptcy proceedings for companies with weak privatization prospects in early February 2015, while ensuring a government decision on adequate budgeting of social benefits in lieu of severance payments as per legislative provisions in the Labor Law.

30. We aim to privatize or find strategic partners for a number of SOEs and concession projects. We will use the proceeds primarily for reducing the stock of public debt but possibly also for funding future financially viable and high return investment projects. The size of investment funding will be determined in consultation with the Fund staff. To support the operation of the telecommunication sector on a strictly market basis, we will launch a privatization tender for Telekom Serbia during the course of 2015. We will eliminate state aid—including budget subsidies, government guarantees, lending from the budget or any other forms of public support—to Zelezara Smederevo, a steel producer, and prevent accumulation of arrears by this company (prior action). At the same time, we will explore long-term concession partnerships for managing the Belgrade airport and operating Corridor XI.

31. We are committed to restructuring the large SOEs to contain the additional fiscal costs that would arise without a change in policies. We will also ensure adequate service provision. In particular, we will focus on the electricity, gas, railways, and road companies which are among the largest public enterprises. To anchor the corporate restructuring process and set the enabling legal framework for reform in the energy sector, the National Assembly approved in December 2014 a new Energy Law in line with EU Directives. To implement the needed corporate and financial restructuring in each of these companies over the medium term, we will take the following steps:

- **Elektroprivreda Srbije (EPS).** On November 27, 2014, we adopted a corporate restructuring plan that focuses on streamlining the organizational structure and management and staff rightsizing, to avoid the need for state aid to EPS in the future. We will also support EPS in preparing a financial restructuring plan based on improved collections, increased efficiency, costs savings, and tariff increases, to be adopted by the government by end-March 2015 (structural benchmark). In this regard, we will support EPS to request an increase of the regulated electricity price for end consumers. This, in combination with an excise tax, would result in a total price increase of 15 percent as of April 1, 2015. Additional adjustments will follow in April 2016 if necessary. Following the restructuring process and financial consolidation, we will seek minority private investment participation that could further enhance the viability of the company and ensure its professional management. The restructuring process will be prepared in close consultation with the World Bank and EBRD. These plans will continue to be implemented through 2016-2017.

- **Srbijagas.** We adopted corporate restructuring plans for Srbijagas in December 2014, which include a framework for unbundling of its distribution section. In line with the fiscal program, we will divest part of Srbijgas' non-core assets and resolve the companies which have been a major source of arrears: Zelezara Smederevo in February (see ¶30 above), Azotara and MSK by end-March, and Petrohemija by end-April 2015. We will hire an independent consultant to develop a financial restructuring plan based on improving collection and increasing the transit and network fees, and the plan will be adopted by end-October 2015, in time for incorporation in the 2016 budget (structural benchmark). The terms of reference for the financial restructuring plan will be prepared with the assistance of the World Bank and the EBRD. These measures will ensure that Srbijagas' financial position does not deteriorate further, thus containing the need for additional state aid in line with the fiscal program.

- **Railways of Serbia**. The government established a Railway Reform Steering Committee, led by the Deputy Prime Minister and including senior representatives from relevant Ministries and entities, to provide overall direction of the reforms. The company will be unbundled according to EU practices into separate passenger, freight, infrastructure, and a holding company by end-March 2015. To support the corporate and financial reorganization of the company, we appointed the director and senior management team in January 2015. The corporate restructuring plan will be centered on asset disposal, network re-optimization, and staff rationalization. Importantly, the freight section will receive no further subsidies and will operate on a pure commercial basis from January 2018. To support market competition, an infrastructure usage fee will be introduced by end-December 2015. We will also continue with the reorganization and improvement of business plans for the holding company, the state-owned passenger and infrastructure companies to strictly limit the amount of state aid disbursed over the medium term. We will cooperate closely with the World Bank, EBRD and EU in determining the optimal corporate and financial restructuring plans, with the help of independent consultants.

These plans will be adopted by the government by end-September 2015 (structural benchmark).

- **Roads of Serbia.** The merger of Roads of Serbia with Corridors of Serbia is expected to be finalized by March 2015 and will result in a single company tasked with road construction and maintenance in Serbia. While we expect efficiency gains from the consolidation of operations, we will also take action on the revenue side by revisiting the adequacy of toll rates and on the expenditure side by removing rigidities in pricing maintenance contracts by March 2016. The savings should result in lower budget support in the future. We will also explore concession options for the construction and maintenance of Corridor XI. The corporate and financial restructuring plans will be developed in close consultation with the World Bank.

32. We will develop a comprehensive program to enhance Serbia's competiveness and business environment to support investment, job creation and private sector development. The program will be developed in close consultation with the World Bank and EBRD (including through the Investment Climate and Governance Initiative) and will ensure that growth-supporting policies are well coordinated and targeted. Specific actions will focus on the following areas:

- To foster investment, we adopted the regulatory framework for the establishment of one-stop shops for issuing construction permits in December 2014, to be operational by end-June 2015. We will also adopt the framework that regulates the conversion of land usage into ownership rights by end-December 2015.

- To enhance predictability and reduce corruption and the grey economy, we will adopt a new Law on Inspection Oversight by end-June 2015.

- We will adopt a new Investment Law that will replace and broaden the scope of the Foreign Investment Law to include domestic investments by end-March 2015. In addition, the new law will regulate the operations of the Quick Response Office for Investment within the MOE to enable the efficient coordination of investment related permits.

- We will develop plans for the rationalization of investment promotion programs, in particular the Development Fund, and their agencies, including a reform of the two agencies administering investment incentives and export financing programs (Serbian Export Credit and Insurance Agency (AOFI) and Serbia Investment and Export Promotion Agency (SIEPA)), by end-December 2015.

- We will implement an action plan to improve the business environment for SMEs based on the SME strategy for 2015-2020 prepared by the MOE.

- We will work to enhance innovation capacity through stepping up the work of the Innovation Fund and reform the system of financing research institutions.

- As part of our job creation initiatives, we will improve targeting of Active Labor Market Policies and implement rationalization and reorganization of the National Employment Service.

PROGRAM MONITORING

33. Progress in the implementation of the policies under this program will be monitored through quarterly quantitative performance criteria (PCs) and indicative targets (ITs)—including an inflation consultation clause, continuous performance criteria (CPCs) and structural benchmarks (SBs). These are detailed in Tables 1 and 2, with definitions provided in the attached Technical Memorandum of Understanding. Quantitative targets are set for end March, June, September and December 2015.

Table 1. Serbia: Quantitative Program Targets 1/

	2015			
	March Prog.	June Prog.	Sep Proj.	Dec Proj.
I. Quantitative performance criteria (quarterly)				
1 Floor on net international reserves of the NBS (in millions of euros)	6,290	6,063	5,718	5,835
2 Ceiling on the augmented deficit of the consolidated general government 2/ 3/ (in billions of dinars)	55.7	96.3	153.1	232.1
3 Ceiling on augmented current primary expenditure of the Serbian Republican Budget excluding capital expenditure and interest payments (in billions of dinars)	207.4	429.2	657.2	906.3
4 Ceiling on gross issuance of new guarantees by the Serbian Republican Budget for project and corporate restructuring loans (in millions of euros)	0	121	401	481
5 Ceiling on contracting or guaranteeing of new short-term external debt by the General Government, Development Fund, and AOFI (up to and including one year, in millions of euros)	0	0	0	0
II. Continuous performance criteria				
6 Ceiling on gross issuance of new guarantees by the Serbian Republican Budget and the Development Fund for liquidity support (in billions of dinars)	0	0	0	0
7 Ceiling on accumulation of external debt payment arrears by General Government, Development Fund, and AOFI (in billions of euros)	0	0	0	0
III. Indicative targets (quarterly)				
8 Ceiling on gross accumulation of domestic payment arrears by the consolidated general government except local governments, the Development Fund, and AOFI (in billions of dinars)	0	0	0	0
9 Ceiling on borrowing by the Development Fund and AOFI (in billions of dinars)	0	0	0	0
10 Ceiling on new below-the-line lending by the Republican Government (in millions of euros)	176	250	314	384
IV. Inflation consultation band (quarterly)				
Outer band (upper limit, 2.5 percent above center point)	4.2	5.5	5.1	6.7
Inner band (upper limit, 1.5 percent above center point)	3.2	4.5	4.1	5.7
End of period inflation, center point 4/	*1.7*	*3.0*	*2.6*	*4.2*
Inner band (lower limit, 1.5 percent below center point)	0.2	1.5	1.1	2.7
Outer band (lower limit, 2.5 percent below center point)	-0.8	0.5	0.1	1.7

1/ As defined in the Letter of Intent, the Memorandum of Economic and Financial Policies, and the Technical Memorandum of Understanding.
2/ Cumulative since 01-01-2015.
3/ Refers to the fiscal balance on a cash basis, including the amortization of called guarantees.
4/ Defined as the change over 12 months of the end-of-period consumer price index, as measured and published by the Serbian Statistics Office.

Table 2. Serbia: Prior Actions and Structural Benchmarks

Measures	Target date
I. Prior Actions	
1 Approval by the National Assembly of the 2015 budget and the accompanying legislation consistent with the program fiscal parameters (MEFP ¶8).	Met
2 Approval by the National Assembly of legislative changes related to the comprehensive revision of the bank resolution framework (MEFP ¶21).	Met
3 Amendments of the Law on Development Fund by removing the article stipulating that all guarantees issued by the Fund are backed by the Republic of Serbia (MEFP ¶12).	Met
4 Elimination of state aid—including budget subsidies, government guarantees, lending from the budget, or any other forms of public support—to steel producer Zelezara Smederovo and preventing accumulation of arrears by this company (MEFP ¶30).	In progress
II. Structural Benchmarks	
Fiscal	
1 Adoption by the Government of a decree that regulates the role and responsibility of the Ministry of Finance, Ministry of Economy and the line ministries with respect to monitoring SOEs and PPPs (MEFP ¶12).	Mar-15
2 Adoption of the Tax Administration Transformation Program 2014-19 developed by the MoF as the official medium term reform program (MEFP ¶13).	Mar-15
3 Adoption by the Government of a financial restructuring plan for EPS (MEFP ¶31).	Mar-15
4 Approval by the National Assembly of amendments to the Local Government Financing Law (MEFP ¶9).	Jun-15
5 Finalization and validation of a full registry of public employees, including all employees at the central government and local level, and in public agencies and institutions, and SOEs (MEFP ¶11).	Jun-15
6 Approval by the National Assembly of changes to the Law on Payments in Commercial Transactions to include transactions between public entities including SOEs (MEFP ¶12).	Jun-15
7 Adoption by the Government of a corporate and financial restructuring plan for Railways of Serbia, to be prepared by an independent consultant (MEFP ¶31).	Sep-15
8 Adoption by the Government of a financial restructuring plan for Srbijagas, to be prepared by an independent consultant (MEFP ¶31).	Oct-15
Financial	
9 Completion of special diagnostic studies of banks (MEFP ¶20).	Sep-15

Attachment II. Technical Memorandum of Understanding

1. This Technical Memorandum of Understanding (TMU) sets out the understandings regarding the definition of indicators used to monitor developments under the program. To that effect, the authorities will provide the necessary data to the European Department of the IMF as soon as they are available. As a general principle, all indicators will be monitored on the basis of the methodologies and classifications of monetary, financial, and fiscal data in place on December 31, 2014, except as noted below.

A. Floor for Net International Reserves of the NBS

	In millions of euro
Outstanding stock:	
End-December 2014	7,008
Floor on international reserves:	
End-March 2015 (performance criterion)	6,290
End-June 2015 (performance criterion)	6,063
End-September 2015 (indicative target)	5,718
End-December 2015 (indicative target)	5,835

2. **Net international reserves** (NIR) of the NBS are defined as the difference between reserve assets and reserve liabilities, measured at the end of the quarter.

3. For purposes of the program, **reserve assets** are readily available claims on nonresidents denominated in foreign convertible currencies. They include the NBS holdings of monetary gold, SDRs, foreign currency cash, foreign currency securities, deposits abroad, and the country's reserve position at the Fund. Excluded from reserve assets are any assets that are pledged, collateralized, or otherwise encumbered (e.g., pledged as collateral for foreign loans or through forward contracts, guarantees and letters of credit), NBS' claims on resident banks and nonbanks, as well as subsidiaries or branches of Serbian commercial banks located abroad, claims in foreign exchange arising from derivatives in foreign currencies vis-à-vis domestic currency (such as futures, forwards, swaps, and options), precious metals other than monetary gold, domestically acquired gold without international certificates, assets in nonconvertible currencies, and illiquid assets.

4. For purposes of the program, **reserve liabilities** are defined as all foreign exchange liabilities to residents and nonresidents with a maturity of less than one year, including commitments to sell foreign exchange arising from derivatives (such as futures, forwards, swaps, and options, including any portion of the NBS gold that is collateralized), and all credit outstanding from the Fund. Excluded from reserve liabilities are government foreign exchange deposits with NBS, and amounts received under any SDR allocations received after August 20, 2009.

5. For purposes of the program, all foreign currency-related assets will be valued in euros at **program exchange rates** as specified below. The program exchange rates are those that prevailed on September 30, 2014. Monetary gold will be valued at the average London fixing market price that prevailed on September 30, 2014.

Cross Exchange Rates and Gold Price for Program Purposes, September 30, 2014

	Valued in:				
	RSD	Euro	USD	SDR	GBP
Currency:					
RSD	1.0000	0.0084	0.0107	0.0072	0.0066
Euro	118.8509	1.0000	1.2695	0.8563	0.7808
USD	93.6202	0.7877	1.0000	0.6745	0.6150
SDR	138.7994	1.1678	1.4826	1.0000	0.9119
GBP	152.2168	1.2807	1.6259	1.0967	1.0000
Gold	113,888.97	958.25	1,216.50	820.53	748.20

Source: NBS

6. **Adjustors.** For program purposes, the NIR target will be adjusted upward by the value of long-term assets and foreign-exchange-denominated claims on resident banks and nonbanks as well as Serbian commercial banks abroad, recovered by the NBS since December 31, 2014. The NIR floor will be adjusted upward by the full amount of any eurobond issuance proceeds cumulative since December 31,2014. The NIR floor will also be adjusted upward by the value of domestically acquired gold for which certification was obtained after December 31, 2014. The NIR floor will also be adjusted upward by any privatization revenue in foreign exchange received after December 31, 2014. Privatization receipts are defined in this context as the proceeds from sale, lease, or concession of all or portions of entities and properties held by the public sector that are deposited in foreign exchange at the NBS either directly or through the Treasury.

B. Inflation Consultation Mechanism

7. Inflation is defined as the change over 12 months of the end-of-period consumer price index (CPI), as measured and published by the Serbian Statistics Office.

8. Breaching the inflation consultation inner band limits (specified in MEFP, Table 1) at the end of a quarter would trigger discussions with IMF staff on the reasons for the deviation and the proposed policy response. Breaching the outer limits would trigger a consultation with the IMF's Executive Board on the reasons for the deviation and the proposed policy response before further purchases could be requested under the SBA.

C. Fiscal Conditionality

9. The general government augmented fiscal balance, on a cash basis, is defined as the difference between total general government revenue (including grants) and total general government expenditure (irrespective of the source of financing) including expenditure financed from foreign project loans, payments of called guarantees, cost of bank resolution and recapitalization, cost of debt takeover if debt was not previously guaranteed, repayments of debt takeover if debt was previously guaranteed, and payment of arrears. For program purposes, the consolidated general government comprises the Serbian Republican government (without indirect budget beneficiaries), local governments, the Pension Fund, the Health Fund, the Military Health Fund, the National Agency for Employment, the Roads of Serbia Company (JP Putevi Srbije) and any of its subsidiaries, and the company Corridors of Serbia. Any new extra budgetary fund or subsidiary established over the duration of the program would be consolidated into the general government. Privatization receipts are classified as a financial transaction and are recorded "below the line" in the General Government fiscal accounts. Privatization receipts are defined in this context as the proceeds from sale, lease, or concession of all or portions of entities and properties held by the public sector.

10. Government augmented primary current expenditure of the Republican budget (without indirect budget beneficiaries) includes wages, subsidies, goods and services, transfers to local governments and social security funds, social benefits from the budget, other current expenditure, net lending, payments of called guarantees, cost of bank resolution and recapitalization, cost of debt takeover if debt was not previously guaranteed, repayments of debt takes over if debt was previously guaranteed, and payment of arrears. It does not include capital spending and interest payments.

Adjustors:

- The quarterly ceilings on **the general government augmented fiscal deficit and the augmented primary current expenditure of the Republican budget** will be adjusted upward (downward) to the extent that cumulative severance payments (including payments from the Transition Fund) exceed (fall short of) the programmed levels up to the yearly budgeted amount.

Cumulative programmed severance payments (in billions of dinars)

	End-March 2015	End-June 2015	End-Sep 2015	End-Dec 2015
Programmed cumulative severance payments	3	10	19	29

- The quarterly ceilings on the **augmented primary current expenditure of the Republican budget** will be adjusted upward (downward) to the extent that (i) cumulative earmarked grant receipts exceed (fall short of) the programmed levels and (ii) cumulative proceeds from small-scale disposal of assets recorded as non-tax revenues exceed the programmed levels up to a cumulative annual amount of 2 billion dinars in 2015. For the purposes of the adjustor, grants are defined as noncompulsory current or capital transfers received by the Government of Serbia, without any expectation of repayment, from either another government or an international organization including the EU.

11. Cumulative receipts from earmarked grants and small-scale asset disposal (in billions of dinars)

	End-March 2015	End-June 2015	End-Sep 2015	End-Dec 2015
Programmed cumulative ear-marked grants receipts	2.5	5	7.5	10
Programmed cumulative receipts from small-scale disposal of assets	0	0	0	0

12. Ceiling on the gross issuance of debt guarantees by the Republican Budget for project and for liquidity support. Guarantees for liquidity support are defined in this context as guarantees related to loans provided without any pre-specified purpose other than satisfying funding needs of the company that ensure its normal production and business activities. Guarantees for viable project loans are defined in this context as guarantees related to loans with high probability of repayment provided with a pre-specified objective establishing that all funding should be used for well-defined investment or corporate restructuring projects, confirmed by a reliable feasibility study and/or the investment or restructuring plan endorsed by the government.

13. Ceiling on below-the-line lending by the Republican Government. Below-the-line lending is defined as the lending by the Republican Government which is used to provide financing to entities outside the General Government coverage. Below-the-line lending by the Republican Government will only be provided in cases where the probability of repayment is assessed to be high. These entities include the Deposit Insurance Agency (DIA), beneficiaries of the APEX lending program, and EPS, among others.

14. Ceiling on borrowing by the Development Fund and the Export Credit and Insurance Agency (AOFI). Borrowing by the Development Fund and AOFI is defined as gross accumulation of financial claims on these entities.

15. The amendments to the Budget System Law will involve a modification specifying the following wage and pension indexation rule:

> *Fiscal sustainability rule imposes that the share of general government salaries in GDP do not exceed 7 percent, and that the share of pensions in GDP do not exceed 11 percent.*

After 2014, salaries and/or pensions will not be increased in the years in which the share of general government salaries in GDP is above 7 percent, and/or share of pensions in GDP is above 11 percent.

In years in which it is expected that the share of general government salaries in GDP will be below 7 percent, indexation will take place twice a year. In April, salaries will be indexed by the previous 6-month CPI inflation and previous year annual real GDP growth above 3 percent, and in October, salaries will be indexed by the previous 6-month CPI inflation, but taking into account that after these indexations the share of general government salaries in GDP must be below 7 percent.

In years in which it is expected that general government pension payments will be below 11 percent, indexation will take place twice a year. In April, pensions will be indexed by the previous 6-month CPI inflation and previous year annual real GDP growth above 3 percent, and in October, pensions will be indexed by the previous 6-month CPI inflation, but taking into account that after these indexations the share of general government pensions in GDP must be below 11 percent.

16. Domestic arrears. For program purposes, domestic arrears are defined as the belated settlement of a debtor's liability which is due under the obligation (contract) for more than 60 days, or the creditor's refusal to receive a settlement duly offered by the debtor. The program will include indicative targets on the change in domestic arrears of (i) all consolidated general government entities as defined in ¶8 above, except local governments; (ii) the Development Fund, and (iii) AOFI. Arrears to be covered include outstanding payments on wages and pensions; social security contributions; obligations to banks and other private companies and suppliers; as well as arrears to other government bodies.

D. Ceilings on External Debt

17. Definitions. The ceilings on contracting or guaranteeing of short-term external debt (with maturities up to one year) consolidated general government, the AOFI, and the Development Fund applies not only to debt as defined in point 9 of the Guidelines on Performance Criteria with Respect to External Debt in Fund Arrangements, Decision No. 6230-(79/140), as amended, but also to commitments contracted or guaranteed for which value has not been received. Excluded from this performance criterion are normal short-term import credits. For program purposes, debt is classified as external when the residency of the creditor is not Serbian. For new debt to budgetary users, the day the debt is contracted will be the relevant date for program purposes. For new debt to non-budgetary users, the day the first guarantee is signed will be the relevant date. Contracting or guaranteeing of new debt will be converted into euros for program purposes at the program cross exchange rates described in this TMU.

E. Ceiling on External Debt Service Arrears

18. Definition. External debt-service arrears are defined as overdue debt service arising in respect of obligations incurred directly or guaranteed by the consolidated general government, the Export Credit and Insurance Agency (AOFI), and the Development Fund, except on debt subject to rescheduling or restructuring. The program requires that no new external arrears be accumulated at any time under the arrangement on public sector or public sector guaranteed debts. The authorities are committed to continuing negotiations with creditors to settle all remaining official external debt-service arrears.

19. Reporting. The accounting of non-reschedulable external arrears by creditor (if any), with detailed explanations, will be transmitted on a monthly basis, within two weeks of the end of each month. Data on other arrears, which can be rescheduled, will be provided separately.

F. Prior Action on Eliminating State Aid to Zelezara Smederevo

20. Eliminating state aid to Zelezara Smederevo and preventing accumulation of arrears by this company can be implemented by either (i) signing a Strategic Partnership Investment Agreement with a private investor for Zelezara Smederevo, or (ii) adopting a Government Decision to resolve Zelezara Smederevo in a way that eliminates state aid to this company and prevents accumulation of arrears. Servicing of old government-guaranteed debts (outstanding before the completion of the prior action) is not considered state aid for program purposes.

G. Reporting

21. General government revenue data and the Treasury cash position table will be submitted weekly; updated cash flow projections for the Republican budget for the remainder of the year fourteen calendar days after the end of each month; and the stock of spending arrears of the Republican budget, the Road of Serbia, and the social security funds 45 days after the end of each quarter. General government comprehensive fiscal data (including social security funds) would be submitted by the 25th of each month.

Data Reporting for Quantitative Performance Criteria		
Reporting Agency	Type of Data	Timing
NBS	Net international reserves of the NBS (including data for calculating adjustors)	Within one week of the end of the month
Statistical Office and NBS	CPI inflation	Within four weeks of the end of the month
Ministry of Finance	Augmented deficit of the consolidated general government	Within 25 days of the end of the month
Ministry of Finance	Augmented current primary expenditure of the Republican Budget excluding capital expenditure and interest payments	Within 25 days of the end of the month
Ministry of Finance	Gross issuance of new guarantees by the Republican Government for (i) project and corporate restructuring loans and (ii) gross issuance of new guarantees by the Serbian Republican Government for liquidity support.	Within three weeks of the end of the month
Ministry of Finance	New short-term external debt contracted or guaranteed by the general government, the Development Fund and AOFI.	Within four weeks of the end of the quarter
Ministry of Finance	External debt payment arrears by general government, Development Fund and AOFI.	Within four weeks of the end of the month
Ministry of Finance	Gross accumulation of domestic payment arrears by the Republican budget, the Development Fund, and AOFI	Within four weeks of the end of the month
Ministry of Finance	Borrowing by the Development Fund and AOFI	Within four weeks of the end of the month
Ministry of Finance	Cumulative below-the-line lending by the Republican Government	Within 25 days of the end of the month
Ministry of Finance	Severance payments by general government, with a breakdown by government level.	Within four weeks of the end of the quarter
Ministry of Finance	Earmarked grants and receipts from small-scale disposal of assets	Within four weeks of the end of the quarter

Annex I. Serbia: Public Sector Debt Sustainability Analysis[1]

The Public Debt Sustainability Analysis (DSA) indicates the existence of significant vulnerabilities of debt dynamics to various shocks under the program scenario (baseline scenario under the DSA). This is reflected in the persistently high public debt levels and large gross financing needs over the projection period, which are further exacerbated in the event of shocks to economic growth, the exchange rate, primary fiscal balance, interest rate, and the realization of contingent liabilities. The programmed fiscal adjustment is sizeable, yet it is needed to reverse the upward trend of public debt by 2017. Future privatization of profitable SOEs and EU integration constitute upside risks for debt dynamics.

1. General government debt has increased substantially during the last few years. Total gross debt reached almost 61½ percent of GDP in 2013—almost doubling from the 2008 level—owing to expansionary fiscal policies and sluggish output growth since the start of the global financial crisis. The public debt fiscal rule, which sets the public debt ceiling at 45 percent of GDP, was thus breached. About 8½ percent of Serbia's public debt consists of government guarantees to large SOEs and local governments. Unguaranteed local government debt is negligible (about ½ percent of GDP as of 2013). External public debt accounts for 60 percent of the total, while more than ¾ of total public debt is denominated in foreign currencies. Most external debt is owed to multilateral and bilateral creditors (57 percent of total external public debt), which has helped Serbia keep interest cost relatively low. However, the share of market debt has been increasing rapidly since the first eurobond issuance in 2011, suggesting that debt costs will increase further. Domestically-issued debt, dominated by T-bills and T-bonds with maturities above 12 months, increased as a share of total debt significantly over the last five years.

2. The DSA analysis is based on the macroeconomic assumptions under the program scenario. Real GDP is estimated to have contracted by 2 percent in 2014 reflecting the effects of the floods, weak domestic demand, and moderate growth in the Euro area. A gradual recovery is projected in the medium term to about 3½ percent of GDP, partly reflecting confidence effects of fiscal consolidation and structural reforms. Inflation is expected to stay within the tolerance band of the NBS. The fiscal deficit is projected to decline gradually from estimated 7½ percent of GDP in 2014 to about 2¾ percent of GDP by 2020, supported by a multi-year fiscal consolidation program focused on expenditure restraint, notably through wage and pension bill rationalization, and reduced state aid to SOEs. The current account deficit is expected to narrow as Serbia embarks on export-led growth, while import compression due to fiscal consolidation is partly offset by higher capital imports associated with FDI.

[1] The baseline scenario of the DSA reflects the program scenario outlined in the MEFP.

3. Serbia faces high risks to debt sustainability despite the significant fiscal adjustment assumed in the baseline scenario (Figure 1). Serbia's public debt is estimated to have reached about 70 percent of GDP in 2014, and will remain above this level during the projection period, despite the relatively sizeable fiscal adjustment proposed for 2015–17 (3½ percent of GDP on a structural basis). As a result, Serbia's public debt is highly vulnerable under all shock scenarios. Specifically, the debt profile is highly susceptible to exchange rate fluctuations due to the large share of public debt denominated in foreign currencies. Moreover, limited absorption capacity of domestic banks and high domestic interest rates suggest that Serbia will increasingly have to rely on external market financing in the future, thereby embedding significant risks to adverse market sentiment. In the DSA, a significant fraction of gross external financing is secured through the issuance of eurobonds, reaching about $1.2 billion a year on average during 2015–20.

4. The fan charts illustrate the possible public debt dynamics over the medium term, using a symmetric and asymmetric distribution of risks, with the latter imposing no positive growth and no primary balance shocks. In this scenario, the asymmetric fan chart shows the presence of significant risks to the debt outlook, which further indicate the need for fiscal consolidation.

5. Financing needs are projected to remain large, and would remain highly vulnerable to shocks. The gross financing needs are driven by a number of factors: (i) the rapid buildup of debt during the recent years in a context of large fiscal deficits, entailing large debt repayments in the years ahead, (ii) the authorities' strategy to lengthen the maturities of domestic securities has helped temporarily, and the breathing space it has provided is narrowing, and (iii) repeated issuance of eurobonds given the low interest rates environment (5 eurobonds were issued in 2011–13 for a total of $5.25 billion or 12¼ percent of 2014 GDP). In fact, two eurobonds totaling $1.75 billion (almost 4½ percent of 2014 GDP) will mature in 2017–18, representing a critical market test for Serbia. In the absence of fiscal consolidation, rollover risks and budget financing will pose major challenges.

6. Past forecast errors were caused by exogenous shocks, but also weaker fiscal discipline in the absence of an IMF-supported program (Figure 2). In particular, real GDP growth was lower than anticipated in 2009 due to a sharp output contraction amid the global financial crisis, and later in 2012 following severe weather shocks that affected agricultural and industrial output. However, the unexpected large primary fiscal deficit in 2012 was driven by significant slippages due to election spending and bank recapitalization and resolution costs.

7. The projected fiscal adjustment is relatively sizeable, as indicated by the fact that Serbia is in the top quartile of fiscal adjustments observed during 1990–2011 for advanced and emerging economies with debt greater than 60 percent of GDP (Figure 2). Nevertheless, this fiscal effort is the lower bound of the adjustment that Serbia needs to undertake to stabilize and later reduce the public debt level. Under the DSA baseline (program) scenario, gross public debt will rise steadily until 2016 peaking at 78½ percent of GDP, after which it will start declining as the primary balance reaches its debt-stabilizing level (Figure 3).

Public debt is projected to continue declining throughout the DSA projection horizon, reaching about 72¼ percent of GDP by 2020.

8. **The projected decline in public debt is susceptible to a number of shocks**, particularly a growth slowdown, a real exchange rate shock, and the realization of contingent liabilities (Figure 5):

- **Growth shock**. If projected real GDP growth for 2016–17 is lower by one standard deviation (3¾ percentage points lower in both years than in the baseline), the debt-to-GDP ratio would peak at 89¾ percent of GDP by 2017–11¾ percentage points of GDP higher than under the DSA baseline scenario.

- **Primary fiscal balance shock.** A shock that leads to a worsening of the primary balance by about ½ percent of GDP on average during 2016–20, relative to the DSA baseline scenario, would result in a significant deviation from the medium-term fiscal consolidation path, implying higher debt levels. Public debt could reach 75 percent of GDP by 2020, compared to 72¼ percent of GDP under the DSA baseline scenario.

- **Interest rate shock.** Although interest payments currently account for a relatively small share of the budget relative to other emerging countries, the shift from concessional to market financing will impose a significant burden on the budget and worsen debt dynamics. This scenario simulates a permanent increase in interest rates by 200 basis points starting in 2016, on top of the projected gradual increase in international interest rates envisaged under the DSA baseline scenario. Higher borrowing costs will worsen the headline fiscal deficit, and require more borrowing for budget financing. The public debt ratio would be about 2¾ percentage points of GDP higher than in the baseline scenario by 2020.

- **Real exchange rate shock.** The large share of foreign currency debt gives rise to significant vulnerabilities to currency depreciations. A 13 percent real depreciation (comparable to what Serbia experienced in 2005 and 2008) will push public debt to 83¼ percent of GDP in 2016, well above the 78¼ percent of GDP projected under the DSA baseline scenario, before declining slightly to about 79 percent of GDP by 2020.

- **Combined shock.** In the extreme case of multiple shocks affecting growth, the primary fiscal balance, interest rates, and the exchange rate, Serbia's public debt ratio could reach 98½ percent of GDP by 2020. The associated gross financing needs could peak at about 30 percent of GDP by 2020, about 10 percentage points of GDP higher than under the DSA baseline scenario.

- **Contingent liability shock.** This scenario considers a one-time increase in non-interest expenditures (equivalent to a one-off financial sector bailout of 10 percent of total banking assets), which combined with the above growth shock, would push public debt to 87¼ percent of GDP in 2016, and around 85½ percent of GDP through 2020. Gross financing needs would climb to about 22½ percent of GDP in 2017, slightly declining to 25 percent of GDP in 2020. Other sources of contingent liabilities not modeled under this shock include the stock of non-guaranteed debt of state- and socially owned enterprises and restitution debt.[2]

9. Debt reductions from asset sales and a new concessional loan constitute upside risks. Current DSA baseline assumptions do not incorporate proceeds from possible privatization of viable state-owned enterprises, as well as potential disbursement of another concessional loan from the United Arab Emirates (UAE) in the amount of $2 billion (4.7 percent of 2014 GDP), which could be used to retire expensive market debt.[3] In addition, the current DSA baseline scenario does not factor in the potential benefits from EU accession negotiations, which could strengthen economic governance and boost structural reforms.

[2] Restitution debt refers to compensations for nationalization of property after World War II. The 2011 restitution law capped total financial compensations at EUR2bn (about 6½ percent of 2014 GDP).

[3] A disbursement of $1 billion already took place in the second half of 2014.

Figure A.1. Serbia: Public DSA Risk Assessment

Heat Map

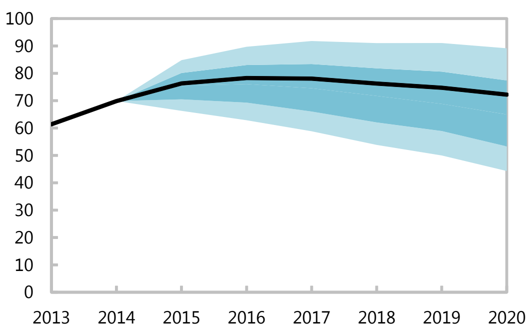
Debt level 1/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs 2/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile 3/	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

Evolution of Predictive Densities of Gross Nominal Public Debt

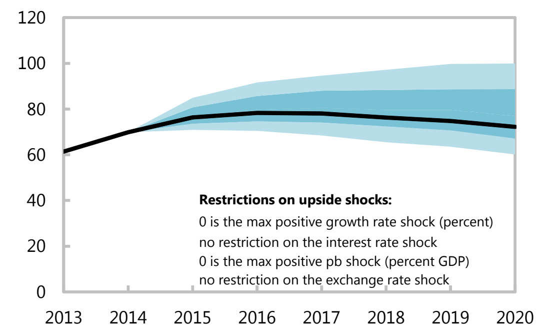
(in percent of GDP)

Baseline Percentiles: 10th-25th 25th-75th 75th-90th

Symmetric Distribution



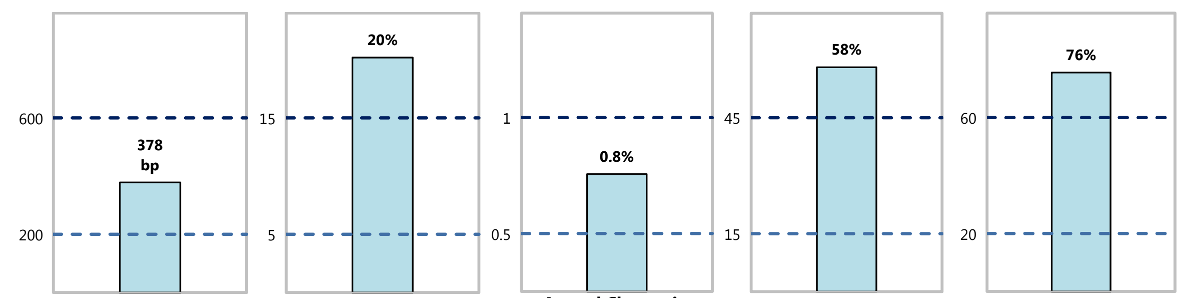
Restricted (Asymmetric) Distribution



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2014)

Serbia Lower early warning Upper early warning



EMBIG	External Financing Requirement	Annual Change in Short-Term Public Debt	Public Debt Held by Non-Residents	Public Debt in Foreign Currency
(in basis points) 4/	(in percent of GDP) 5/	(in percent of total)	(in percent of total)	(in percent of total)

Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 70% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 15% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.

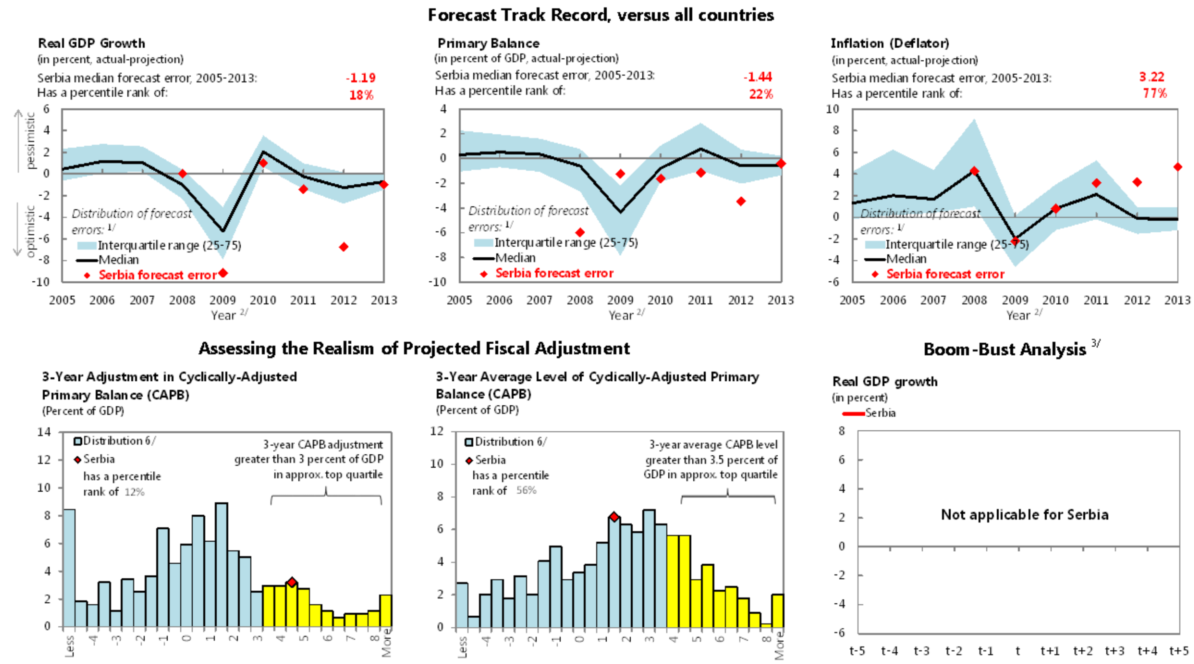
Lower and upper risk-assessment benchmarks are:

200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

4/ EMBIG, an average over the last 3 months, 14-Oct-14 through 12-Jan-15.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

Figure A.2. Serbia: Public DSA - Realism of Baseline Assumptions



Source : IMF Staff.
1/ Plotted distribution includes all countries, percentile rank refers to all countries.
2/ Projections made in the spring WEO vintage of the preceding year.
3/ Not applicable for Serbia, as it meets neither the positive output gap criterion nor the private credit growth criterion.
4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Figure A.3. Serbia: Public Sector Debt Sustainability Analysis (DSA) - Baseline Scenario

(In percent of GDP unless otherwise indicated)

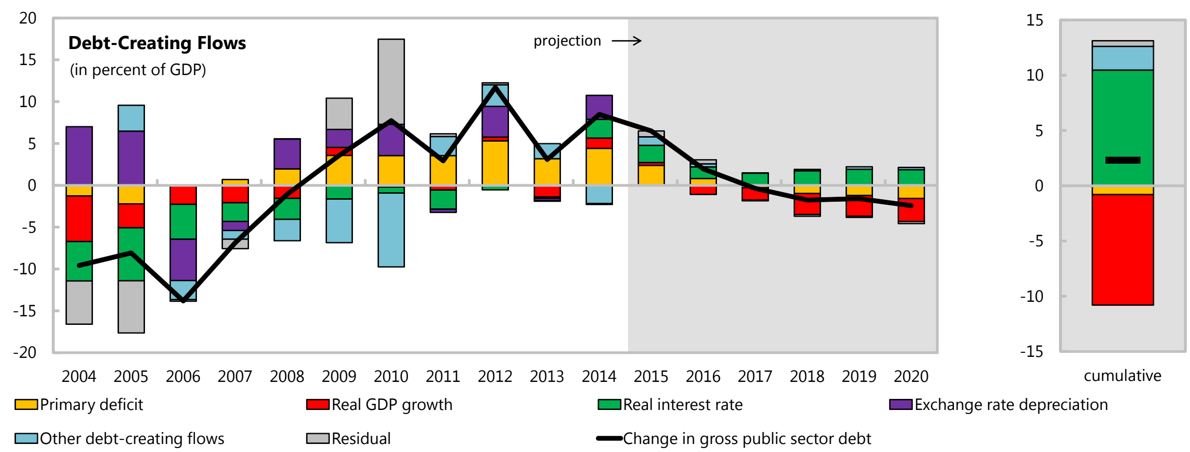
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2004-2012 [2/]	2013	2014	2015	2016	2017	2018	2019	2020
Nominal gross public debt	45.2	61.4	69.9	76.4	78.4	78.0	76.2	74.6	72.2
Of which: guarantees	4.4	8.5	8.0	9.5	9.0	8.5	7.9	7.3	6.7
Public gross financing needs	7.5	16.2	17.4	16.9	16.7	19.1	19.2	17.7	20.8
Real GDP growth (in percent)	3.2	2.6	-2.0	-0.5	1.5	2.0	3.5	3.5	4.0
Inflation (GDP deflator, in percent)	9.3	5.4	2.2	2.7	4.1	4.1	4.0	4.0	4.0
Nominal GDP growth (in percent)	12.9	8.2	0.1	2.2	5.7	6.2	7.6	7.6	8.2
Effective interest rate (in percent) [4/]	3.2	5.3	5.8	5.7	6.1	6.2	6.6	6.9	6.9

As of January 12, 2015		
Sovereign Spreads		
EMBIG (bp) 3/		435
5Y CDS (bp)		332
Ratings	Foreign	Local
Moody's	B1	B1
S&Ps	BB-	BB-
Fitch	B+	B+

Contribution to Changes in Public Debt

	Actual			Projections							
	2004-2012	2013	2014	2015	2016	2017	2018	2019	2020	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	-1.5	3.1	8.5	6.5	2.0	-0.4	-1.8	-1.6	-2.4	2.3	
Identified debt-creating flows	-1.7	3.2	8.6	5.8	1.5	-0.3	-1.6	-1.5	-2.2	1.8	
Primary deficit	1.7	3.2	4.4	2.4	0.8	-0.3	-1.0	-1.2	-1.6	-0.8	-0.6
Primary (noninterest) revenue and grants	40.6	37.9	39.4	38.7	37.7	36.9	36.8	36.7	36.6	223.4	
Primary (noninterest) expenditure	42.3	41.1	43.8	41.1	38.5	36.6	35.8	35.5	35.0	222.6	
Automatic debt dynamics [5/]	-2.1	-1.8	6.3	2.4	0.3	0.0	-0.8	-0.6	-0.9	0.5	
Interest rate/growth differential [6/]	-4.3	-1.5	3.5	2.4	0.3	0.0	-0.8	-0.6	-0.9	0.5	
Of which: real interest rate	-2.8	-0.2	2.2	2.1	1.4	1.5	1.7	1.9	1.9	10.5	
Of which: real GDP growth	-1.5	-1.4	1.2	0.3	-1.1	-1.5	-2.5	-2.5	-2.8	-10.0	
Exchange rate depreciation [7/]	2.2	-0.3	2.9	…	…	…	…	…	…	…	
Other identified debt-creating flows	-1.3	1.8	-2.2	1.0	0.4	0.0	0.2	0.3	0.3	2.1	
Privatization/Deposits Drawdown (negative)	-2.4	1.0	-1.2	0.5	0.3	0.0	0.1	0.2	0.2	1.4	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Net issuance of guarantees to SOEs	1.0	0.8	-1.0	0.5	0.1	0.1	0.0	0.0	0.0	0.8	
Residual, including asset changes [8/]	0.2	-0.1	-0.1	0.7	0.5	-0.1	-0.2	-0.1	-0.2	0.5	



Source: IMF staff.

1/ Public sector is defined as general government and includes public guarantees, defined as Guarantees issued by the central government to State-owned enterprises.

2/ Based on available data.

3/ EMBIG.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as $[(r - \pi(1+g) - g + ae(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as $r - \pi(1+g)$ and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as $ae(1+r)$.

8/ Includes changes in the stock of guarantees, asset changes, and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

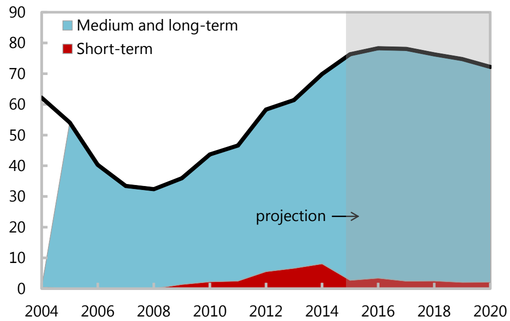
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure A.4. Serbia: Public DSA - Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

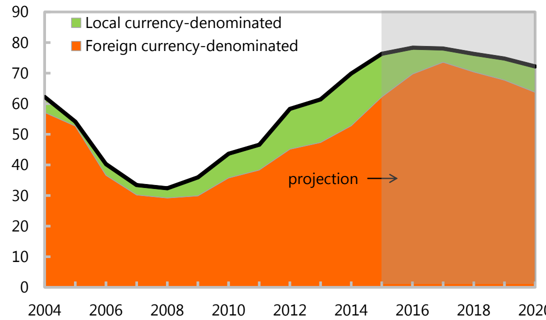
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

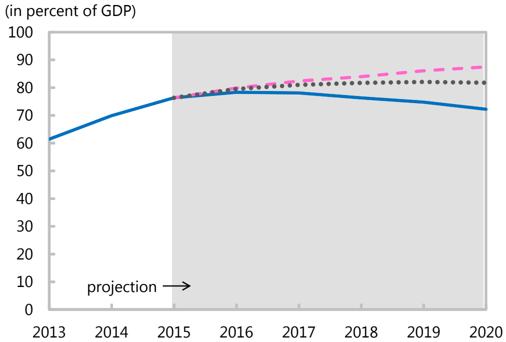


Alternative Scenarios

Baseline   Historical   Constant Primary Balance

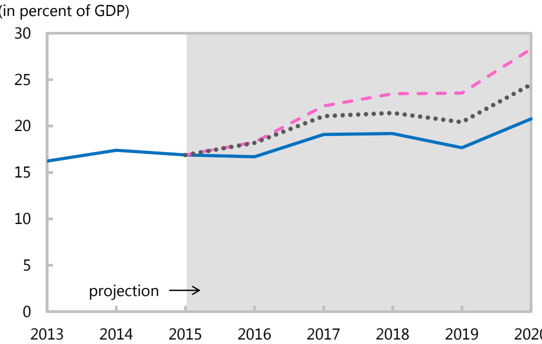
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

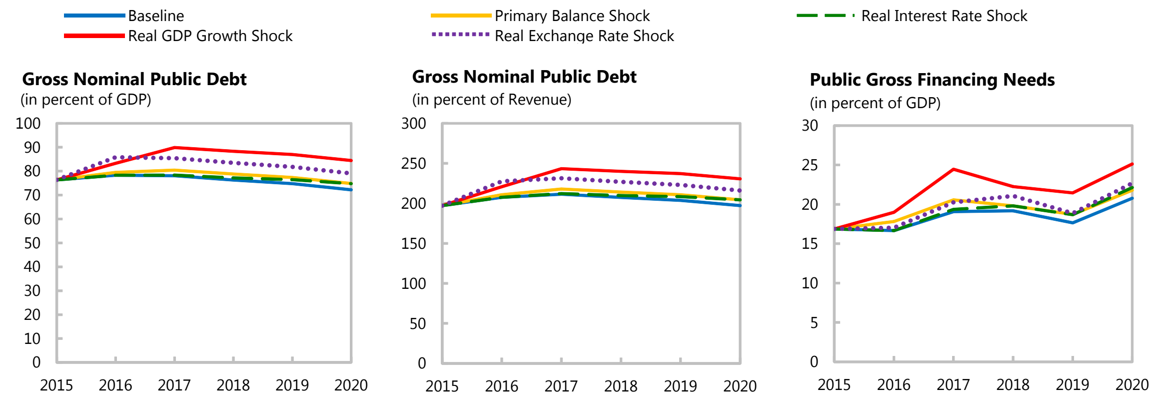
Baseline Scenario	2015	2016	2017	2018	2019	2020
Real GDP growth	-0.5	1.5	2.0	3.5	3.5	4.0
Inflation	2.7	4.1	4.1	4.0	4.0	4.0
Primary Balance	-2.4	-0.8	0.3	1.0	1.2	1.6
Effective interest rate	5.7	6.1	6.2	6.5	6.9	6.9
Constant Primary Balance Scenario						
Real GDP growth	-0.5	1.5	2.0	3.5	3.5	4.0
Inflation	2.7	4.1	4.1	4.0	4.0	4.0
Primary Balance	-2.4	-2.4	-2.4	-2.4	-2.4	-2.4
Effective interest rate	5.7	6.1	6.2	6.6	6.9	7.0

Historical Scenario	2015	2016	2017	2018	2019	2020
Real GDP growth	-0.5	2.0	2.0	2.0	2.0	2.0
Inflation	2.7	4.1	4.1	4.0	4.0	4.0
Primary Balance	-2.4	-2.4	-2.4	-2.4	-2.4	-2.4
Effective interest rate	5.7	6.1	4.7	3.6	2.7	2.3

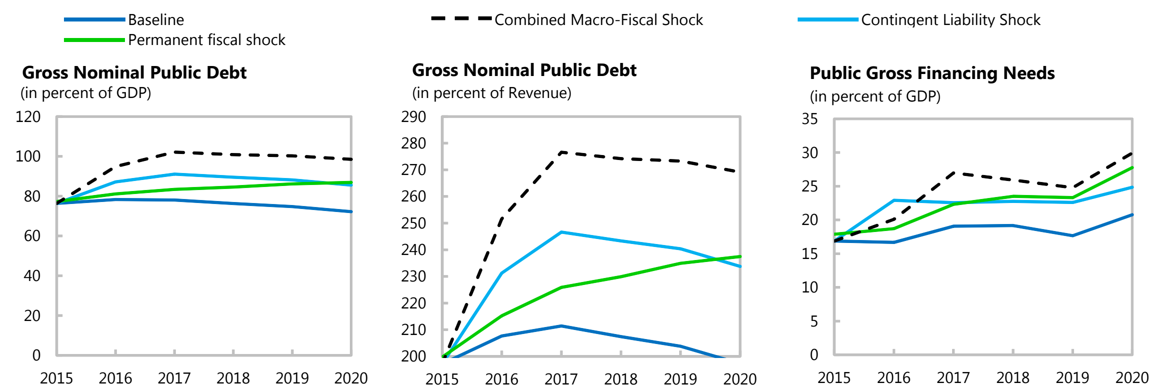
Source: IMF staff.

Figure A.5. Serbia: Public DSA - Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions
(in percent)

	2015	2016	2017	2018	2019	2020
Primary Balance Shock						
Real GDP growth	-0.5	1.5	2.0	3.5	3.5	4.0
Inflation	2.7	4.1	4.1	4.0	4.0	4.0
Primary balance	-2.4	-2.0	-0.9	1.0	1.2	1.6
Effective interest rate	5.7	6.1	6.3	6.7	7.0	7.0
Real Interest Rate Shock						
Real GDP growth	-0.5	1.5	2.0	3.5	3.5	4.0
Inflation	2.7	4.1	4.1	4.0	4.0	4.0
Primary balance	-2.4	-0.8	0.3	1.0	1.2	1.6
Effective interest rate	5.7	6.1	6.6	7.4	8.1	8.3
Combined Shock						
Real GDP growth	-0.5	-1.9	-1.4	3.5	3.5	4.0
Inflation	2.7	3.3	3.3	4.0	4.0	4.0
Primary balance	-2.4	-2.5	-2.9	1.0	1.2	1.6
Effective interest rate	5.7	6.7	6.4	7.3	8.0	8.1

	2015	2016	2017	2018	2019	2020
Real GDP Growth Shock						
Real GDP growth	-0.5	-1.9	-1.4	3.5	3.5	4.0
Inflation	2.7	3.3	3.3	4.0	4.0	4.0
Primary balance	-2.4	-2.5	-2.9	1.0	1.2	1.6
Effective interest rate	5.7	6.1	6.3	7.0	7.2	7.1
Real Exchange Rate Shock						
Real GDP growth	-0.5	1.5	2.0	3.5	3.5	4.0
Inflation	2.7	8.6	4.1	4.0	4.0	4.0
Primary balance	-2.4	-0.8	0.3	1.0	1.2	1.6
Effective interest rate	5.7	6.7	6.0	6.4	6.8	6.8
Contingent Liability Shock						
Real GDP growth	-0.5	-1.9	-1.4	3.5	3.5	4.0
Inflation	2.7	3.3	3.3	4.0	4.0	4.0
Primary balance	-2.4	-6.1	0.3	1.0	1.2	1.6
Effective interest rate	5.7	6.6	6.7	7.0	7.2	7.0

Source: IMF staff.

Table A.1. Serbia: External Debt Sustainability Framework, 2010–20 1/

(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2010	2011	2012	2013	2014			2015	2016	2017	2018	2019	2020	**Debt-stabilizing non-interest current account 6/**
Baseline: External debt	80.3	74.5	84.3	79.3	83.8			**88.2**	**87.1**	**84.0**	**77.7**	**72.3**	**67.4**	**-6.5**
Change in external debt	6.8	-5.7	9.7	-4.9	4.5			4.4	-1.1	-3.1	-6.3	-5.4	-4.9	
Identified external debt-creating flows (4+8+9)	10.2	-10.2	20.1	-6.1	4.9			1.2	-0.4	-1.2	-2.6	-2.8	-3.2	
Current account deficit, excluding interest payments	4.1	6.0	9.0	3.5	3.4			1.9	1.9	1.6	1.5	1.2	1.1	
Deficit in balance of goods and services	20.5	20.8	22.7	15.3	14.2			11.9	10.7	9.7	9.3	8.9	8.8	
Exports	45.2	46.2	47.6	55.8	53.9			56.4	56.4	58.1	59.4	60.8	61.0	
Imports	65.7	67.0	70.3	71.2	68.1			68.3	67.1	67.8	68.7	69.7	69.8	
Net non-debt creating capital inflows (negative)	-2.9	-5.6	-2.1	-3.6	-3.6			-4.0	-3.8	-4.0	-4.2	-4.2	-4.2	
Automatic debt dynamics 2/	9.0	-10.6	13.1	-6.0	5.0			3.3	1.5	1.2	0.1	0.3	-0.1	
Contribution from nominal interest rate	2.3	2.3	2.7	2.8	2.3			2.8	2.8	2.8	2.9	2.8	2.6	
Contribution from real GDP growth	-0.5	-0.9	0.9	-1.9	1.6			0.5	-1.2	-1.6	-2.7	-2.5	-2.7	
Contribution from price and exchange rate changes 3/	7.2	-11.9	9.6	-6.9	1.0			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 4/	-3.4	4.5	-10.3	1.1	-0.4			3.2	-0.7	-1.9	-3.7	-2.6	-1.8	
External debt-to-exports ratio (in percent)	177.5	161.3	177.2	142.1	155.6			156.5	154.5	144.7	130.8	119.0	110.5	
Gross external financing need (in billions of US dollars) 5/	9.0	10.7	9.7	10.0	7.9			6.4	5.6	7.3	7.6	7.2	8.9	
in percent of GDP	23.1	23.0	23.8	22.1	17.9	10-Year	10-Year	15.7	13.0	15.8	15.3	13.5	15.6	
Scenario with key variables at their historical averages 6/								**88.2**	**91.7**	**93.3**	**93.0**	**93.4**	**94.2**	**-7.8**
Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation							
Nominal GDP (US dollars)	39.0	46.5	40.8	45.5	44.0			40.7	43.3	45.9	49.4	53.1	57.2	
Real GDP growth (in percent)	0.6	1.4	-1.0	2.6	-2.0	2.0	3.4	-0.5	1.5	2.0	3.5	3.5	4.0	
GDP deflator in US dollars (change in percent)	-8.9	17.4	-11.4	8.9	-1.3	3.9	13.3	-7.2	4.8	3.9	4.1	3.9	3.5	
Nominal external interest rate (in percent)	2.9	3.4	3.2	3.7	2.8	3.7	0.9	3.1	3.3	3.4	3.7	3.9	3.9	
Growth of exports (US dollar terms, in percent)	4.0	21.7	-9.7	31.1	-6.7	14.4	24.3	-3.3	6.4	9.2	10.2	10.0	8.0	
Growth of imports (US dollar terms, in percent)	-4.3	21.3	-7.9	13.0	-7.4	9.5	28.2	-7.4	4.6	7.1	9.2	9.1	7.8	
Current account balance, excluding interest payments	-4.1	-6.0	-9.0	-3.5	-3.4	-7.9	5.1	-1.9	-1.9	-1.6	-1.5	-1.2	-1.1	
Net non-debt creating capital inflows	2.9	5.6	2.1	3.6	3.6	5.8	4.0	4.0	3.8	4.0	4.2	4.2	4.2	

1/ Baseline reflects the program scenario described in the main document.

2/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

3/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

4/ For projection, line includes the impact of price and exchange rate changes.

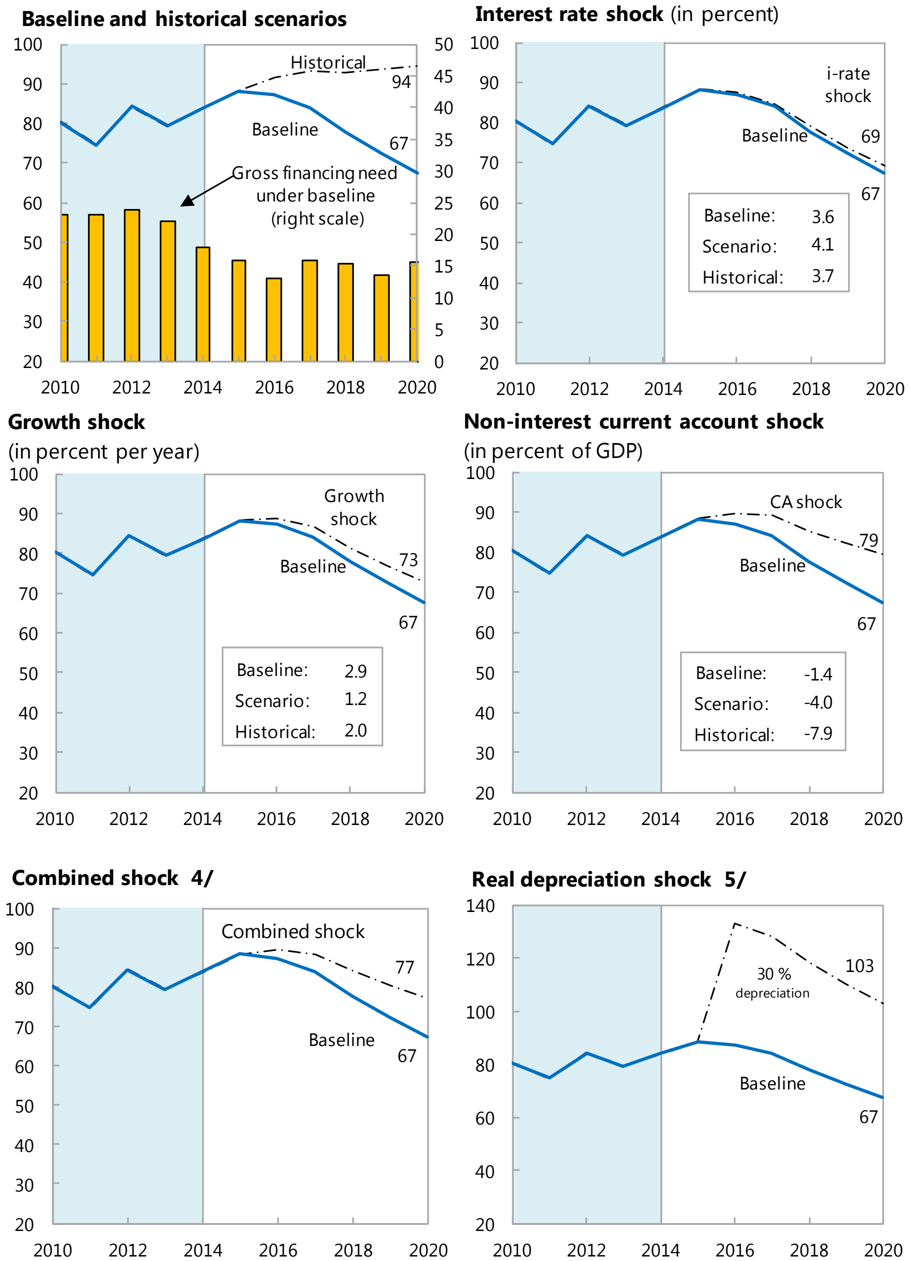
5/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

6/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

7/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Figure A.1. Serbia: External Debt Sustainability: Bound Tests 1/ 2/ 3/

(External debt in percent of GDP)



Sources: International Monetary Fund, Serbia desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.

3/ Baseline reflects the adjustment scenario described in the main document.

4/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

5/ One-time real depreciation of 30 percent occurs in 2016.