INTERNATIONAL MONETARY FUND

IMF Country Report No. 18/237

REPUBLIC OF SERBIA

July 2018

REQUEST FOR A 30-MONTH POLICY COORDINATION INSTRUMENT—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR REPUBLIC OF SERBIA

In the context of the Request for a 30-Month Policy Coordination Instrument, the following documents have been released and are included in this package:

- A **Press Release** including a statement by the Chair of the Executive Board.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on July 18, 2018, following discussions that ended on June 13, 2018, with the officials of Republic of Serbia on economic developments and policies underpinning the IMF arrangement under the Policy Coordination Instrument. Based on information available at the time of these discussions, the staff report was completed on June 29, 2018.
- A **Statement by the Executive Director** for Republic of Serbia.

The documents listed below have been or will be separately released.

Program Statement sent to the IMF by the authorities of Republic of Serbia*
Technical Memorandum of Understanding*
*Also included in Staff Report

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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July 18, 2018

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IMF Executive Board Approves 30-Month Policy Coordination Instrument for Serbia

On July 18, 2018, the Executive Board of the International Monetary Fund (IMF) approved a new 30-month Policy Coordination Instrument (PCI) for Serbia.[1]

The PCI-supported program will build on the precautionary Stand-By Arrangement successfully completed in February 2018 and aims at maintaining macroeconomic and financial stability and advancing an ambitious structural and institutional reform agenda to foster rapid and inclusive growth, job creation and improved living standards. Program reviews will take place on a semi-annual fixed schedule. While the PCI involves no use of IMF financial resources, successful completion of program reviews will help signal Serbia's commitment to continued strong macroeconomic policies and structural reforms.

Following the Executive Board's decision, Mr. Tao Zhang, Deputy Managing Director and Acting Chair, issued the following statement:

"Serbia has chosen to cement the success of its 2015-18 Precautionary Stand-By Arrangement with a new economic reform program focused on strengthening institutions and improving competitiveness for faster growth, which are critical to secure sustainable growth and faster convergence with EU living standards.

"The program maintains a strong fiscal position and foresees a continued decline in public debt, while also accommodating growth-enhancing measures. Increased public investment would likely deliver the strongest growth dividend, especially as Serbia continues to improve the selection, appraisal, and preparation of infrastructure projects. Targeted tax measures can also improve incentives for investment and employment and reduce informality.

[1] The PCI is available to all IMF members that do not need Fund financial resources at the time of approval. It is designed for countries seeking to demonstrate commitment to a reform agenda or to unlock and coordinate financing from other official creditors or private investors. (See https://www.imf.org/en/About/Factsheets/Sheets/2017/07/25/policy-coordination-instrument).

“Monetary policy under the inflation targeting framework is reducing inflation and inflation expectations, while also supporting economic activity. With still elevated levels of euroization, full implementation of an updated dinarization strategy, including better agency coordination and allowing more short-term exchange rate flexibility, will strengthen monetary policy transmission and market development.

“Financial sector reforms will reinforce stability and improve intermediation. Efforts to reduce NPLs are yielding good results, but greater attention is needed to resolve bad assets of public financial institutions, including the development agencies and the Deposit Insurance Agency. Addressing AML/CFT weaknesses identified by FATF will be important for ensuring continued strong foreign investment and improving the business climate.

“Structural and institutional reforms will gradually strengthen Serbia’s potential growth, helping to prepare the country for EU accession. Priorities supported by the program include strengthened tax administration and public investment management, an improved business climate, reduced informality, and a recasting of the role of the state away from direct participation in the economy towards supporting a full market economy.”

ANNEX

Recent Economic Developments

Serbia has succeeded in addressing macroeconomic imbalances and restoring confidence. Supported by a three-year precautionary SBA successfully completed in February 2018, the authorities have restored fiscal sustainability, putting public debt on a firm downward path, and realigned the external position with fundamentals. Monetary policy has kept inflation under firm control, while supporting economic recovery and maintaining broad exchange rate stability. The confidence instilled by the improved macroeconomic situation has been reflected in rising investment, both from foreign and domestic sources, and supported an economic recovery.

The economic outlook remains positive. Growth reached 4.6 percent y-o-y in the first quarter and is expected to reach at least 3.5 percent in 2018, driven by consumption, investment, and exports. Inflation remains low, and is projected to be around 2 percent at end-2018, supported by the appropriate monetary policy of the National Bank of Serbia. Budget results for the first quarter of 2018 point to another year of fiscal surplus.

Nonetheless, Serbia remains susceptible to spillovers from regional and global developments and market volatility, including potential increased risk aversion for emerging markets. On the domestic front, delay in delivering on structural reforms, or erosion of fiscal discipline, could undermine confidence and reduce medium-term growth prospects.

Program Summary

The program is designed to maintain macroeconomic and financial stability, while advancing an ambitious structural and institutional reform agenda, to foster rapid and inclusive growth, job creation, and improved living standards. The authorities' fiscal policy targets a small overall deficit from 2019 on, accommodating growth-oriented policies such as increased capital spending to address Serbia's large infrastructure needs and some targeted reductions in the tax burden on labor and business, while supporting the reduction of public debt to about 50 percent of GDP by the end of the program.

The National Bank of Serbia's (NBS) current state-contingent monetary policy stance remains appropriate in light of the domestic and external environment. The PCI aims to further strengthen coordination of liquidity management and promote dinarization. The authorities' financial sector priorities include continued reduction of non-performing loans, reforming state-owned financial institutions, aligning financial regulatory and supervisory frameworks with EU standards, and addressing identified weaknesses in the AML/CFT framework.

Structural and institutional reforms focus on tackling the large shadow economy, further increasing labor market participation, and reducing the economic reliance on the public sector, including through public administration reforms and restructuring of state-owned utilities, enterprises, and financial institutions.

INTERNATIONAL MONETARY FUND

REPUBLIC OF SERBIA

June 29, 2018

REQUEST FOR A 30-MONTH POLICY COORDINATION INSTRUMENT

KEY ISSUES

Context. Serbia succeeded in addressing macroeconomic imbalances and restoring confidence and growth under the precautionary SBA which expired in February 2018. Fiscal sustainability has been restored by placing public debt on a firm downward path and the external position has been realigned with fundamentals. Monetary policy has kept inflation under firm control, while supporting economic recovery. The resilience of the financial sector has improved. Progress has also been made on structural and institutional reforms, including in rationalizing the size of public sector employment, addressing fiscal risks from SOEs, and improving the business environment. However, challenges remain for achieving robust, inclusive, and sustainable growth, which Serbia needs for faster income convergence with its EU peers. The authorities requested a 30-month Policy Coordination Instrument (PCI) to provide a framework for continued macroeconomic stability and reforms, and maintain close policy dialogue with staff.

Main policy commitments:

- **Fiscal policy:** Fiscal policy will center on safeguarding the fiscal adjustment to ensure public debt falls to safer levels, while accommodating increased infrastructure spending. Tax policy and administration reforms will support formal employment and growth. Reforms of public employment and wage systems will improve public service efficiency and contain mandatory spending.
- **Monetary and financial sector policies:** The authorities plan to strengthen monetary and exchange rate policy frameworks and improve policy coordination. Financial sector supervision and regulation reforms will focus on enhancing resilience and completing reforms of state-owned financial institutions.
- **Structural reforms:** The focus is on reducing informality and improving labor force participation; and completing restructuring and/or privatization of SOEs.

Risks. Risks to the program are considered moderate. Serbia remains vulnerable to spillovers from regional developments and market volatility. Domestic risks center on complacency or resistance to deliver on structural reforms or maintain fiscal discipline, while failure to address AML/CFT weaknesses could undermine investment attractiveness.

Approved By
Thanos Arvanitis (EUR) and Petya Koeva Brooks (SPR)

Discussions were held in Belgrade during May 7–May 18, 2018. The staff team comprised James Roaf (head), Ruben Atoyan, Christine Richmond, (all EUR), Pietro Dallari (FAD), Rachid Awad (MCM), Daniela Marchettini (SPR), Sebastian Sosa (resident representative), Desanka Obradović and Marko Paunović (Belgrade office). Vuk Djoković (OED) attended some discussions. HQ support was provided by Min Kyu Song and Brett Stewart (both EUR).

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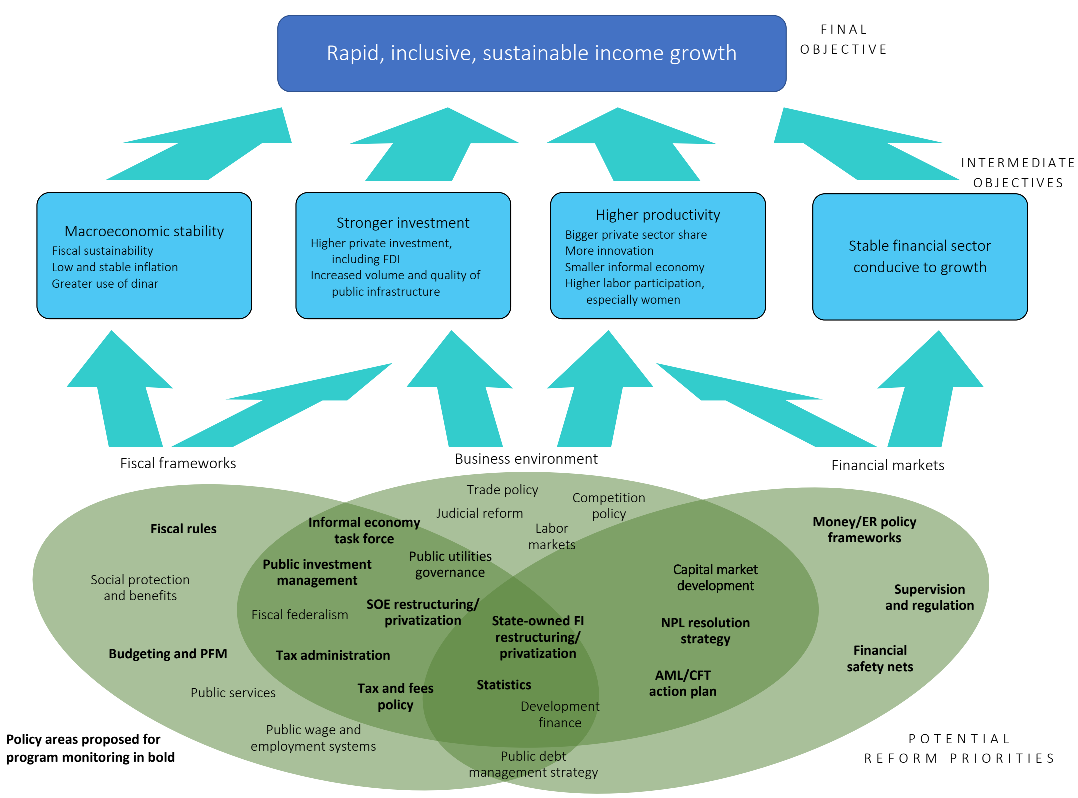
CONTEXT

1. **Serbia has succeeded in addressing macroeconomic imbalances and restoring confidence.** Supported by a three-year precautionary SBA successfully completed in February 2018, the authorities have restored fiscal sustainability by putting public debt on a firm downward path, and realigned the external position with fundamentals. Monetary policy has kept inflation under firm control, while supporting economic recovery and maintaining broad exchange rate stability. The confidence instilled by the improved macroeconomic situation has been reflected in rising investment, both from foreign and domestic sources, and supported an economic recovery.

2. **Financial sector resilience has improved and banks are now in a stronger position to support the economy.** Financial sector reforms have resulted in strengthened bank soundness, improved profitability, and rapidly reducing bad loans. Robust deposit growth has continued and lending surveys point to increasing willingness to lend to SMEs amid interbank competition, cheaper sources of funding, and higher risk tolerance. Prudential and regulatory standards are becoming aligned with EU standards.

3. **Despite this progress, further effort in implementing the structural and institutional reform agenda is needed to put Serbia on a faster convergence path.** The economy remains excessively reliant on the public sector, with a large shadow economy and a formal private sector that is too small to provide for a high standard of living across the whole of society. Reforms in public administration and restructuring of state-owned utilities, enterprises, and financial



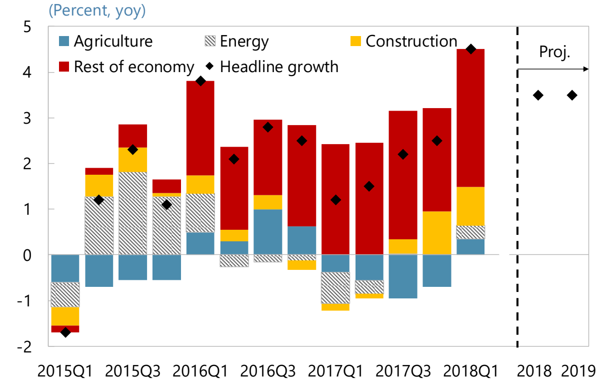
institutions remain incomplete. State aid remains high and poorly targeted for growth. More progress is needed in areas such as public finance, tax administration, judicial, and education reform, while public infrastructure needs remain large. Growth also needs to be made more inclusive through higher labor market participation and better targeted social assistance.

4. To address remaining vulnerabilities and create conditions for accelerated income convergence with the EU, the authorities have requested a Policy Coordination Instrument (PCI). With no balance of payments need expected during the projection horizon, the authorities view the PCI as an appropriate vehicle to demonstrate Serbia's commitment to push foward with its reform agenda and maintain a close policy dialogue with the Fund.

RECENT DEVELOPMENTS, OUTLOOK AND RISKS

5. Strong economic performance continues in 2018. Temporary supply shocks (a drought and electricity disruptions) moderated growth to 1.9 percent in 2017, but growth is now accelerating. 2018Q1 GDP registered 4.6 percent year-on-year—the strongest reading in ten years—supported by continued recovery of private consumption, investment, and strong FDI (Figure 2). Labor market participation continues to improve, with robust employment growth in the formal sector and stabilizing unemployment (Figure 8).

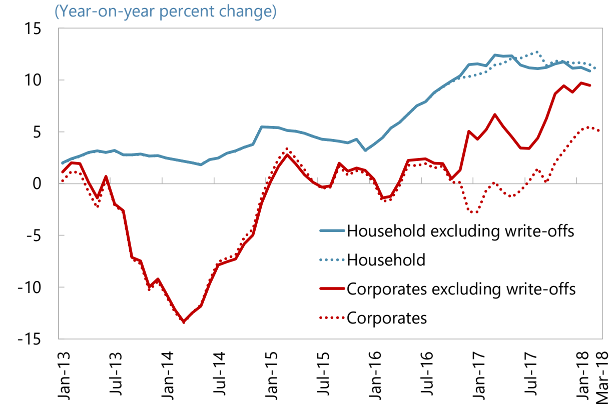
Contributions to growth
(Percent, yoy)



Sources: SORS; and IMF staff calculations and projections.

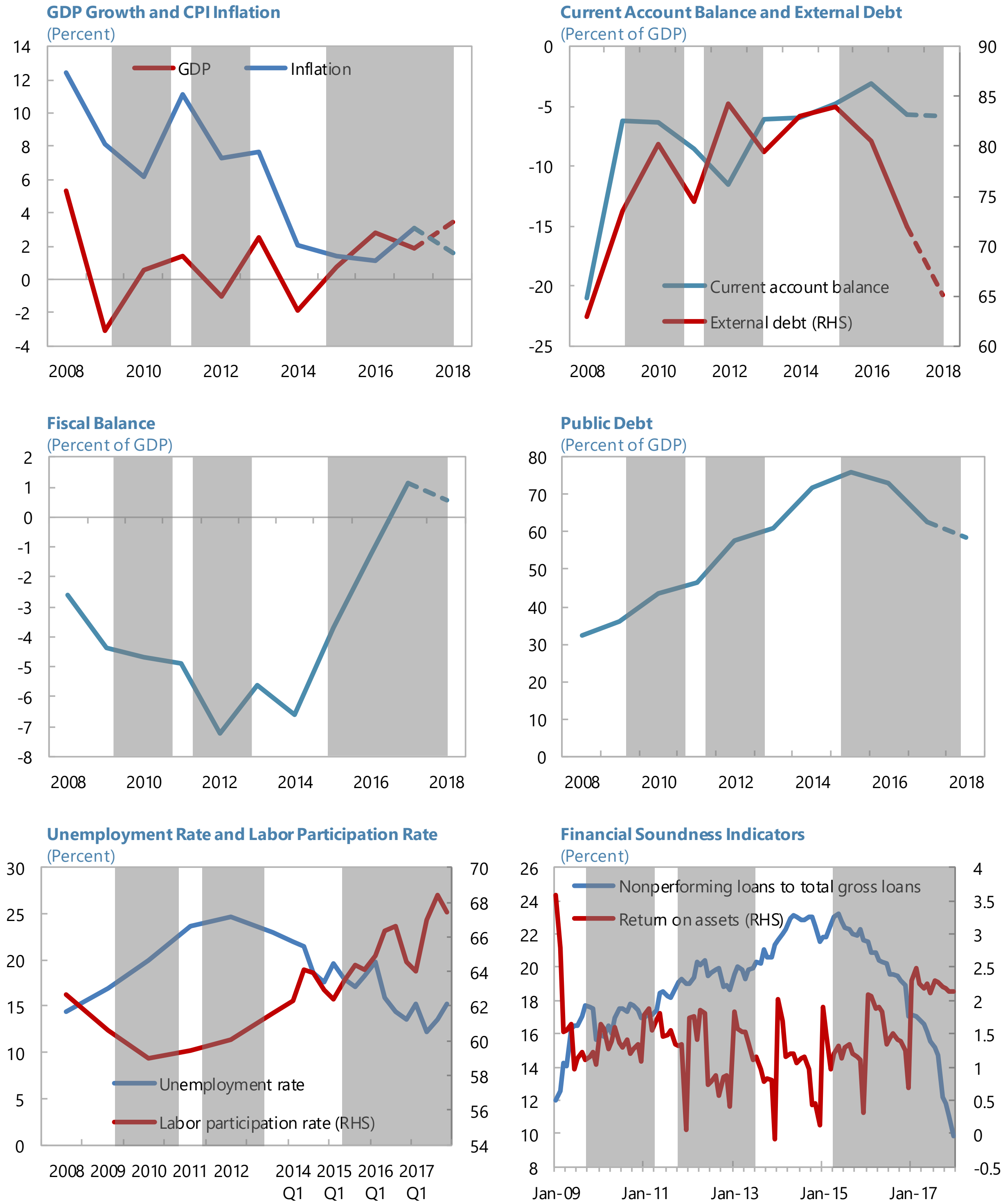
6. Headline inflation fell below the target band in March and April, but has since returned. The decline in inflation is mainly due to low food prices and the high 2017 base effect. Core inflation remains low, but stable (Figure 5). In response to the weaker inflation outlook and sustained nominal dinar appreciation pressures, the NBS lowered the key policy rate with two consecutive 25 basis points cuts in March and April to a historic low of 3 percent, while also narrowing the interest rate corridor to +/-1.25 percentage points. Lending interest rates continue to decline and write-off-adjusted credit growth is strengthening (11 and 9 percent year-on-year at end-March for households and corporates, respectively) (Figure 7). Reflecting the improved economic and labor conditions, private sector wage growth has picked up to around 6½ percent, while the minimum wage was increased by 10 percent and public wages by an average of 7 percent in January.

Credit Growth
(Year-on-year percent change)



Sources: National Bank of Serbia.

Figure 1. Serbia: Key Macroeconomic Indicators 1/

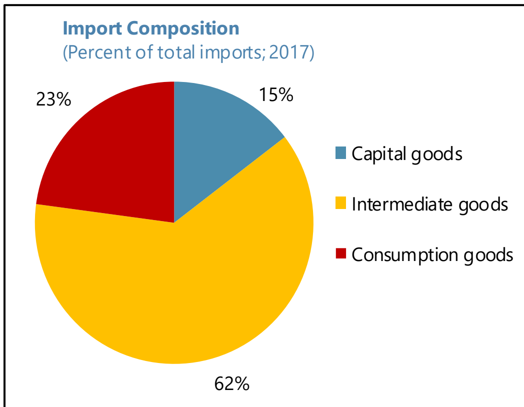


Source: SORS; MOF; NBS; and IMF staff estimates.

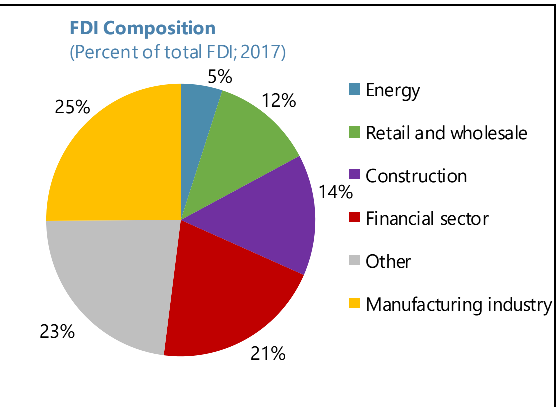
1/ Shaded areas correspond to periods under IMF-supported programs.

7. The external position remains sustainable on account of robust FDI and other capital inflows.

- **The current account deficit widened** to 5.7 percent of GDP in 2017 due to the effects of the drought on agriculture and electricity, along with dividend payments on investment income, and some deterioration in the terms of trade. However, external debt has continued to decline as the deficit was fully covered by strong net FDI inflows (Figure 3). These trends persisted, with 2018Q1 registering a sizable current account deficit (about 7 percent of GDP). Vulnerabilities associated with the high deficit are partly mitigated by the favorable import composition, mainly tilted towards investment-related imports, and by the fact that the current account remains fully financed by non-debt generating inflows (Figure 3). Private sector deleveraging has continued to slow, reflecting higher rollover rates in the banking sector as well as a reduction in deposits abroad. Portfolio inflows have been robust and since January 2018 the NBS has purchased about EUR 1 billion foreign exchange from the market, while accomodating slight appreciation against the euro (Figure 4).

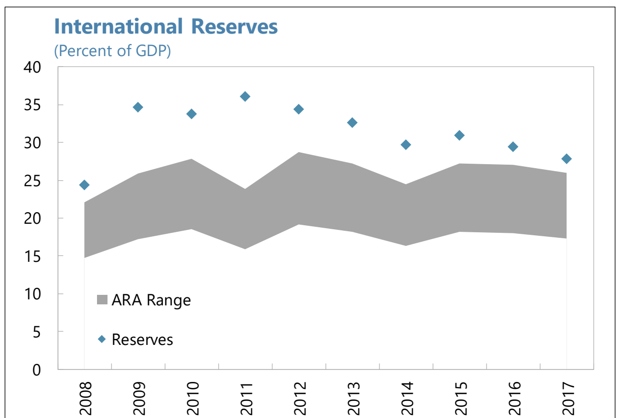


Source: Statistical Office of Serbia.



Source: National Bank of Serbia.

- **The updated external stability assessment confirms the findings reported in the 2017 Article IV consultation.** It suggests that Serbia's external position is broadly consistent with fundamentals and desirable policy settings, but subject to risks associated with the relatively large negative net international investment position (although mainly related to high net FDI liabilities) (Annex 3). Reserves stood at 27.84 percent of GDP at end-2017, remaining slighly above the precautionary range of the ARA metric for a country with a floating exchange rate regime.[1]



Sources: NBS, IMF staff calculations.

[1] Gross reserves at end-2017 correspond to 165 percent of the ARA metric (assuming Serbia returns to a floating exchange rate classification) and 138 percent of the ARA metric (assuming the current fixed change rate classification).

8. Strong fiscal performance has improved fiscal sustainability. The general government registered a surplus of 1.2 percent of GDP in 2017, securing about 6½ percent of GDP of structural adjustment under the 2015-18 precautionary SBA and decisively addressing fiscal slippages that built up following the global financial crisis. More than half of the adjustment was achieved by containing primary current spending, with revenue overperformance, led by VAT, CIT, and excises, accounting for the remainder (Figure 6). The strong fiscal performance continued in 2018Q1, led by revenues from social security contributions, CIT and PIT. VAT was flat compared to a year earlier, due to the postponement of RSD12 billion refunds into January. Current spending, including mandatory spending on wages and pensions, grew in line with expectations, while capital spending surprised on the upside as a result of favorable weather conditions and the inclusion of all project loans in the treasury accounts. General government debt fell to 63 percent of GDP at end-2017 and to 60 percent of GDP at end-March. On the back of improved confidence and fundamentals, yields on government securities continue to decline (Figure 3).

Serbia: General Government Fiscal Operations, RSD billion

	January - March		
	2017	2018	*% Change*
Total revenue	**434.4**	**473.8**	***9.1***
Tax revenue	370.8	420.0	*13.3*
of which: VAT	109.6	110.3	*0.7*
of which: Social security contributions	114.0	142.5	*25.0*
of which: Excises	64.9	76.9	*18.6*
Non-tax revenue	60.9	51.1	*-16.2*
Other revenues	2.6	2.7	*3.9*
Total expenditure	**423.0**	**470.1**	***11.1***
Current expenditure	400.5	433.6	*8.2*
Capital expenditure	12.0	28.9	*140.6*
Net lending	2.2	3.6	*64.8*
Amortization of activated guarantees	8.3	4.0	*-51.5*
Fiscal balance	**11.4**	**3.7**	***-67.5***
General government debt (percent of GDP)	**69.3**	**60.1**	***-13.2***

Sources: MOF, IMF staff calculations.

9. The economic outlook remains positive, supported by the continued reform momentum (Tables 1-8).

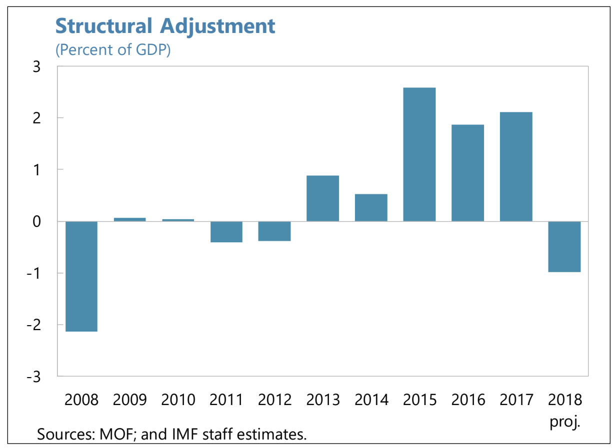
- **Real GDP growth** is projected at 3½ percent in 2018-19, with the output gap fully closed by 2020. Structural reforms envisaged under the PCI represent an upside risk to medium-term potential growth.
- **Inflation** is projected to gradually increase, but remain in the lower half of the inflation target band during 2018 and 2019.
- **The current account deficit** is expected to remain at about 5¾ percent of GDP in 2018 due to investment-related imports in the manufacturing and construction sectors, and to decline to around 4½ percent of GDP over the medium term.

10. The outlook is subject to risks. Serbia remains susceptible to spillovers from regional and global developments and market volatility, including potential increased risk aversion for emerging markets. Complacency or political resistance in delivering on structural reforms, or failure to maintain fiscal discipline, could undermine confidence and reduce medium-term growth prospects. Failure to decisively address AML/CFT weaknesses identified by FATF could undermine Serbia's investment attractiveness. Moreover, contingent liabilities arising from unfinished reforms of state-owned enterprises and banks, or from the way temporary pension cuts were implemented in 2014, could arise. On the upside, growth could outperform near-term projections as the effects of the 2017 one-off supply shocks reverse.

PROGRAM POLICY DISCUSSIONS

A. Fiscal Policy: Advancing the Pro-Growth Fiscal Agenda

11. The general government is projected to post a fiscal surplus of 0.6 percent of GDP in 2018, compared to a budgeted deficit of 0.7 percent of GDP. This overperformance is based on updated projections for revenues from PIT, CIT, and social security contributions, as well as non-tax revenues. Capital spending has been revised down compared to the budget (0.3 percent of GDP) to be better aligned with past execution rates. The favorable financing conditions and exchange rate also prompted a reduction in estimated interest expenses (by 0.4 percent of GDP). The airport concession fee of about EUR500 million is expected in 2018 but may be delayed to 2019, and will be recorded by the IMF as a financial transaction below-the-line. Staff supported the authorities plans to use the windfall from the airport concession to prepay some expensive external debt. Under this scenario, public debt would end 2018 below 60 percent of GDP, with an improved maturity profile and currency composition. Over the medium term, Serbia's public debt is deemed sustainable and vulnerabilities to macroeconomic shocks have declined (Annex I).



12. For 2019 onward, staff and the authorities agreed to target a small overall deficit of about ½ percent of GDP. Consistent fiscal overperformance under the SBA has opened space that can be used to address Serbia's large developmental needs and support private sector employment, while still delivering on a lower-than-expected public debt trajectory. In 2019, this will provide space for capital spending—recognizing existing implementation constraints—to address Serbia's large infrastructure needs and permit a reduction of the tax burden on businesses and labor, while supporting the reduction of public debt to about 50 percent of GDP by the end of the program. Given the estimated slightly negative output gap and monetary policy autonomy, the implied structural loosening is appropriate and not expected to result in overheating of the economy.

13. In addition to higher capital spending allocation, strengthening public investment management frameworks will help bridge the existing large gaps in the quantity and quality of public infrastructure. Notwithstanding efforts to enhance the project appraisal process and establish a single project pipeline, and the recent adoption of the new Planning System Law, structural deficiencies in implementing public investment remain. The current institutional and legal frameworks are fragmented and poorly integrated across different sectors. The authorities agreed with the need to improve the public investment management framework in line with IMF technical assistance recommendations. In this regard, they plan to issue a rule book unifying appraisal methodologies for all line ministries and agencies (**end-January 2019 reform target**), as well as to publish summary feasibility studies for large projects. The authorities also plan to establish the Capital Investment Commission (CIC), clarify institutional roles, and bring IPA-funded projects and government-to-government projects into the single project pipeline (**end-April 2019 reform target**). The authorities recognize the need to build capacity to assess investment documentation and have requested long-term technical assistance from the EU.

14. Completion of the public wage system and employment reforms will improve the efficiency of public services and contain mandatory expenditure.

- ***Wage system reform.*** The Law on Public Sector Employees Wage System approved in 2016 sets the stage for a new system where pay levels are set across the government, in a more market-oriented, equitable, transparent and systematic manner. Secondary legislation for local governments and public services (health, education, culture, and social protection) was approved in December 2017, and the decree specifying the coefficients under the new wage system will be adopted by end-September (**reform target**). Staff urged mapping employees to the new wage matrix and completion of consultations with stakeholders in time for implementation with the 2019 budget cycle. The authorities reiterated their commitment to avoiding the general government wage bill increasing as a share of GDP compared to its 2018 level, and agreed to set a base wage for the new system consistent with this target.

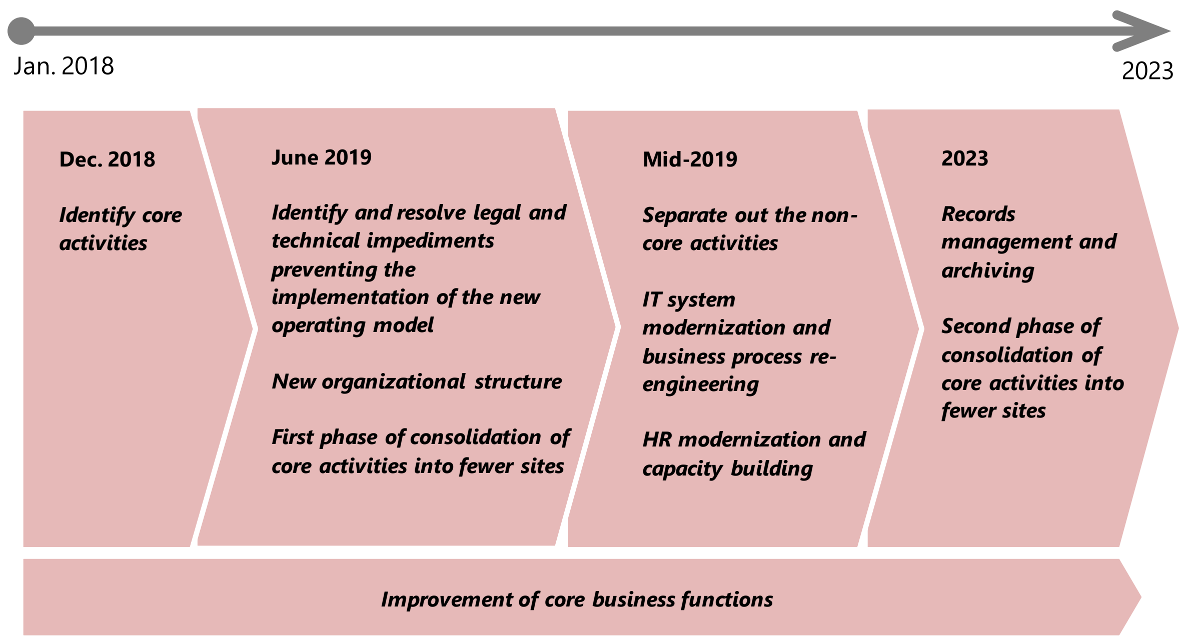
- ***Pension spending.*** The authorities agreed to keep pension spending from rising as a share of GDP. The authorities also viewed that with the recovery now well under way, it was important to address the legal and fiscal risk associated with the crisis-related temporary cuts in higher-end pensions and are exploring options to unwind the cuts in line with the law and within the overall pension spending envelope. In this regard, pension increases will be measured, with due attention to support lower-income pensioners.

- ***General government employment frameworks.*** The current framework is governed by an annual law setting employment ceilings on permanent staff at the unit level and an employment freeze, with exceptions granted by the government Employment Commission, considering individual institutions' employment ceilings, budgetary envelopes, and specialist staffing needs. The system applies to the broader public sector and is used to control the hiring within public enterprises. This system has succeeded in containing public employment, but also contributed to a reliance on fixed-term and contractual positions and staffing shortages in some units. Staff and the authorities agreed that the system is not sustainable in the medium-term and there is a need for greater flexibility to reallocate resources to fit needs, while controlling the wage bill. It was decided to continue discussions during program reviews to identify feasible options in time for the 2020 budget cycle.

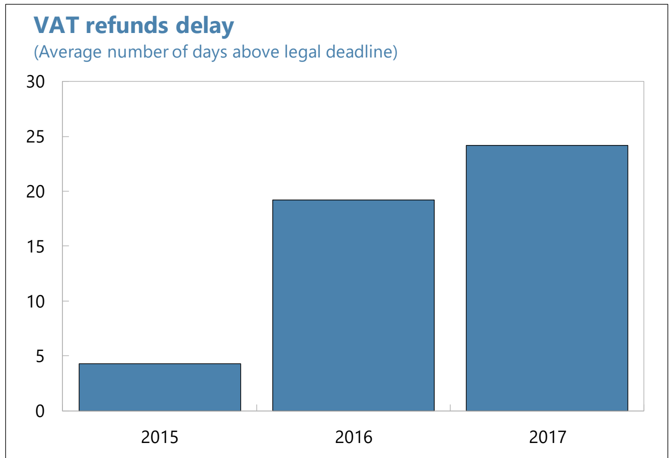
15. Tax administration reforms will support efforts to improve the efficiency of tax collection while providing better services to taxpayers.

- **The new Transformation Action Plan (TAP, 2018-23)**, developed in consultation with the IMF and approved by the government in December 2017, provides strategic guidance and timelines on actions needed to create a modern tax administration utilizing electronic business processes, improved taxpayer services, and a risk-based approach to compliance. The authorities reiterated their commitment to tax administration reform and agreed to complete the consolidation of core activities into fewer sites (**end-June 2019 reform target**). As a **prior action**, the authorities published a public tender for an external consultant to assist with the implementation of the TAP.

STA Transformation Program Action Plan, 2018-23



- **Further efforts are needed to reduce the VAT refund processing backlog.** The authorities noted that they take a cautious view to minimize refund fraud, but expect the introduction of IT software changes in July to improve processing time. Staff stressed that VAT refund audits should be risk-based to address fraud while speeding up regular refunds, in line with on-going modernization activities. The authorities and staff agreed to monitor the stock of pending refunds under the program, with an aim to progressively reduce processing times, and to agree on a specific numeric target.



Sources: Serbia Tax Administration; and IMF staff calculations.

16. Tax policy reforms can support growth and improve the business environment, while respecting the overall fiscal objectives (Box 1):

- ***Tax policy for investment and employment.*** Following the strong fiscal adjustment, there is scope to reassess the design of the tax system to ensure that it is effective, equitable, and administratively efficient. In this regard, the authorities see scope to: (i) review ***corporate income tax*** legislation, including to streamline tax incentives and replace them with targeted accelerated depreciation to incentivize investment; (ii) review ***personal income tax*** legislation to improve progressivity and simplify tax schedules and the taxation of small and micro businesses; (iii) review the ***presumptive tax regime*** for self-employed to increase transparency and eliminate abuses; and (iv) reduce the labor tax wedge and increase progressivity by lowering ***social insurance contributions*** (SIC), aligning the thresholds of wage taxation and SIC, and distinguishing the application of minimum contributions between self-employed and wage-earners. Discussions will continue with the help of FAD technical assistance, with specific measures to be included in the 2019 budget after discussion in the context of the first program review.

- ***Rationalizing the parafiscal tax burden.*** In May the government completed the public consultation on the draft Law on Charges, which aims to consolidate all Republican-level charges and corresponding rates faced by businesses in one law to reduce uncertainty and increase transparency. Staff urged the authorities to be ambitious, taking the opportunity to eliminate or merge some charges, and help reduce the non-core activities of the STA. The law will be submitted to the National Assembly (**end-October reform target**) with a view to be adopted by parliament by end-December.

17. During the program period, the authorities intend to pursue reform of fiscal frameworks. The current fiscal rules framework – a combination of debt, deficit, and indexation rules – exhibits several shortcomings, undermining its operational effectiveness and credibility[2]. Staff and the authorities discussed revisions to the framework, to be implemented over the program period, to achieve the following principles: (i) stronger institutional significance of the debt limit as the primary medium-term anchor for fiscal policy; and (ii) a more transparent and credible operational rule to help achieve the objective, while also helping to improve accountability and facilitate transition towards the EU fiscal framework. The authorities intend also to revisit local government financing arrangements. To strengthen the budget-making process, the authorities will follow more closely the legally prescribed budget deadlines than in the past.

Box 1. Dividends of Growth-Friendly Fiscal Policy Mix

Appropriately targeted use of fiscal space for growth-enhancing fiscal policies is expected to yield significant growth dividends. Staff estimates that measures envisaged under the authorities' program aimed at reducing labor and business taxation and increasing budgetary allocations for public infrastructure spending could increase the long-term real GDP level by around 1 percent.[1] The greatest growth dividends are expected to come from public infrastructure investments, particularly if coupled with strong progress in improving public investment management. Moreover, measures to reduce the tax wedge on labor will support the government's efforts to reduce the shadow economy, while easing the tax burden on businesses will help to increase private investment and employment.

The program design treats growth dividends from the use of fiscal space as an upside risk. Given high uncertainty about their size and timing the program assumes that growth dividends will be realized only in the medium-to-long term with any positive spillovers to near-term economic developments treated as an upside risk.

Long-Term Effects of Fiscal Stimulus

	Size of fiscal stimulus	GDP level effect
Measures to:	Percent of GDP	Percent
Reduce labor tax wedge	0.6	0.4
Reduce tax burden on businesses	0.2	0.1
Increase public infrastructure investment 1/	0.4	0.4-0.8
Total	1.2	0.9-1.3

Source: IMF staff estimates.

1/ Higher fiscal multipliers assume effects of strengthened public investment management framework.

[1] Results are obtained by calibrating the *Toolkit for Solving a Multisector Heterogeneous Agents General Equilibrium Model* (developed by SPR staff) to key macroeconomic and distributional parameters of Serbia's economy.

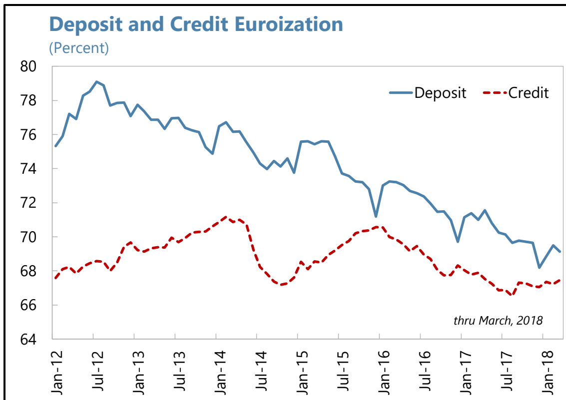
B. Monetary Policy: Strengthening Operational Frameworks

18. The current state-contingent stance of monetary policy remains appropriate in light of the domestic and external environment. In this context, staff supported the recent cuts in

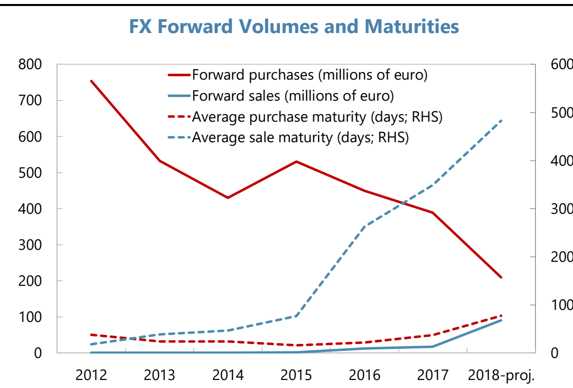
[2] See CR/17/17/263 Annex II. Towards a New Fiscal Rule for Serbia.

the key policy rate to 3 percent, on the back of subdued core inflation, lower medium-term inflation outlook, and continued exchange rate appreciation pressures. Staff also welcomed the narrowing of the interest rate corridor to +/-1.25 percentage points (from +/-1.50) in April which will improve the signaling role of policy interest rates and enhance transparency. Staff welcomed the strengthening of private sector credit growth but warned that risks associated with rising household cash loans—especially over longer maturities—warrant close monitoring.

19. Enhancing the credibility of the inflation targeting regime requires a strong liquidity management framework. Recent IMF technical assistance pointed to challenges in calibrating NBS liquidity management operations arising from insufficient communication with the Ministry of Finance (MOF). This leads to forecast errors in cashflows for the government accounts, while partial segmentation in the interbank market induces a demand for excess reserves, complicating open market operations. The authorities and staff agreed to (i) formalize communication between the NBS and MOF through a Service Level Agreement concerning single treasury account management and information provision; and (ii) establish a joint Consultative Committee on Liquidity Management aimed at strengthening the management and oversight of the Consolidated Treasury Account balance and improving the quality of liquidity forecasting.



Sources: National Bank of Serbia (NBS); IMF staff estimates.



Source: National Bank of Serbia.

20. The authorities' dinarization strategy is gradually yielding results, but needs to be strengthened to mitigate entrenched fears of greater exchange rate flexibility. To support dinarization, the NBS has imposed higher reserve requirements on FX deposits, differentiated prudential debt service-to-income ratios by currency and borrower's income, abolished the compulsory deposit for dinar loans, and conducted outreach to explain currency hedging opportunities. The MOF has increased its share of borrowing in domestic currency, but FX-denominated issuance remains significant. Since the dinarization strategy came into effect in 2012, deposit dinarization has been gradually increasing, but credit dinarization has proved more difficult to achieve. Falling volumes of forward FX purchases and increasing maturities and volumes of FX forward sales suggest that exchange rate expectations are becoming more balanced. The authorities and staff agreed to:

- **Update the dinarization strategy** (**end-December reform target**) aimed to (i) overcome persistent fears of exchange rate depreciation; (ii) develop local and foreign currency markets; and (iii) encourage prudent pricing of risks of unhedged FX borrowing. Staff recommended greater two-way exchange rate flexibility with interventions limited to smoothing excessive volatility, gradually moving to neutral liquidity conditions with short-term rate anchored around the key policy rate, strengthened monitoring of banks' FX exposures, fuller dissemination of information on risks of FX borrowing, and use of prudential measures to contain risks of unhedged FX borrowing. The NBS generally concurred with these priorities, but expressed caution about reducing the frequency of interventions, as in their view they may continue to need to counteract significant flows on the forex market.

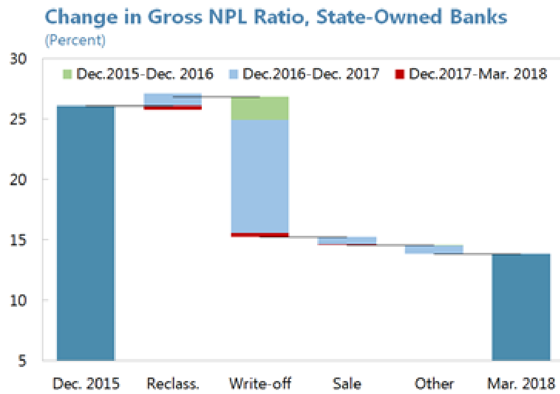
- **Strengthen public debt management** by (i) updating the legal foundation of debt management (**end-December reform target**); (ii) establishing the primary dealer system and developing adequate supervisory framework; and (iii) improving the Public Debt Agency's (PDA) operational framework and creating a Debt Market Committee comprised of representatives of the PDA, MOF, NBS, and primary dealers.

C. Financial Sector Policies: Enhancing Resilience

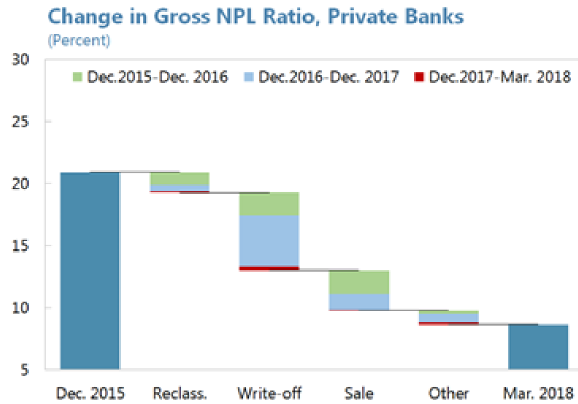
21. The authorities made strong progress in resolving NPLs during 2017-18, but state-owned banks (SOBs) still lag. In private banks, significant NPL sales and mandatory write-offs helped lower NPLs to 8.7 percent in March 2018, below pre-crisis levels. However, the gross NPL ratio remains relatively high for SOBs (13.9 percent in March 2018), notwithstanding significant improvement driven primarily by write-offs following the September 2017 NBS decision on the accounting of bank assets. Staff encouraged the authorities to complete ongoing work, supported by IFIs, to update their NPL resolution strategy, focusing on measures to speed up NPL resolution in SOBs, while also broadening the scope to include the Development Fund (DF), export promotion agency (AOFI), and assets managed by the Deposit Insurance Agency (DIA). In line with the updated NPL resolution strategy, as an **end-December reform target**, the government and DIA will approve a time-bound action plan to resolve the higher-value parts of the DIA's portfolio of bad assets by end-2020 through a tendering process, and complete the first phase of the sale. The action plan will also include options to resolve the residual portfolio of relatively lower valued assets. As a first step, the DIA has engaged consultants to prepare the first phase of the tender process.

22. Implementation of the state-owned financial institutions reform agenda continues to advance:

- ***Banka Poštanska Štedionica (BPS).*** In December 2017, the BPS Board approved the external consultant's report in relation to the bank's reorientation towards retail banking and small businesses and other strategic and operational priorities. After some delays, the authorities are finalizing terms of reference to procure consultants, with the support of the World Bank, to assist in the implementation of the business plan and a new IT infrastructure system. `



Sources: National Bank of Serbia; and IMF Staff calculations.



Sources: National Bank of Serbia; and IMF Staff calculations.

- ***Development Fund and the export development agency.*** DF and AOFI have made progress in implementing the government conclusions related to the findings of the independent diagnostic assessments, including recognizing losses in their credit portfolios, and working to enhance their credit risk management procedures and their IT systems and applications. Staff commended the progress, but stressed the need for DF and AOFI to continue implementing the government conclusions and to ensure that their portfolio of bad assets be included in the updated NPL resolution strategy.

- ***Komercijalna Bank.*** Staff urged the authorities to move ahead with the bank privatization process expeditiously. The authorities will adopt a decision to initiate the privatization of Komercijalna Bank by end-February 2019, with a view to launch a privatization tender by end-June 2019 (**reform target**) and complete the sale of the bank by end-September 2019. In the meantime, the bank is taking measures to enhance its governance framework and address the findings of the latest NBS inspection.

- ***Smaller state-owned banks.*** The implementation of the government strategy for smaller SOBs is moving ahead, but with significant delays. In April, the authorities delicensed Jugobanka Jugbanka and approved the takeover of parts of its assets and liabilities by BPS after longstanding efforts to find a strategic investor to recapitalize the bank failed. Staff welcomed the move, noting it would be important to ensure proper management of the new operations assumed by BPS along with adequate monitoring and oversight by the NBS to limit any potential implications for BPS' risk profile. The authorities also initiated market research for the sale of the government's shares in Jubmes Bank. Staff stressed the need to move ahead in implementing remaining actions without further delays.

23. The authorities will continue the process of aligning Serbia's financial regulatory and supervisory frameworks with EU standards. Basel III capital and liquidity standards were adopted in June 2017. The supervisory approach has become more risk-based and has been aligned with the EBA guidelines for common procedures and methodologies.

24. Staff and the authorities agreed that financial safety nets should be further strengthened. Significant progress has been achieved in strengthening the bank resolution, deposit insurance, and crisis management frameworks, but additional efforts are warranted to ensure alignment with international standards. A new methodology for the identification of critical functions and a manual for planning the resolution of banks and banking groups were completed in December 2017. The authorities will review the parameters of the deposit insurance framework (including the target level, premium, and deposit base) and to proceed with an independent external assessment based on IADI core principles for effective deposit insurance systems before end-2018. The findings will serve as inputs to amend the laws on Deposit Insurance Agency and on deposit insurance and introduce risk-based deposit insurance premia (**end-March 2019 reform target**).

25. An effective development finance framework and more active capital markets could play an important role in supporting economic growth and structural reforms. Challenges identified by the external audit of DF and AOFI in 2017 suggest that the past strategy of development finance support was poorly targeted and executed. The authorities have established an inter-governmental working group that will develop, with support from the World Bank, a strategy for development finance to be adopted in 2019, while ensuring fiscal and quasi-fiscal risks are minimized. Capital markets in Serbia remain underdeveloped, with limited equity market activity, nascent domestic bond market volumes, and an absent corporate bond market. Alternative sources of financing, such as private equity or venture capital, are negligible. The World Bank will also assist the authorities in performing a diagnostic assessment focused on developing capital markets and diversifying sources of long-term financing, to feed into a capital market development strategy.

26. The authorities plan to maintain their existing capital account framework during the program period. In April, the National Assembly approved amendments to the Law on Foreign Exchange Operations, aimed at liberalizing short-term borrowing and portfolio investment. Existing capital flow management measures include the longstanding restrictions on residents' holdings of foreign exchange in bank accounts abroad and on financial derivatives transactions. The authorities plan to liberalize these transactions subsequently by the date of EU accession.

27. The authorities are addressing the deficiencies in the AML/CFT framework. The February decision by FATF to place Serbia on the "grey list" of jurisdictions with strategic deficiencies raises the urgency of this issue to minimize risks to the economy. The authorities are addressing the shortcomings identified in the 2016 MONEYVAL AML/CFT mutual evaluation report through an inter-agency working group, with the aim to complete their work ahead of the January 2019 deadlines agreed with FATF. The authorities reported that the Law on Anti-Money Laundering came into effect on April 1 defining notaries as a new obliged entity and providing a clear legal base for the tax administration to start inspections in casinos. A targeted National Risk Assessment was completed in June. The authorities expressed their commitment to fully implement the Serbia's action plan to address the significant AML/CFT weaknesses identified by the FATF (**end-February 2019 reform target**). Staff stressed the importance of demonstrating improved implementation of AML/CFT measures in this regard.

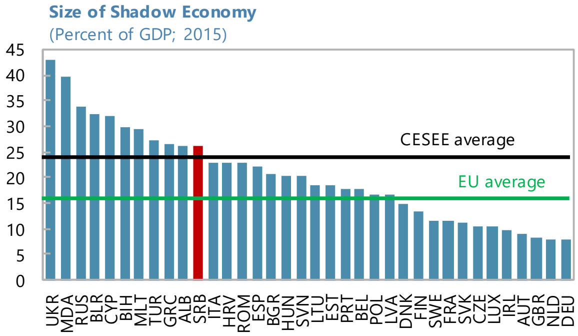
D. Structural Policies: Improving the Business Climate

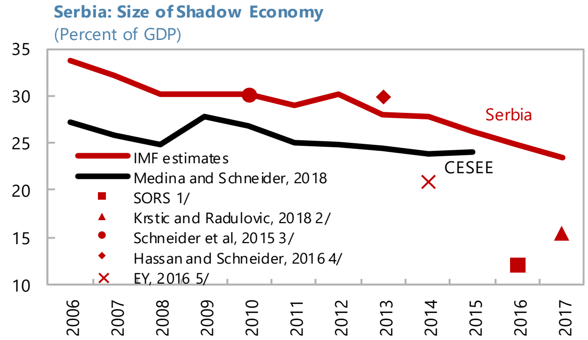
28. The authorities intend to complete the reform of large public enterprises, which were the source of large fiscal costs in the past. The strategy under the 2015-18 program of reducing fiscal risks, improving transparency of operations, and focusing on resolution and privatization has been largely successful, but some companies remain to be fully resolved, including 7 of the 17 strategic companies in the former Privatization Agency portfolio and the loss-making Resavica coal mines. The authorities reiterated their commitment to reduce and monitor fiscal risks, noting that the MOF's Fiscal Risk Unit will be fully staffed by September 2018. After the chemical company MSK failed to sell in the first offer, a second round was launched in May. A third and final round at a lower offer price will be initiated by end-September if necessary. The Azotara fertilizer plant resumed accumulating arrears to Srbijagas and, after failing to find a strategic investor, the Ministry of Economy requested the State Attorney Office to initiate bankruptcy procedures in June (**prior action**). The public tender for a strategic partner for copper mine RTB Bor, and the privatization tender for dairy firm PKB, will be launched in July. The authorities will launch the privatization tender for Petrohemija by end-September (**reform target**).

29. Serbia has a sizable informal economy, which holds back growth and generates significant costs (Box 2). Authorities and staff agreed that tackling the informal economy is important for improving competition and the overall business environment, protecting workers, capturing forgone revenue, and providing access to finance. The authorities pointed to the 2017 update of the Action Plan for Countering the Shadow Economy (prepared together with private sector partners and monitored by a government working group), which includes about 80 measures aimed at reducing the share of the grey economy. Priorities include improvements in the inspection system (better coordination, and increased use of IT systems), reform of Tax Administration (risk based audits, trainings, reorganization, and better control of trading in excise goods), and providing incentives for voluntary compliance. The authorities pointed to the success of their *Take a Receipt and Win* campaign in raising awareness of the grey economy, as well as stricter fines being imposed for not issuing fiscal receipts. Staff urged the authorities to take stock of the current action plan and identify a small number of critical measures with clear responsibilities, implementation timelines, and performance indicators. The authorities saw merit in the exercise and will amend the Law on Inspection Supervision (**end-September reform target**) and align all sectoral laws to permit supervision of unregistered activities as well as improve coordination across inspections.

Box 2. The Grey Economy

There are many estimates of the size of Serbia's shadow economy, but consensus is that it is sizable and broad based – perpetuated through unregistered employees (20.7 percent of total employment is informal[1]), cash payments, and undeclared profits (the VAT compliance gap is estimated at 15 percent[2]). Nevertheless, staff estimates suggest that the shadow economy has shrunk by 10 percent of GDP over the past 10 years, following a similar trend to other CESEE countries.[3] The size of Serbia's shadow economy is above the European Union and CESEE averages, but ranks amongst the smallest in the Western Balkans.





Source: Medina and Schneider (2018), IMF staff calculations.

Notes:

1/ Estimate by SORS using national accounts non-observed economy (NOE) methodology in line with international standards.

2/ Krstic, G, and B. Radulovic. 2018. Shadow Economy in Serbia in 2017. Key Findings and Recommendations. Belgrade, Serbia: NALED. Based on survey methodology.

3/ Schneider, F., G. Krstic, M. Arsic, and S. Randelovic. 2015. What is the Extent of the Shadow Economy in Serbia? In Krstic, G. and F. Schneider (eds). Formalizing the Shadow Economy in Serbia. Policy Measures and Growth Effects. Belgrade, Serbia: Springer Open.

4/ Hassan, M. and F. Schneider. 2015. Size and Development of the Shadow Economies of 157 Countries Worldwide: Updated and New Measures from 1999 to 2013. IZA

5/ Ernst and Young. 2016. Reducing the Shadow Economy through Electronic Payments: Serbia.

In 2015, Serbia adopted a National Program for Countering the Grey Economy and an Action Plan for its implementation, which was since updated to cover 2018-19. Documents were prepared in coordination with the National Alliance for Local Economic Development and members of the Fair Competition Alliance, with the support of USAID.

The National Program identifies the following main factors contributors to the grey economy in Serbia: 1) low level of tax morale, caused by a lack of trust in the government and non-transparent use of public resources; 2) complicated and frequently changing regulatory frameworks, applied by weak institutions; 3) high tax and non-tax burdens with high administrative barriers and costs; 4) high level of corruption and high level of tolerance for the grey economy (in institutions such as inspections, customs, judiciary, police); and 5) high unemployment and poverty.

The National Program aims to reduce the size of the grey economy by achieving the specific goals of: 1) efficient oversight over grey economy flows; 2) improving functioning of the fiscal system; 3) reducing administrative and parafiscal burdens; and 4) raising public awareness and motivating to respect for the regulations.

The Action Plan contains around 80 specific activities that are organized around these four specific goals and identifies deadlines for implementation, performance indicators, source of indicator, planned costs, institutions in charge, and a potential development partner in some cases. The government working group (WG) adopted a report on the implementation of the National Program for 2016, summarizing overall progress as mixed. Progress will be assessed by the WG on a quarterly basis going forward.

[1] IMF staff calculation from 2017 labor force survey data published by SORS.

[2] Ministry of Finance. 2017. Government of the Republic of Serbia Fiscal Strategy for 2017 with Projections for 2018 and 2019. Estimate for 2015. Belgrade, Serbia: Republic of Serbia.

[3] Medina, L. and F. Schneider. 2018. "Shadow Economies Around the World: What Did We Learn Over the Last 20 Years?", IMF Working Paper No. 18/17. Serbia and CESEE estimates based on the MIMIC model.

30. Concerted efforts are needed to raise labor force participation. Low participation rates, particularly of women, a high degree of informality, and a shrinking working age population all accentuate the need for a comprehensive set of policies to raise formal labor market participation. To this end, reform of labor taxation, parental benefits, and access to affordable childcare are important priority areas. While the 2014 amendments to the Labor Law, which aligned legislation with EU standards, have helped create a more favorable business environment, more flexibility needs to be introduced in areas of staff leasing, part-time employment, dual vocational training, and fixed-term employment. To address labor flexibility, the authorities reported that the Law on Simplified Seasonal Employment in Specific Industries was amended in June to simplify hiring procedures and guarantee legal labor status of workers, and by end-2018 the Law on Work Through Temporary Employment Agencies will also be updated.

PROGRAM MODALITIES AND RISKS

31. The attached Program Statement (PS) details the authorities' policy commitments under the 30-month PCI. Serbia does not need the Fund's financial assistance under the baseline and is not seeking financial assistance from the Fund as the program is fully financed. Reviews are set out in PS Table 1, with quantitative targets for the key set of macroeconomic variables to be monitored on a semi-annual basis: general government fiscal deficit, current primary expenditure of the Republican budget, domestic payment arrears, and the inflation consultation band. In addition, there is a continuous target on the non-accumulation of external debt payment arrears. The authorities' reform targets for the next 12 months, which aim to support the structural reform agenda in the areas of public financial management, tax administration, financial sector, and business environment, are proposed in PS Table 2.

32. Two prior actions were set for the completion of the program request: (i) the publication of a public tender for external consultant to assist the implementation of the Tax Administration Transformation Program (an important and overdue step to advance the reform agenda); and (ii) the Ministry of Economy requested the State Attorney Office to initiate bankruptcy procedures for Azotara (to reduce fiscal risks).

33. Downside risks to the PCI appear to be moderate given Serbia's track record under the previous precautionary SBA. A safeguard assessment is not required under a PCI. In addition, Serbia has no remaining obligations to the Fund. Although moderate, risks to implementation include exogenous shocks, as well as a possible reversal of the pro-reform sentiment.

34. While statistical data are broadly adequate for surveillance and program monitoring, efforts to strengthen data transparency are recommended. Greater clarity on methodological changes and data revisions would be welcome. Staff welcomed Serbia's implementation of the e-GDDS and launch of the National Summary Data Page in June and urged the authorities to prepare to subscribe to SDDS by the end of the program period, including by publishing an Advance Release Calendar. Staff supports the authorities' efforts to improve national accounts statistics and fiscal reporting following ESA 2010 and GFSM 2014 methodologies.

35. Serbia has small sovereign arrears outstanding. It intends to resolve US$45 million in arrears to Libya, which arose in 1981 due to unsettled government obligations related to a loan for importing crude oil, after establishing the appropriate government counterpart. Staff urged the authorities to continue their efforts to resolve these arrears as soon as possible.

STAFF APPRAISAL

36. Serbia has chosen to cement the success of its 2015-18 program with a new economic reform program focusing on strengthening institutions and improving competitiveness for faster growth. The recently completed program supported by a precautionary SBA focused on addressing macroeconomic imbalances, restoring fiscal discipline, and securing financial sector stability, while initiating a broad-based and ambitious reform agenda.

37. The authorities' new program maintains a strong fiscal position and continued decline in public debt, while using available fiscal space for growth-enhancing measures. Increased public investment would likely deliver the strongest growth dividend, but only if the authorities can succeed in gradually improving capacity to select, appraise and prepare infrastructure projects. Targeted tax measures can also improve incentives for investment and employment growth and reduced informality.

38. Monetary policy will continue to support economic activity, under the inflation targeting framework. Use of the dinar for financial transactions is rising but euroization remains higher than in peer countries. Full implementation of an updated dinarization strategy, including allowing more short-term exchange rate flexibility and better coordination between the MOF and NBS, will strengthen monetary transmission mechanisms and market development.

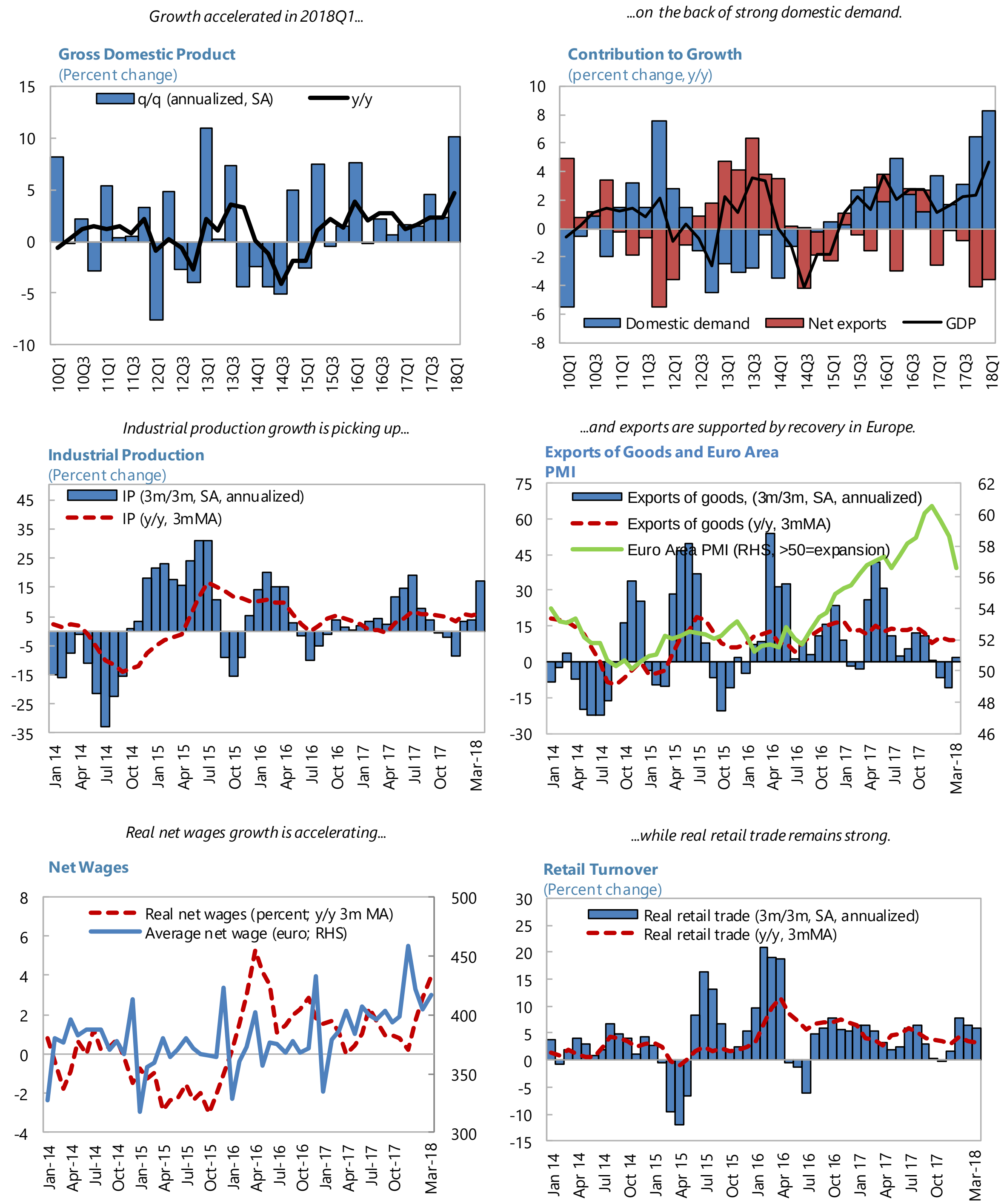
39. Financial sector reforms will continue to reinforce stability and improve intermediation. With NPLs in most private banks reduced to pre-crisis levels, the focus needs to be on resolving bad assets of the public financial institutions, including the development agencies and the Deposit Insurance Agency. Review of the latter against international best practices will also help ensure it contributes efficiently to financial stability.

40. Structural and institutional reforms will gradually strengthen Serbia's potential growth, and help ready the country for eventual EU accession. The faster sustainable growth Serbia can achieve in coming years, the better equipped it will be to compete in the Single Market – not least in terms of the single labor market, which will require rising productivity and incomes to prevent an acceleration of emigration flows upon membership. Priorities supported by the program include higher public investment, an improved business climate, reduced informality, and a recasting of the role of the state away from direct participation in the economy towards supporting a full market economy.

41. The program faces both domestic and external risks. In particular, Serbia needs to maintain a political consensus in favor of fiscal discipline and market-oriented reforms. While the success of the recently completed program in raising employment and incomes should help build support for continued reforms, it will be important to guard against complacency as growth becomes more entrenched and public debt continues to fall. In addition, Serbia remains susceptible to spillovers from regional developments, tighter global financing conditions, and higher global risk aversion. Failure to address AML/CFL weaknesses identified by FATF could undermine Serbia's investment attractiveness.

42. The PCI provides an appropriate instrument to support the authorities' program. With much reduced internal imbalances, a sound and resilient financial sector, the managed floating exchange rate regime and comfortable international reserves, staff does not envisage a need for Fund financing during the program period. Program reviews will test the ongoing commitment to reforms through the program period, as well as providing opportunities to adjust policies in light of developments to ensure program objectives are met. Staff supports the authorities' request.

Figure 2. Serbia: Real Sector Developments, 2010–18



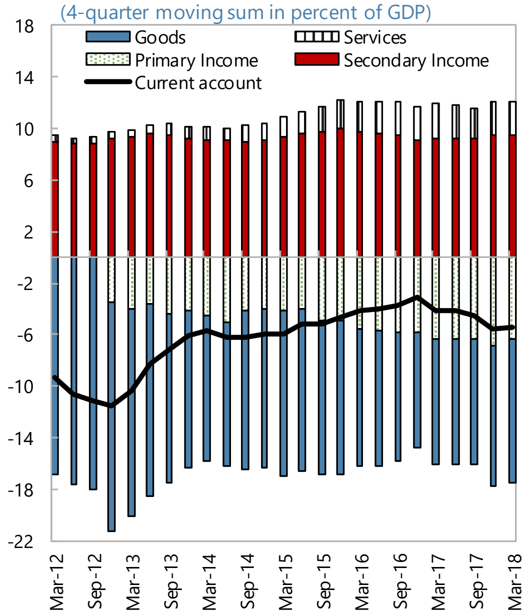
Sources: Haver analytics, SORS; and IMF staff calculations.

Figure 3. Serbia: Balance of Payments and NIR, 2012–18 1/

The current account deficit widened in 2017…

Current Account Balance

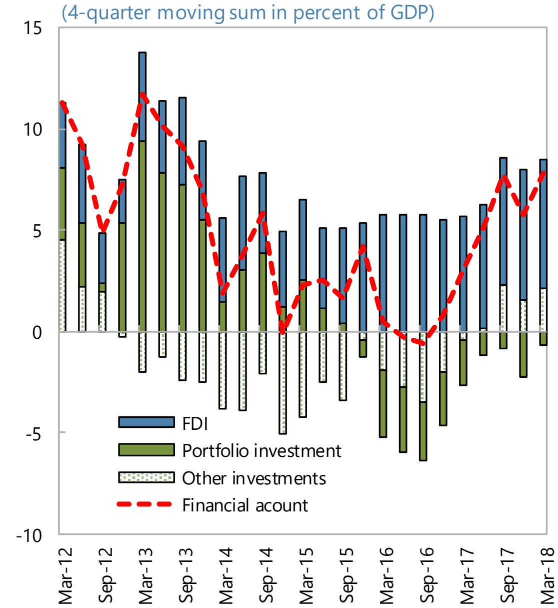
(4-quarter moving sum in percent of GDP)



…but remained fully covered by FDI inflows.

Financial Account Composition

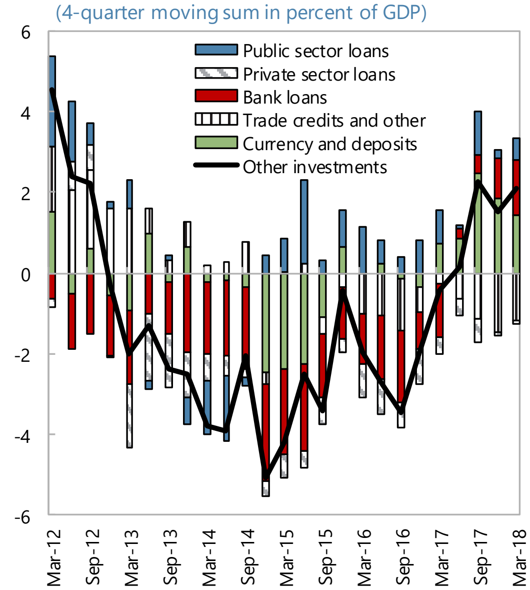
(4-quarter moving sum in percent of GDP)



Outflows in other investments beginning in 2017Q2 were driven by private sector loans and trade credits.

Other Investments 1/

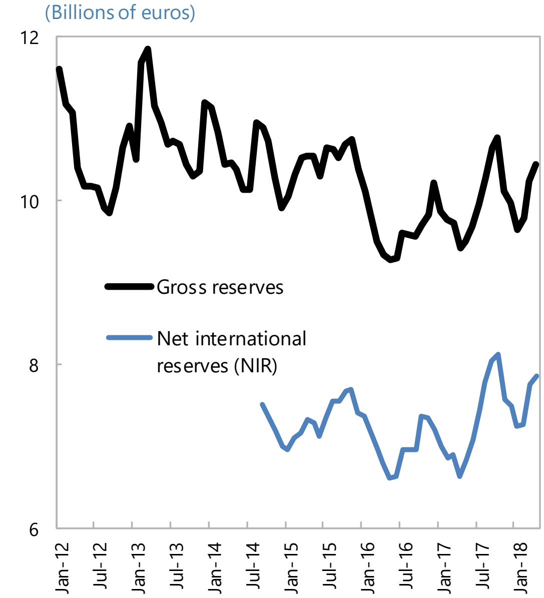
(4-quarter moving sum in percent of GDP)



International reserves remain at comfortable levels.

Foreign Exchange Reserves

(Billions of euros)



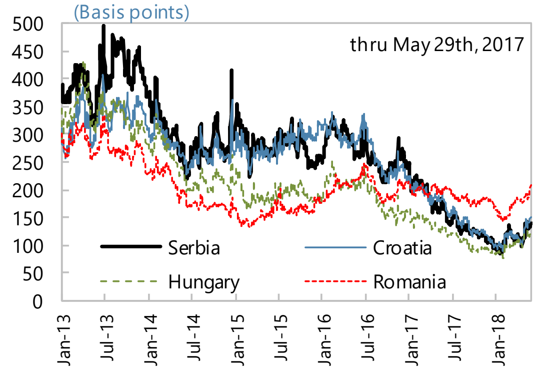
Sources: Haver; and IMF staff calculations.

1/ BPM5 data spliced with BPM6 going forward starting March 2013.

Figure 4. Serbia: Recent Financial and Exchange Rate Developments, 2013–18

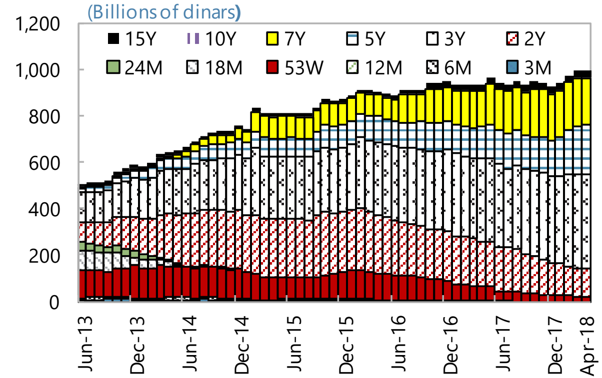
EMBI spreads remain near historic lows.

Sovereign Risk -EMBI spreads
(Basis points)



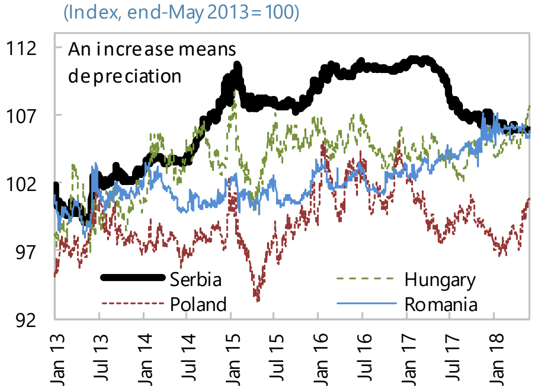
The authorities continue to lengthen the maturity of domestic securities.

T-Bill & T-Bond Stock 1/
(Billions of dinars)



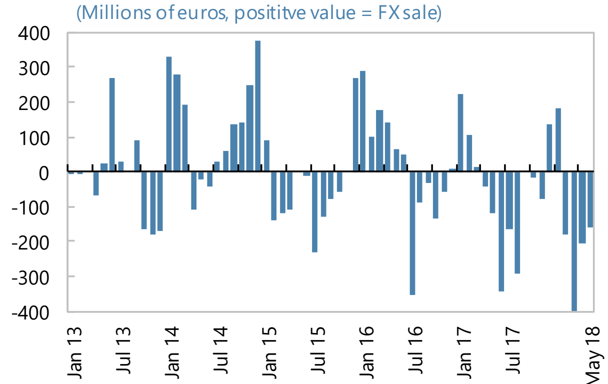
The exchange rate has been appreciating in recent months...

Exchange Rates in the Region
(Index, end-May 2013=100)



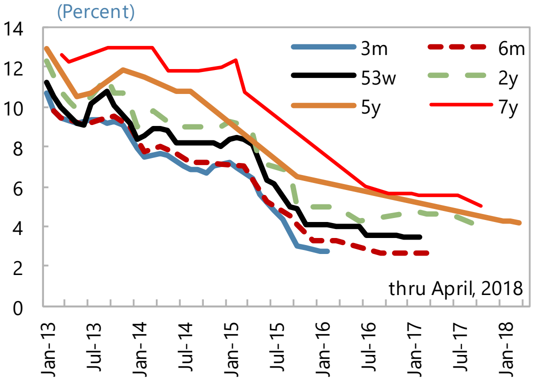
....although some of the pressure was absorbed by intervention.

FX Interventions by NBS
(Millions of euros, posititve value = FX sale)



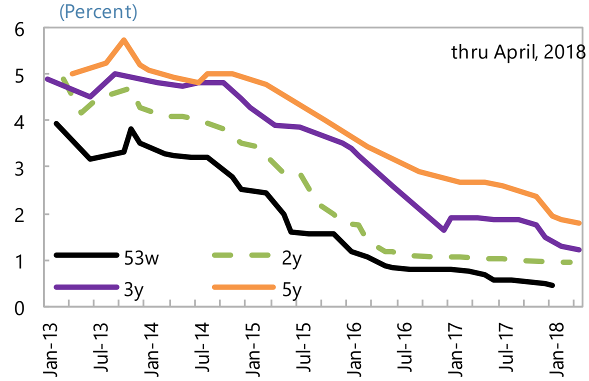
Yields in dinar denominated securities are near recent lows...

Yields on Dinar-Denominated Domestic Securities
(Percent)



...as well as in euro-denominated securities.

Yields on Euro-Denominated Domestic Securities
(Percent)

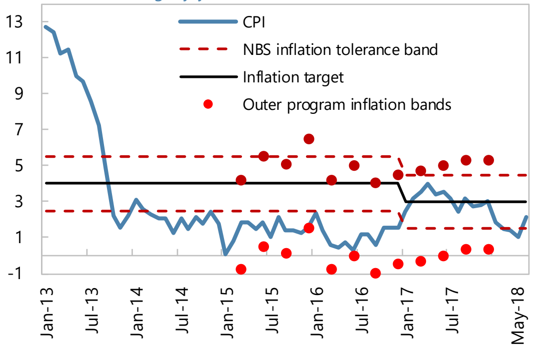


Sources: Serbian Authorities; Bloomberg; and Haver.
1/ Sum of dinar and FX-denominated securities at current exchange rate.

Figure 5. Serbia: Inflation and Monetary Policy, 2013–18

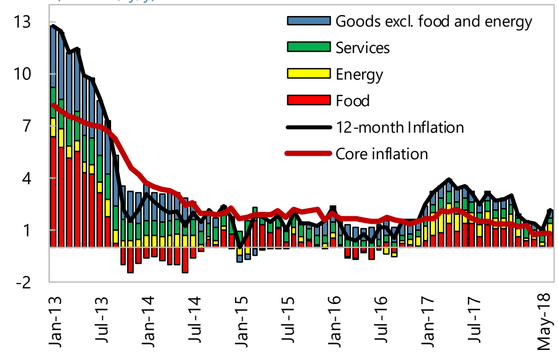
Headline inflation fell briefly outisde of the target band in March and April...

Inflation
(Percent change, y/y)



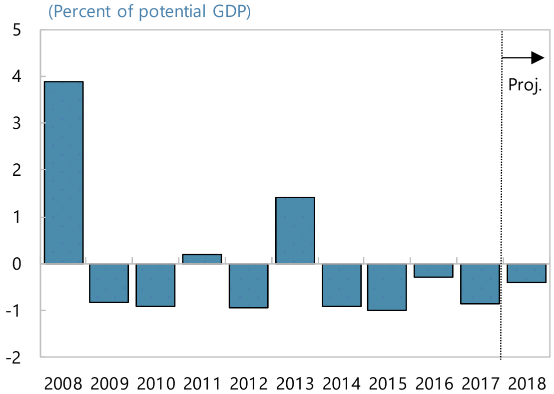
...mainly driven by lower-than-expected contribution of food and energy prices.

Contribution to Annual Inflation
(Percent, y/y)



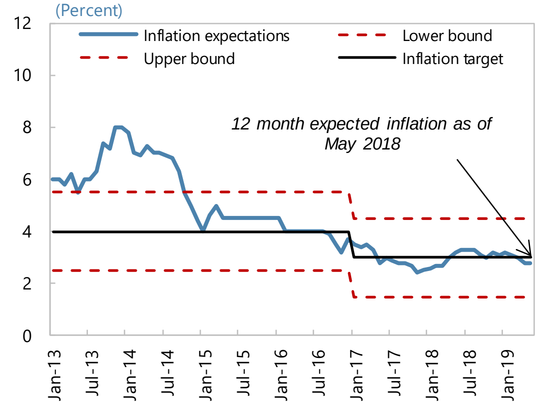
The output gap will narrow somewhat in 2018 ...

Output Gap
(Percent of potential GDP)



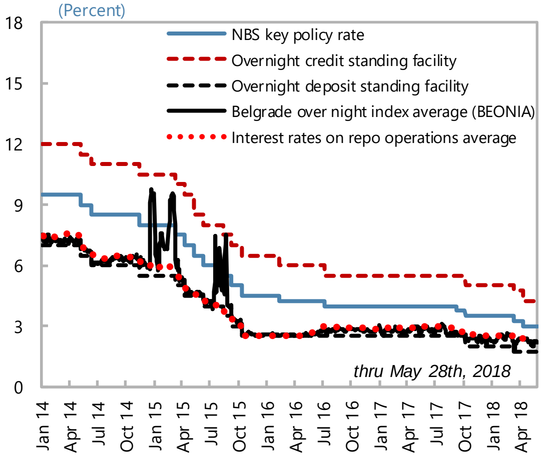
...while inflation expectations remain stable.

One-Year Ahead Inflation Expectations
(Percent)



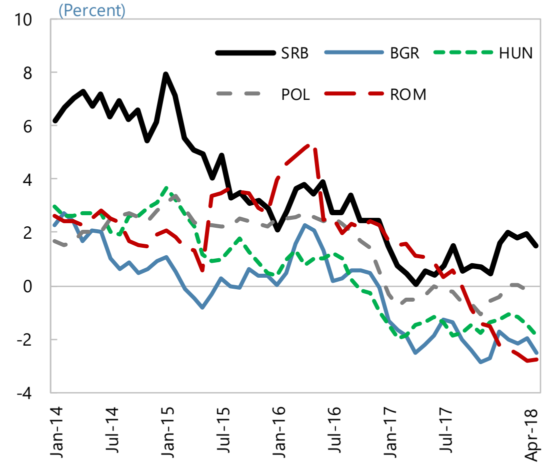
The NBS lowered the key policy rate to a new historic low level in March and again in April...

Interest Rates
(Percent)



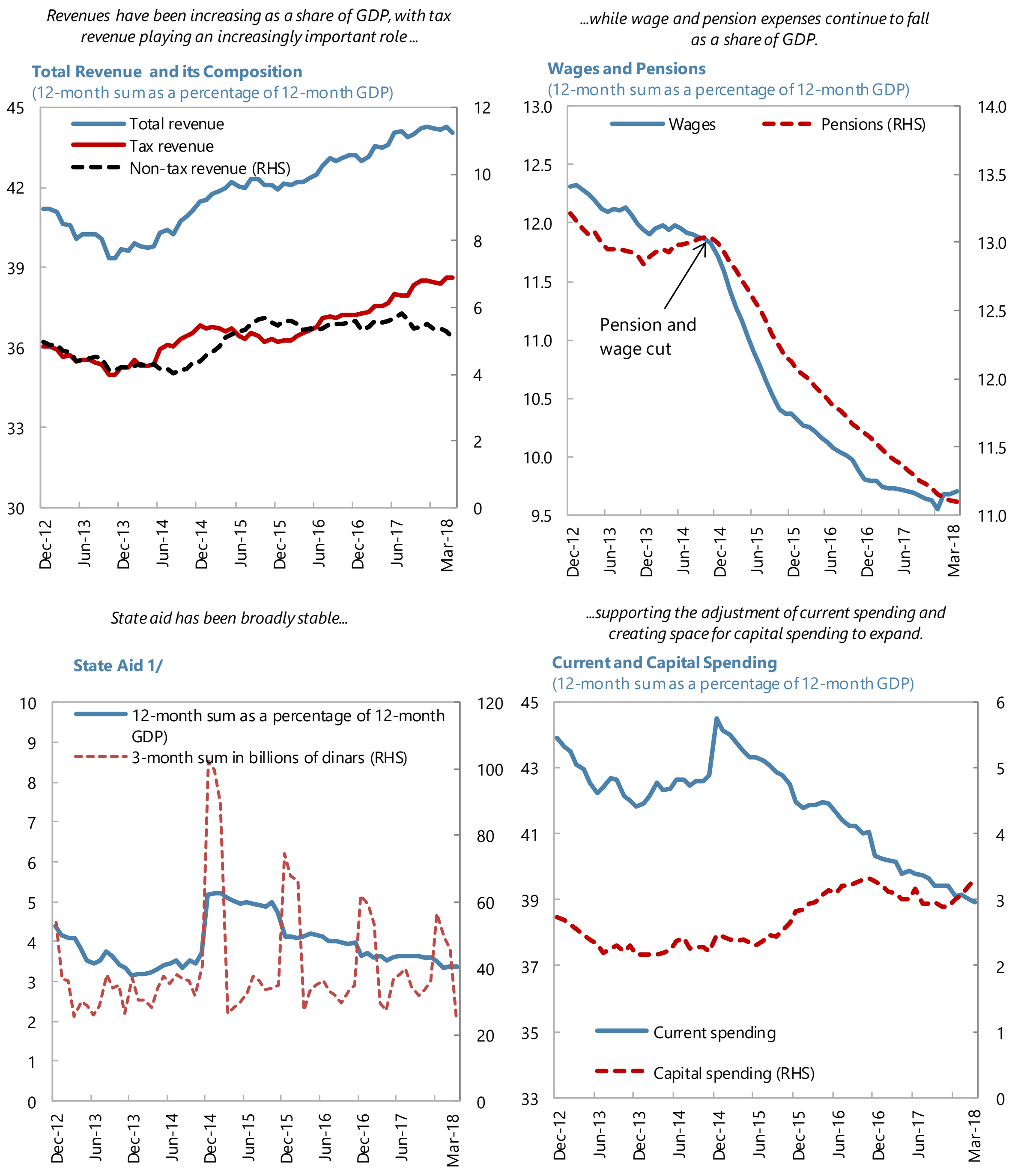
...but it remains above peer countries in real terms.

Policy Rate in Real Terms in Selected Countries 1/
(Percent)



Sources: Haver; Bloomberg; National Bank of Serbia (NBS); SORS; and IMF staff estimates and projections.
1/ Nominal policy rate adjusted by inflation over the past 12 months.

Figure 6. Serbia: Fiscal Developments, 2012–18



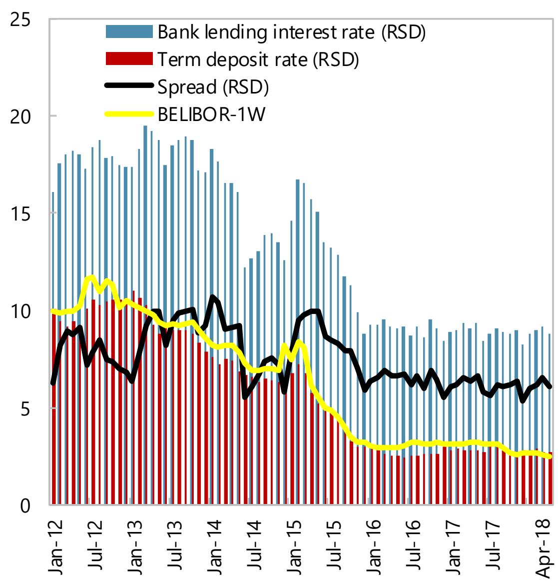
Sources: Ministry of Finance; and IMF staff calculations.

1/ State aid includes direct subsidies, net lending through the budget, assumption of SOE's debt, and the service of guaranteed debt called by creditors.

Figure 7. Serbia: Selected Interest Rates, 2012–18

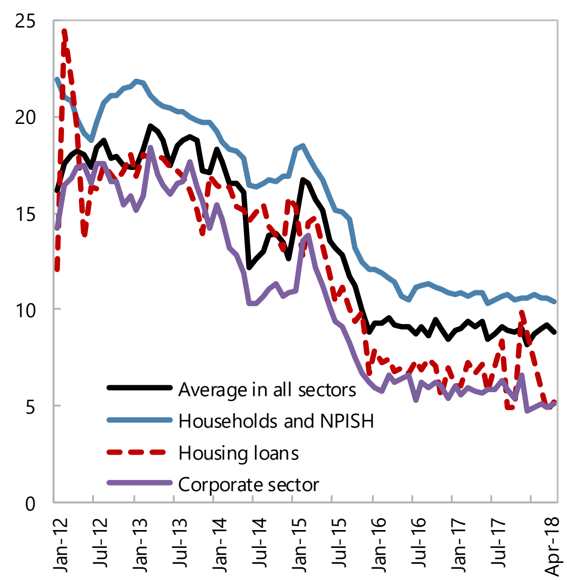
Easing of monetary policy has led to a decline in dinar interest rates...

Selected interest rates (RSD)
(Percent)



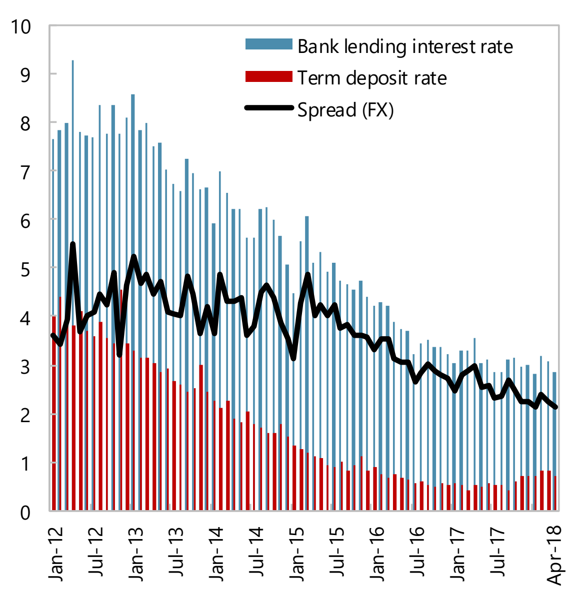
...in both corporate and household markets.

Bank lending interest rates: RSD
(Percent)



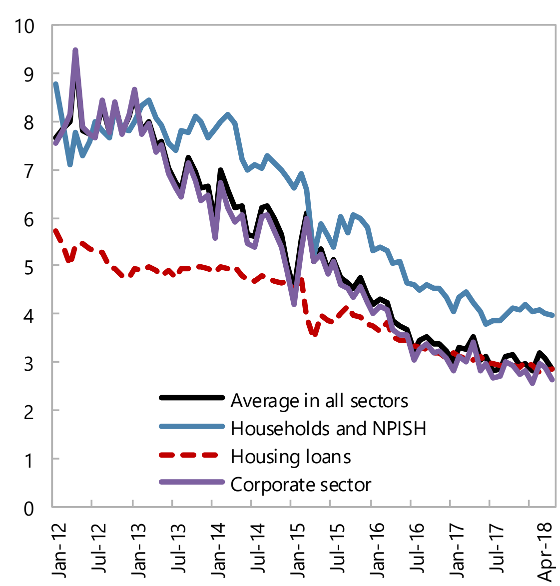
FX (or FX-linked) interest rates have been declining, too...

Selected interest rates (FX and FX-linked)
(Percent)



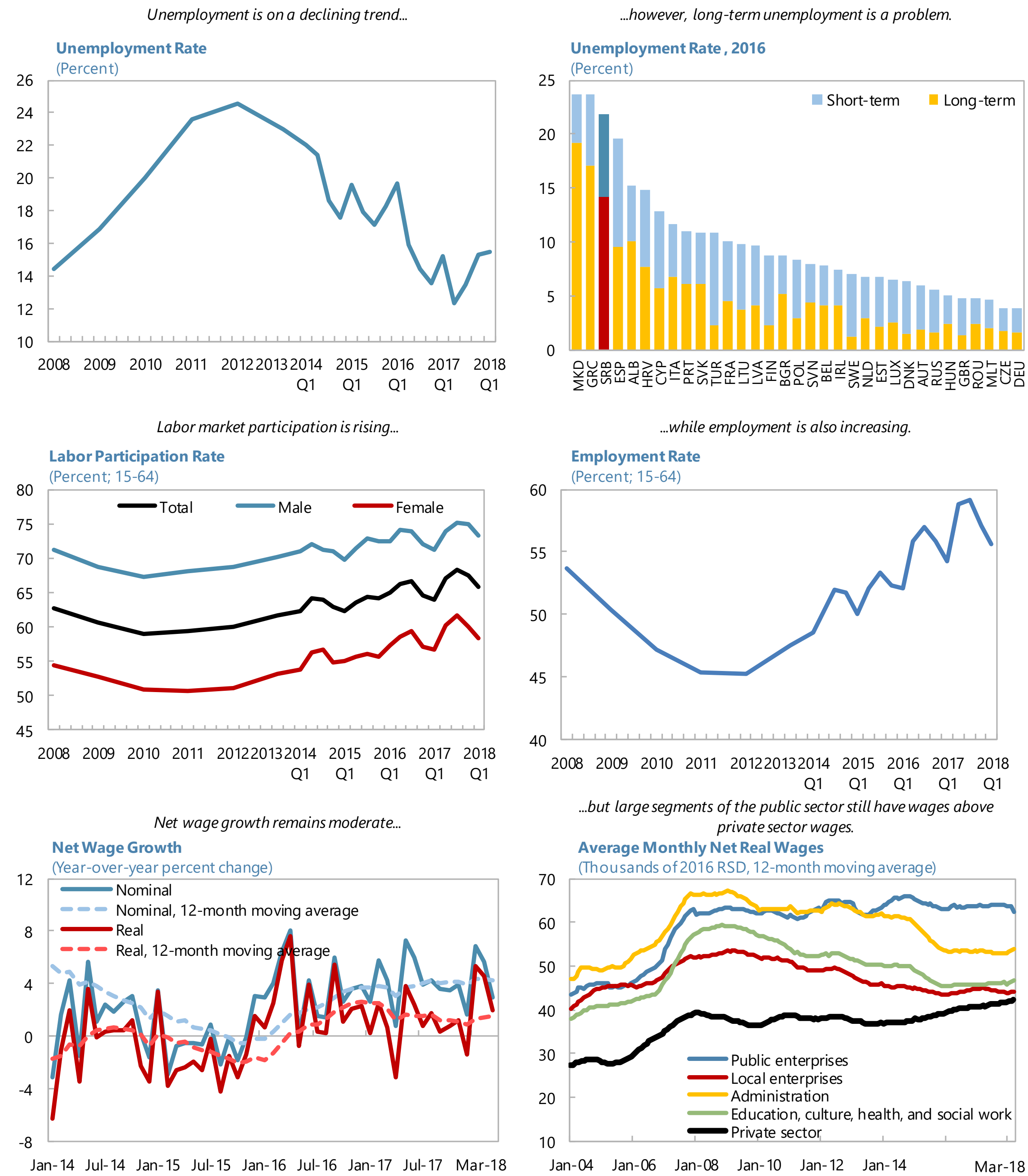
...most recently on account of lower lending rates to the corporate sector.

Bank lending interest rates: FX and FX-linked
(Percent)



Source: NBS.

Figure 8. Serbia: Labor Market Developments, 2008–18



Sources: International Labour Organization; OECD database; Republic of Serbia National Employment Service; Statistical Office of the Republic Serbia; and IMF staff calculations.

Table 1. Serbia: Selected Economic and Social Indicators, 2014–19

	2014	2015	2016	2017	2018	2019
				Est.	Proj.	Proj.
	(Percent change, unless otherwise indicated)					
Real sector						
Real GDP	-1.8	0.8	2.8	1.9	3.5	3.5
Real domestic demand (absorption)	-1.1	1.4	2.3	3.3	3.9	3.7
Consumer prices (average)	2.1	1.4	1.1	3.1	1.6	2.6
GDP deflator	2.7	2.7	2.5	2.8	2.6	3.1
Unemployment rate (in percent) 1/	19.9	18.2	15.9	14.1	…	…
Nominal GDP (in billions of dinars)	3,908	4,043	4,262	4,465	4,740	5,058
	(Percent of GDP)					
General government finances						
Revenue 2/	41.5	41.9	43.2	44.2	43.3	42.2
Expenditure 2/	48.1	45.6	44.5	43.0	42.7	42.7
Current 2/	44.5	41.9	40.2	39.1	38.8	38.6
Capital and net lending	2.8	2.9	3.3	3.3	3.5	3.8
Amortization of called guarantees	0.8	0.7	0.9	0.6	0.4	0.4
Fiscal balance 3/	-6.6	-3.7	-1.3	1.2	0.6	-0.5
Primary fiscal balance (cash basis)	-3.7	-0.5	1.8	3.9	2.8	1.8
Structural primary fiscal balance 4/	-2.6	0.0	1.9	4.0	3.0	1.9
Gross debt	71.9	76.0	73.1	62.5	58.4	55.8
	(End of period 12-month change, percent)					
Monetary sector						
Money (M1)	9.7	17.0	20.3	9.7	8.4	7.7
Broad money (M2)	8.3	7.2	9.8	3.3	5.3	5.4
Domestic credit to non-government 5/	-1.1	2.8	1.8	4.4	4.3	4.5
	(Period average, percent)					
Interest rates (dinar)						
NBS key policy rate	9.0	6.1	4.1	3.9	…	…
Interest rate on new FX and FX-indexed loans	6.0	5.0	3.5	3.2	…	…
	(Percent of GDP, unless otherwise indicated)					
Balance of payments						
Current account balance 6/	-6.0	-4.7	-3.1	-5.7	-5.7	-5.5
Exports of goods	31.9	33.9	37.0	38.3	39.6	41.1
Imports of goods	-44.3	-45.8	-46.0	-49.2	-50.7	-51.7
Trade of goods balance	-12.3	-11.9	-9.0	-10.8	-11.1	-10.6
Capital and financial account balance	1.4	4.5	0.7	5.2	5.8	5.6
External debt (percent of GDP)	83.1	84.0	80.6	72.0	65.2	61.0
of which: Private external debt	34.6	32.7	31.5	32.2	29.3	27.1
Gross official reserves (in billions of euro)	9.9	10.4	10.2	10.4	10.5	10.5
(in months of prospective imports)	6.3	6.4	5.5	5.0	4.6	4.2
(percent of short-term debt)	427.0	333.7	320.8	228.0	286.0	206.0
(percent of broad money, M2)	65.8	64.6	58.7	55.7	52.9	49.8
(percent of risk-weighted metric)	171.4	170.9	165.4	164.8	165.7	156.6
Exchange rate (dinar/euro, period average)	117.2	120.8	123.1	121.4	…	…
REER (annual average change, in percent; + indicates appreciation)	-2.0	-1.6	-1.1	2.9	…	…
Social indicators						
Per capita GDP (in US$)	6,199	5,237	5,426	5,893	7,095	7,686
Population (in million)	7.1	7.1	7.1	7.0	7.0	7.0

Sources: Serbian authorities; and IMF staff estimates and projections.

1/ Unemployment rate for working age population (15-64).
2/ Includes employer contributions.
3/ Includes amortization of called guarantees.
4/ Primary fiscal balance adjusted for the automatic effects of the output gap both on revenue and spending as well as one-offs.
5/ At constant exchange rates.
6/ SORS released revised 2016 BOP statistics in October 2017.

Table 2. Serbia: Medium-Term Framework, 2015–23

	2015	2016	2017	2018	2019	2020	2021	2022	2023
			Est.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
	(percent change)								
Real sector									
GDP growth	0.8	2.8	1.9	3.5	3.5	4.0	4.0	4.0	4.0
Domestic demand (contribution)	1.6	2.6	3.8	4.5	4.3	4.9	4.7	4.7	4.6
Net exports (contribution)	-0.8	0.2	-1.9	-1.0	-0.8	-0.9	-0.7	-0.7	-0.6
Consumer price inflation (average)	1.4	1.1	3.1	1.6	2.6	3.0	3.0	3.0	3.0
Consumer price inflation (end of period)	1.6	1.5	3.0	1.9	2.7	3.0	3.0	3.0	3.0
Output gap (in percent of potential)	-1.0	-0.3	-0.9	-0.4	-0.3	0.0	0.0	0.0	0.0
Potential GDP growth	0.9	2.1	2.5	3.0	3.4	3.7	3.9	4.0	4.0
Domestic credit to non-gov. (constant exchange rate) 1/	2.8	1.8	4.4	4.3	4.5	6.4	6.4	4.8	5.2
	(percent of GDP, unless otherwise indicated)								
General government									
Revenue 2/	41.9	43.2	44.2	43.3	42.2	42.0	41.8	41.7	41.5
Expenditure 2/	45.6	44.5	43.0	42.7	42.7	42.5	42.3	42.2	42.0
Current 2/	41.9	40.2	39.1	38.8	38.6	38.4	38.3	38.2	38.1
of which: Wages and salaries 2/	10.4	9.8	9.5	9.8	9.7	9.6	9.6	9.6	9.6
of which: Pensions	12.1	11.8	11.3	11.1	11.1	11.0	11.0	11.0	11.0
of which: Goods and services	7.5	8.0	8.2	8.6	8.5	8.5	8.4	8.4	8.3
Capital and net lending	2.9	3.3	3.3	3.5	3.8	3.8	3.8	3.8	3.8
Amortization of called guarantees	0.7	0.9	0.6	0.4	0.4	0.3	0.3	0.2	0.1
Fiscal balance 3/	-3.7	-1.3	1.2	0.6	-0.5	-0.5	-0.5	-0.5	-0.5
change (+ = consolidation)	*2.9*	*2.4*	*2.4*	*-0.6*	*-1.1*	*0.0*	*0.0*	*0.0*	*0.0*
Primary fiscal balance	-0.5	1.8	3.9	2.8	1.8	1.9	1.8	1.8	1.7
change (+ = consolidation)	*3.2*	*2.3*	*2.0*	*-1.1*	*-1.0*	*0.1*	*-0.1*	*0.0*	*0.0*
Structural primary balance	0.0	1.9	4.0	3.0	1.9	1.9	1.8	1.8	1.7
change (+ = consolidation)	*2.6*	*1.9*	*2.1*	*-1.0*	*-1.1*	*0.0*	*-0.1*	*0.0*	*0.0*
Structural primary balance net of capital expenditures	2.8	5.1	7.0	6.3	5.5	5.6	5.4	5.4	5.4
Gross debt	76.0	73.1	62.5	58.4	55.8	53.0	50.1	47.5	44.8
Effective interest rate on government borrowing (percent)	4.4	4.3	4.1	3.8	4.2	4.6	4.6	4.9	5.0
Domestic borrowing (including FX)	5.8	5.2	4.8	4.6	5.1	5.2	5.2	5.2	5.2
External borrowing	3.5	3.3	3.2	3.3	3.6	3.7	3.7	3.7	3.7
	(percent of GDP, unless otherwise indicated)								
Balance of payments									
Current account	-4.7	-3.1	-5.7	-5.7	-5.5	-5.3	-5.1	-4.9	-4.5
of which: Trade balance	-11.9	-9.0	-10.8	-11.1	-10.6	-10.4	-10.2	-10.0	-9.7
of which: Current transfers, net (excl. grants)	9.5	8.9	9.2	9.1	8.5	8.3	8.1	8.0	8.0
Capital and financial account	4.5	0.7	5.2	5.8	5.6	5.5	5.3	5.3	5.1
of which: Foreign direct investment	5.4	5.5	6.6	6.6	5.8	5.8	5.8	5.8	5.8
External debt (end of period)	84.0	80.6	72.0	65.2	61.0	56.7	52.5	48.6	44.5
of which: Private external debt	32.7	31.5	32.2	29.3	27.1	24.9	22.9	21.0	19.4
Gross official reserves									
(in billions of euros)	10.4	10.2	10.4	10.5	10.5	10.6	10.7	10.9	11.2
(in percent of short-term external debt)	333.7	320.8	228.0	286.0	206.0	207.2	209.3	213.6	220.0
REER (ann. av. change; + = appreciation)	-1.6	-1.1	2.9	…	…	…	…	…	…

Sources: NBS, MoF, SORS and IMF staff estimates and projections.
1/ Using constant dinar/euro and dinar/swiss franc exchange rates for converting FX and FX-indexed loans to dinars.
2/ Includes employer contributions.
3/ Includes amortization of called guarantees.

Table 3. Serbia: Growth Composition, 2015–23 1/

	2015	2016	2017	2018	2019	2020	2021	2022	2023
			Est.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
			(Percent change, unless otherwise noted)						
Real									
Gross Domestic Product (GDP)	0.8	2.8	1.9	3.5	3.5	4.0	4.0	4.0	4.0
Domestic demand	1.4	2.3	3.3	3.9	3.7	4.3	4.0	4.1	4.0
Consumption	0.1	1.2	1.7	3.0	2.9	4.0	3.8	3.8	3.7
Non-government	0.5	1.0	1.8	2.7	3.2	4.2	4.0	4.0	4.2
Government	-1.5	2.3	1.0	4.1	1.7	3.0	3.0	3.0	1.5
Investment	7.7	6.8	10.3	7.5	6.6	5.4	4.8	4.9	4.9
Gross fixed capital formation	5.6	5.1	6.2	8.8	7.6	6.2	5.3	5.3	5.3
Non-government	4.3	2.2	8.7	7.7	6.5	6.6	5.5	5.5	5.5
Government	14.0	22.0	-6.4	15.3	13.3	4.2	4.3	4.4	4.5
Exports of goods and services	10.2	12.0	9.8	10.3	9.1	8.7	8.8	8.9	9.0
Imports of goods and services	9.3	9.0	10.7	9.5	8.3	8.2	7.9	8.1	8.1
			(contributions to GDP, percent)						
Gross Domestic Product (GDP)	0.8	2.8	1.9	3.5	3.5	4.0	4.0	4.0	4.0
Domestic demand (absorption)	1.6	2.6	3.8	4.5	4.3	4.9	4.7	4.7	4.6
Net exports of goods and services	-0.8	0.2	-1.9	-1.0	-0.8	-0.9	-0.7	-0.7	-0.6
Consumption	0.1	1.1	1.5	2.7	2.6	3.6	3.4	3.4	3.3
Non-government	0.3	0.7	1.3	2.0	2.3	3.0	2.9	2.9	3.1
Government	-0.3	0.4	0.2	0.7	0.3	0.5	0.5	0.5	0.3
Investment	1.5	1.5	2.3	1.8	1.6	1.4	1.2	1.3	1.3
Gross fixed capital formation	1.0	1.0	1.2	1.8	1.6	1.4	1.2	1.2	1.3
Non-government	0.7	0.4	1.4	1.4	1.2	1.2	1.1	1.1	1.1
Government	0.3	0.6	-0.2	0.5	0.4	0.2	0.2	0.2	0.2
Change in inventories	0.5	0.5	1.0	0.0	0.0	0.0	0.0	0.0	0.0
Exports of goods and services	4.5	5.8	5.2	5.8	5.5	5.5	5.9	6.2	6.6
Imports of goods and services	5.4	5.6	7.1	6.8	6.3	6.5	6.5	6.9	7.2
			(Percent change, unless otherwise noted)						
Nominal									
Gross Domestic Product (GDP)	3.5	5.4	4.8	6.2	6.7	7.2	7.2	7.2	7.3
Domestic demand (absorption), contribution to GDP growth	2.7	3.5	6.5	6.2	6.7	7.6	7.4	7.4	7.5
Net exports of goods and services, contribution to GDP growth	0.8	1.9	-1.8	0.0	0.0	-0.4	-0.2	-0.2	-0.1
Non-government	2.2	2.2	4.0	4.7	5.6	7.2	7.1	7.2	7.3
Government	-5.3	3.9	4.3	10.5	5.8	6.2	6.2	6.2	6.2
Investment	11.5	6.7	15.3	5.7	8.3	7.2	6.5	6.5	6.5
Gross fixed capital formation	9.7	5.6	9.0	11.2	10.5	9.2	8.2	8.1	8.1
Non-government	8.2	2.6	12.0	9.9	9.3	9.7	8.4	8.3	8.3
Government	18.6	21.7	-4.0	17.7	16.3	7.2	7.2	7.2	7.3
Exports of goods and services	11.3	13.0	9.8	9.1	10.9	10.6	10.5	10.6	10.6
Imports of goods and services	7.7	7.4	11.7	7.9	9.4	10.0	9.6	9.7	9.7
Memorandum items:									
GDP deflator (percent)	2.7	2.5	2.8	2.6	3.1	3.1	3.0	3.1	3.2
Nominal GDP (billions of dinars)	4043	4262	4465	4740	5058	5421	5809	6226	6683

Sources: Serbian Statistical Office; and IMF staff estimates and projections.
1/ SORS released revised 2016 national accounts in October 2017.

Table 4a. Serbia: Balance of Payments, 2015–23 1/

(Billions of Euros)

	2015	2016	2017	2018	2019	2020	2021	2022	2023
			Est.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
	(Billions of euros)								
Current account balance	-1.6	-1.1	-2.1	-2.3	-2.4	-2.4	-2.5	-2.6	-2.5
Trade of goods balance	-4.0	-3.1	-4.0	-4.4	-4.5	-4.8	-5.0	-5.2	-5.4
Exports of goods	11.4	12.8	14.1	15.9	17.6	19.4	21.4	23.7	26.2
Imports of goods	-15.4	-15.9	-18.1	-20.3	-22.1	-24.2	-26.5	-28.9	-31.7
Services balance	0.7	0.9	1.0	1.1	1.2	1.3	1.4	1.5	1.7
Exports of nonfactor services	4.3	4.6	5.2	5.7	6.4	7.0	7.8	8.6	9.5
Imports of nonfactor services	-3.5	-3.7	-4.3	-4.6	-5.2	-5.8	-6.4	-7.1	-7.8
Income balance	-1.7	-2.0	-2.6	-2.6	-2.7	-2.7	-2.9	-3.1	-3.3
Net interest	-1.0	-1.0	-0.9	-0.7	-0.8	-0.8	-0.8	-0.9	-0.9
Current transfer balance	3.3	3.2	3.5	3.7	3.6	3.8	4.0	4.2	4.5
Others, including private remittances	3.2	3.1	3.4	3.6	3.6	3.8	4.0	4.2	4.5
Capital and financial account balance 2/	1.5	0.2	1.9	2.3	2.4	2.5	2.6	2.8	2.9
Foreign direct investment balance	1.8	1.9	2.4	2.6	2.5	2.6	2.8	3.0	3.2
Portfolio investment balance	-0.3	-0.9	-0.8	-0.4	0.3	0.4	0.3	0.2	-0.1
of which: debt liabilities	-0.2	-0.9	-0.8	-0.4	0.3	0.4	0.3	0.2	-0.1
Other investment balance	0.0	-0.7	0.3	0.1	-0.4	-0.5	-0.5	-0.5	-0.3
Public sector 2/ 3/	0.5	0.3	0.0	0.2	-0.3	-0.3	-0.3	-0.3	-0.2
Domestic banks	-0.1	-0.5	0.9	0.1	0.1	0.1	0.1	0.1	0.1
Other private sector 4/	-0.4	-0.5	-0.5	-0.1	-0.2	-0.3	-0.3	-0.3	-0.2
Errors and omissions	0.4	0.5	0.4	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	0.3	-0.3	0.2	0.0	0.0	0.1	0.1	0.2	0.3
Financing	-0.3	0.3	-0.2	0.0	0.0	-0.1	-0.1	-0.2	-0.3
Gross international reserves (increase, -)	-0.2	0.3	-0.2	0.0	0.0	-0.1	-0.1	-0.2	-0.3
Financing Gap	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Use of Fund credit, net	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Purchases	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Repurchases	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Sources: NBS; and IMF staff estimates and projections.

1/ SORS released revised 2016 BOP in October 2017.

2/ Excluding net use of IMF resources.

3/ Includes SDR allocations in 2009.

4/ Includes trade credits (net).

Table 4b. Serbia: Balance of Payments, 2015–23 1/
(Percent of GDP)

	2015	2016	2017	2018	2019	2020	2021	2022	2023
			Est.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
					(Percent of GDP)				
Current account balance	-4.7	-3.1	-5.7	-5.7	-5.5	-5.3	-5.1	-4.9	-4.5
Trade of goods balance	-11.9	-9.0	-10.8	-11.1	-10.6	-10.4	-10.2	-10.0	-9.7
Exports of goods	33.9	37.0	38.3	39.6	41.1	42.5	43.8	45.2	46.5
Imports of goods	-45.8	-46.0	-49.2	-50.7	-51.7	-52.9	-54.0	-55.2	-56.2
Services balance	2.2	2.6	2.6	2.8	2.8	2.8	2.9	2.9	3.0
Income balance	-5.0	-5.8	-7.0	-6.5	-6.2	-6.0	-5.9	-5.8	-5.8
Current transfer balance	10.0	9.1	9.6	9.1	8.5	8.3	8.1	8.0	8.0
Official grants	0.5	0.2	0.4	0.1	0.0	0.0	0.0	0.0	0.0
Others, including private remittances	9.5	8.9	9.2	9.1	8.5	8.3	8.1	8.0	8.0
Capital and financial account balance 2/	4.5	0.7	5.2	5.8	5.6	5.5	5.3	5.3	5.1
Capital transfers balance	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign direct investment balance	5.4	5.5	6.6	6.6	5.8	5.8	5.8	5.8	5.8
Portfolio investment balance	-0.9	-2.6	-2.2	-1.1	0.8	0.9	0.6	0.5	-0.1
Other investment balance	0.0	-2.1	0.9	0.2	-0.9	-1.2	-1.0	-0.9	-0.6
Public sector 2/ 3/	1.4	0.9	-0.1	0.4	-0.6	-0.7	-0.6	-0.6	-0.4
Domestic banks	-0.2	-1.4	2.4	0.1	0.2	0.2	0.2	0.2	0.2
Other private sector 4/	-1.2	-1.5	-1.4	-0.3	-0.6	-0.7	-0.6	-0.5	-0.4
Errors and omissions	1.2	1.6	1.1	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	0.9	-0.8	0.6	0.1	0.1	0.1	0.2	0.4	0.6
Memorandum items:									
Export growth	6.7	12.8	10.0	12.5	10.9	10.4	10.4	10.6	10.6
Import growth	4.1	3.8	13.4	12.3	8.8	9.4	9.4	9.4	9.4
Export volume growth	8.7	13.6	8.6	11.0	9.1	8.7	8.8	8.9	9.0
Import volume growth	9.0	9.1	10.0	10.3	7.7	7.8	7.8	7.8	7.8
Trading partner import growth	2.7	5.4	8.5	6.7	4.6	4.6	4.6	4.6	4.6
Export prices growth	-1.8	-0.7	1.2	1.4	1.6	1.6	1.5	1.5	1.5
Import prices growth	-4.5	-4.9	3.1	1.9	1.1	1.5	1.5	1.5	1.5
Change in terms of trade	2.8	4.4	-1.8	-0.5	0.6	0.1	0.0	0.0	0.0
Gross official reserves (in billions of euro)	10.4	10.2	10.4	10.5	10.5	10.6	10.7	10.9	11.2
(In months of prospective imports of GNFS)	6.4	5.5	5.0	4.6	4.2	3.9	3.6	3.3	3.0
(in percent of short-term debt)	333.7	320.8	228.0	286.0	206.0	207.2	209.3	213.6	220.0
(in percent of broad money, M2)	64.6	58.7	55.7	52.9	49.8	46.8	44.2	42.0	40.3
(in percent of risk-weighted metric) 5/	170.9	165.4	164.8	165.7	156.6	152.7	155.4	154.3	154.3
GDP (billions of euros)	33.5	34.6	36.8	40.1	42.7	45.7	49.0	52.5	56.4

Sources: NBS; and IMF staff estimates and projections.
1/ SORS released revised 2016 BOP in October 2017.
2/ Excluding net use of IMF resources.
3/ Includes SDR allocations in 2009.
4/ Includes trade credits (net).
5/ Gross reserves at end-2017 correspond to 165 percent of the ARA metric (assuming Serbia returns to a floating exchange rate classification) and 138 percent of the ARA metric (assuming the current fixed exchange rate classification).

Table 5. Serbia: External Financing Requirements, 2015–23

	2015	2016	2017	2018	2019	2020	2021	2022	2023
			Est.			Proj.			
					(Billions of euros)				
1. Total financing requirement	**4.1**	**3.9**	**5.5**	**6.9**	**6.1**	**7.6**	**7.9**	**6.5**	**6.5**
Current account deficit	1.6	1.1	2.1	2.3	2.4	2.4	2.5	2.6	2.5
Debt amortization	2.3	3.1	3.2	4.6	3.7	5.1	5.3	3.7	3.6
Medium and long-term debt	2.2	2.8	2.5	3.7	2.8	4.2	4.4	2.8	2.8
Public sector	0.9	1.0	1.8	2.4	1.5	2.6	3.1	1.4	1.5
Of which: IMF	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Of which: Eurobonds	0.0	0.2	0.7	0.8	0.0	1.2	1.7	0.0	0.0
Of which: Domestic bonds (non-residents)	0.0	0.0	0.0	0.8	0.7	0.7	0.6	0.6	0.7
Commercial banks	0.8	1.0	0.2	0.4	0.5	0.6	0.6	0.7	0.8
Corporate sector	0.6	0.8	0.5	0.9	0.8	0.9	0.7	0.7	0.5
Short-term debt	0.1	0.3	0.7	0.9	0.9	0.9	0.9	0.9	0.9
Public sector	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Commercial banks	0.1	0.2	0.6	0.8	0.8	0.8	0.8	0.8	0.8
Corporate sector	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Change in gross reserves (increase=+)	0.2	-0.3	0.2	0.0	0.0	0.1	0.1	0.2	0.3
2. Total financing sources	**4.1**	**3.9**	**5.5**	**6.9**	**6.1**	**7.6**	**7.9**	**6.5**	**6.5**
Capital transfers	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign direct investment (net)	1.8	1.9	2.4	2.6	2.5	2.6	2.8	3.0	3.2
Portfolio investment (net) 1/	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Debt financing	2.2	2.7	2.9	4.2	3.6	5.0	5.1	3.5	3.3
Medium and long-term debt	1.9	2.0	2.0	3.4	2.7	4.1	4.2	2.6	2.4
Public sector 2/	1.2	1.1	1.1	2.2	1.6	2.7	3.0	1.4	1.2
Of which: Eurobonds	0.0	0.0	0.0	0.0	0.0	1.0	1.8	0.0	0.0
Of which: Domestic bonds (non-residents)	0.0	0.0	0.0	1.2	1.1	1.3	0.9	0.9	0.7
Commercial banks	0.2	0.3	0.4	0.4	0.6	0.7	0.7	0.8	0.9
Corporate sector	0.5	0.6	0.5	0.7	0.5	0.6	0.4	0.4	0.3
Short-term debt	0.3	0.7	0.9	0.9	0.9	0.9	0.9	0.9	0.9
Public sector	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Commercial banks	0.2	0.6	0.8	0.8	0.8	0.8	0.8	0.8	0.8
Corporate sector	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Other net capital inflows 3/	0.2	-0.7	0.2	0.0	0.0	0.0	0.0	0.0	0.0
o/w trade credit and currency and deposits	-0.1	0.3	0.6	0.0	0.0	0.0	0.0	0.0	0.0
3. Total financing needs	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Memorandum items:									
Debt service	3.2	4.1	4.0	5.3	4.4	5.9	6.2	4.6	4.6
Interest	0.9	0.9	0.9	0.7	0.8	0.8	0.8	0.9	0.9
Amortization	2.3	3.1	3.2	4.6	3.7	5.1	5.3	3.7	3.6

Sources: NBS; and Fund staff estimates and projections.

1/ Only includes equity securities and financial derivatives.
2/ Excluding IMF.
3/ Includes all other net financial flows and errors and omissions.

Table 6a. Serbia: General Government Fiscal Operations, 2015–23 1/
(Billions of RSD)

	2015	2016	2017	2018	2019	2020	2021	2022	2023
			Est.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Revenue	1,695	1,843	1,973	2,051	2,134	2,279	2,429	2,595	2,772
Taxes	1,464	1,586	1,718	1,800	1,877	2,013	2,157	2,315	2,482
Personal income tax	147	155	168	177	167	176	186	197	209
Social security contributions 2/	506	527	567	609	628	675	728	785	840
Taxes on profits	63	80	112	104	111	118	127	136	148
Value-added taxes	416	454	479	504	538	580	624	667	718
Excises	236	266	280	288	306	328	351	377	404
Taxes on international trade	33	36	40	43	47	50	50	54	59
Other taxes	63	67	72	75	80	86	92	98	104
Non-tax revenue	221	239	241	235	241	248	253	260	268
Capital revenue	3	8	6	0	0	0	0	0	0
Grants	7	9	9	16	17	18	19	20	22
Expenditure	1,843	1,897	1,922	2,024	2,160	2,306	2,457	2,628	2,808
Current expenditure	1,696	1,715	1,745	1,838	1,950	2,084	2,222	2,379	2,545
Wages and salaries 3/	419	418	426	467	493	523	560	600	644
Goods and services	303	339	365	406	431	459	488	520	554
Interest	130	132	121	106	117	130	133	144	152
Subsidies	134	113	113	113	121	129	139	149	160
Transfers	710	714	720	746	789	842	902	966	1,036
Pensions 4/	490	503	506	527	560	597	641	687	738
Other transfers 5/	219	211	214	219	229	245	262	279	298
Capital expenditure	115	139	134	158	183	196	210	226	242
Net lending	3	3	14	8	8	9	9	10	11
Amortization of activated guarantees	30	39	29	21	19	17	15	14	10
Fiscal balance	-149	-54	51	27	-26	-27	-28	-33	-36
Financing	149	54	-51	-27	26	27	28	33	36
Privatization proceeds	1	5	2	20	0	0	0	0	0
Equity investment	0	0	0	0	0	0	0	0	0
Domestic	120	20	-37	49	46	99	54	54	62
Banks	165	148	-65	52	25	18	11	37	38
Government deposits ((-) means accumulation)	32	35	5	-12	-5	-10	-8	-10	-11
Securities held by banks (net)	93	99	-3	76	54	53	43	69	70
Other domestic bank financing	39	14	-68	-12	-24	-25	-24	-22	-22
Non-banks (incl. non-residents)	-45	-128	28	-3	21	80	43	17	23
Securities held by non-banks (non-residents, net)	35	-37	43	8	23	80	43	17	23
Others (incl. amortization)	-80	-91	-15	-11	-2	0	0	0	0
External	28	29	-16	-97	-21	-72	-26	-21	-26
Program	17	0	61	0	0	0	0	0	0
Project	55	73	60	57	45	48	51	55	59
Bonds and loans	12	23	0	59	20	119	208	0	0
Amortization	-56	-67	-137	-213	-85	-239	-285	-76	-85
Memorandum items:									
Wages and salaries excluding severance payments	419	418	426	467	493	523	560	600	644
Gross 1 wages and salaries	356	354	361	394	421	446	478	512	549
Arrears accumulation (domestic)	-3	-1	-1	-1	-1	0	0	0	0
Quasi-fiscal support to SOEs (gross new issuance of guarantees)	105	86	54	8	30	15	10	7	0
Government deposits (stock)	142	107	102	113	118	128	137	147	157
Gross public debt	3074	3114	2792	2770	2821	2873	2912	2955	2996
Gross public debt (including restitution)	3317	3357	3035	3013	3044	3077	3096	3119	3141
Nominal GDP (billions of dinars)	4043	4262	4465	4740	5058	5421	5809	6226	6683

Sources: Ministry of Finance; and IMF staff estimates and projections.

1/ Includes the republican budget, local governments, social security funds, and the Road Company, but excludes indirect budget beneficiaries (IBBs) that are reporting only on an annual basis.

2/ Includes employer contributions.

3/ Including severence payments. Includes employer contributions.

4/ Includes RSD10 billion military pension payment in 2015 following a Constitution Court ruling.

5/ Excluding foreign currency deposit payments to households, reclassified below the line.

Table 6b. Serbia: General Government Fiscal Operations, 2015–23 1/

(Percent of GDP)

	2015	2016	2017	2018	2019	2020	2021	2022	2023
			Est.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Revenue	41.9	43.2	44.2	43.3	42.2	42.0	41.8	41.7	41.5
Taxes	36.2	37.2	38.5	38.0	37.1	37.1	37.1	37.2	37.1
Personal income tax	3.6	3.6	3.8	3.7	3.3	3.3	3.2	3.2	3.1
Social security contributions 2/	12.5	12.4	12.7	12.8	12.4	12.4	12.5	12.6	12.6
Taxes on profits	1.5	1.9	2.5	2.2	2.2	2.2	2.2	2.2	2.2
Value-added taxes	10.3	10.6	10.7	10.6	10.6	10.7	10.7	10.7	10.7
Excises	5.8	6.2	6.3	6.1	6.0	6.1	6.0	6.1	6.1
Taxes on international trade	0.8	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9
Other taxes	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6
Non-tax revenue	5.5	5.6	5.4	5.0	4.8	4.6	4.3	4.2	4.0
Capital revenue	0.1	0.2	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Grants	0.2	0.2	0.2	0.3	0.3	0.3	0.3	0.3	0.3
Expenditure	45.6	44.5	43.0	42.7	42.7	42.5	42.3	42.2	42.0
Current expenditure	41.9	40.2	39.1	38.8	38.6	38.4	38.3	38.2	38.1
Wages and salaries 3/	10.4	9.8	9.5	9.8	9.7	9.6	9.6	9.6	9.6
Goods and services	7.5	8.0	8.2	8.6	8.5	8.5	8.4	8.4	8.3
Interest	3.2	3.1	2.7	2.2	2.3	2.4	2.3	2.3	2.3
Subsidies	3.3	2.6	2.5	2.4	2.4	2.4	2.4	2.4	2.4
Transfers	17.6	16.7	16.1	15.7	15.6	15.5	15.5	15.5	15.5
Pensions 4/	12.1	11.8	11.3	11.1	11.1	11.0	11.0	11.0	11.0
Other transfers 5/	5.4	5.0	4.8	4.6	4.5	4.5	4.5	4.5	4.5
Capital expenditure	2.8	3.3	3.0	3.3	3.6	3.6	3.6	3.6	3.6
Net lending	0.1	0.1	0.3	0.2	0.2	0.2	0.2	0.2	0.2
Amortization of activated guarantees	0.7	0.9	0.6	0.4	0.4	0.3	0.3	0.2	0.1
Fiscal balance	-3.7	-1.3	1.2	0.6	-0.5	-0.5	-0.5	-0.5	-0.5
Financing	3.7	1.3	-1.2	-0.6	0.5	0.5	0.5	0.5	0.5
Privatization proceeds	0.0	0.1	0.0	0.4	0.0	0.0	0.0	0.0	0.0
Equity investment	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Domestic	3.0	0.5	-0.8	1.0	0.9	1.8	0.9	0.9	0.9
Banks	4.1	3.5	-1.5	1.1	0.5	0.3	0.2	0.6	0.6
Government deposits ((-) means accumulation)	0.8	0.8	0.1	-0.2	-0.1	-0.2	-0.1	-0.2	-0.2
Securities held by banks (net)	2.3	2.3	-0.1	1.6	1.1	1.0	0.7	1.1	1.1
Other domestic bank financing	1.0	0.3	-1.5	-0.2	-0.5	-0.5	-0.4	-0.4	-0.3
Non-banks (incl. non-residents)	-1.1	-3.0	0.6	-0.1	0.4	1.5	0.7	0.3	0.4
Securities held by non-banks (non-residents, net)	0.9	-0.9	1.0	0.2	0.5	1.5	0.7	0.3	0.4
Others (incl. amortization)	-2.0	-2.1	-0.3	-0.2	0.0	0.0	0.0	0.0	0.0
External	0.7	0.7	-0.4	-2.0	-0.4	-1.3	-0.4	-0.3	-0.4
Program	0.4	0.0	1.4	0.0	0.0	0.0	0.0	0.0	0.0
Project	1.4	1.7	1.4	1.2	0.9	0.9	0.9	0.9	0.9
Bonds and loans	0.3	0.5	0.0	1.2	0.4	2.2	3.6	0.0	0.0
Amortization	-1.4	-1.6	-3.1	-4.5	-1.7	-4.4	-4.9	-1.2	-1.3
Memorandum items:									
Wages and salaries excluding severance payments	10.4	9.8	9.5	9.8	9.7	9.6	9.6	9.6	9.6
Gross 1 wages and salaries	8.8	8.3	8.1	8.3	8.3	8.2	8.2	8.2	8.2
Arrears accumulation (domestic)	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Government deposits (stock)	3.5	2.5	2.3	2.4	2.3	2.4	2.4	2.4	2.4
Gross financing need	16.5	13.1	9.6	8.7	8.0	9.4	9.9	6.6	6.4
Gross public debt	76.0	73.1	62.5	58.4	55.8	53.0	50.1	47.5	44.8
Gross public debt (including restitution)	82.0	78.8	68.0	63.6	60.2	56.8	53.3	50.1	47.0
Nominal GDP (billions of dinars)	4,043	4,262	4,465	4,740	5,058	5,421	5,809	6,226	6,683

Sources: Ministry of Finance; and IMF staff estimates and projections.

1/ Includes the republican budget, local governments, social security funds, and the Road Company, but excludes indirect budget beneficiaries (IBBs) that are reporting only on an annual basis.

2/ Includes employer contributions.

3/ Including severence payments. Includes employer contributions.

4/ Includes RSD10 billion military pension payment in 2015 following a Constitution Court ruling.

5/ Excluding foreign currency deposit payments to households, reclassified below the line.

Table 7a. Serbia: Monetary Survey, 2015–23

	2015	2016	2017	2018	2019	2020	2021	2022	2023
			Est.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
	(Billions of dinars, unless otherwise indicated; end of period) 1/								
Net foreign assets 2/	1087	1156	986	975	970	967	968	982	1008
in billions of euro	8.9	9.4	8.3	8.3	8.2	8.1	8.2	8.3	8.5
Foreign assets	1480	1512	1391	1383	1390	1399	1413	1438	1476
NBS	1272	1271	1191	1184	1191	1200	1214	1239	1277
Commercial banks	208	241	200	198	199	199	199	199	199
Foreign liabilities (-)	-393	-356	-405	-407	-420	-433	-445	-456	-468
NBS	-8	-6	-4	-4	-4	-4	-4	-4	-4
Commercial banks	-385	-350	-401	-403	-416	-429	-441	-452	-464
Net domestic assets	874	989	1,231	1,359	1,491	1,660	1,827	1,987	2,164
Domestic credit	2,164	2,321	2,362	2,491	2,615	2,778	2,940	3,096	3,271
Government, net	223	341	353	404	430	448	460	496	534
NBS	-228	-210	-215	-226	-231	-241	-249	-260	-270
Claims on government	1	4	4	4	4	4	4	4	4
Liabilities (deposits)	229	214	219	230	235	245	253	264	274
Banks	451	551	568	630	661	689	709	756	804
Claims on government	538	638	630	692	723	752	771	818	867
Liabilities (deposits)	87	87	63	62	62	62	62	62	62
Local governments, net	-7	-20	-31	-31	-31	-31	-31	-31	-31
Non-government sector	1,948	2,000	2,040	2,117	2,216	2,360	2,511	2,631	2,767
Households	760	840	905	962	1,016	1,083	1,152	1,207	1,269
Enterprises	1,162	1,127	1,103	1,122	1,165	1,240	1,320	1,383	1,454
Other	26	34	32	33	35	37	40	42	44
Other assets, net	-1,291	-1,332	-1,131	-1,131	-1,124	-1,118	-1,114	-1,110	-1,107
Capital accounts (-)	-952	-1,016	-963	-956	-941	-928	-915	-903	-892
NBS	-341	-391	-298	-283	-269	-256	-243	-231	-219
Banks	-610	-625	-664	-672	-672	-672	-672	-672	-672
Provisions (-)	-317	-281	-161	-168	-174	-181	-189	-196	-204
Other assets	-23	-34	-7	-8	-8	-9	-10	-10	-11
Broad money (M2)	1955	2146	2217	2335	2461	2626	2795	2969	3173
M1	470	566	621	673	725	777	832	893	958
Currency in circulation	140	159	164	178	191	205	220	236	253
Demand deposits	330	407	457	495	533	572	612	657	705
Time and saving deposits	192	195	196	213	229	245	263	282	303
Foreign currency deposits	1292	1385	1400	1449	1507	1604	1700	1794	1912
in billions of euro	10.6	11.2	11.8	12.3	12.7	13.5	14.3	15.1	16.1
Memorandum items:	(year-on-year change unless indicated otherwise)								
M1	17.0	20.3	9.7	8.4	7.7	7.2	7.2	7.2	7.3
M2	7.2	9.8	3.3	5.3	5.4	6.7	6.4	6.2	6.9
Velocity (Dinar part of money supply)	6.1	5.6	5.5	5.4	5.3	5.3	5.3	5.3	5.3
Velocity (M2)	2.1	2.0	2.0	2.0	2.1	2.1	2.1	2.1	2.1
Deposits at constant exchange rate	7.2	8.5	5.9	5.6	5.0	6.6	6.3	6.2	6.9
Credit to non-gov. (current exchange rate)	1.2	2.8	2.3	1.7	2.3	3.4	3.6	2.5	3.2
Credit to non-gov. (constant exchange rates) 3/	1.0	1.7	5.2	2.3	2.1	3.3	3.5	2.6	3.3
Domestic	2.8	1.8	4.4	4.3	4.5	6.4	6.4	4.8	5.2
Households	4.7	9.8	9.8	6.7	5.6	6.4	6.4	4.8	5.2
Enterprises and other sectors	1.7	-3.3	0.5	2.4	3.7	6.4	6.4	4.8	5.2
External	-2.4	1.6	6.7	-1.6	-2.9	-3.7	-3.6	-3.6	-2.7
Credit to non-gov. (real terms) 4/	-0.3	1.2	-0.7	-0.2	-0.4	0.4	0.5	-0.5	0.2
Domestic credit to non-gov. (real terms)	1.5	1.1	-1.0	1.8	1.9	3.4	3.3	1.7	2.1
Households	3.1	8.8	4.6	4.3	2.9	3.4	3.3	1.7	2.1
Enterprises and other sectors	0.4	-3.8	-5.1	-0.2	1.1	3.4	3.3	1.7	2.1
External	-3.7	1.4	-0.1	-4.2	-5.3	-6.3	-6.4	-6.4	-5.6
12-m change in NBS's NFA, billions of euros	0.3	0.1	-0.2	0.1	0.0	0.0	0.1	0.2	0.3
Deposit euroization (percent of total) 5/	71.2	69.7	68.2	67.2	66.4	66.3	66.0	65.6	65.5
Credit euroization (percent of total) 5/	70.6	68.3	67.1	66.1	65.1	64.1	63.1	62.1	61.1

Sources: National Bank of Serbia; and IMF staff estimates and projections.
1/ Foreign exchange denominated items are converted at current exchange rates.
2/ Excluding undivided assets and liabilities of the FSRY and liabilities to banks in liquidation.
3/ Using constant program dinar/euro and dinar/swiss franc exchange rates for converting FX and FX-indexed loans to dinars agreed under 2015-17 SBA.
4/ Calculated as nominal credit at current exchange rates deflated by the change in the 12-month CPI index.
5/ Using current exchange rates.

Table 7b. Serbia: NBS Balance Sheet, 2015–23

	2015	2016	2017	2018	2019	2020	2021	2022	2023
			Est.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
	(Billions of dinars, unless otherwise indicated; end of period) 1/								
Net foreign assets	1265	1265	1187	1180	1187	1196	1210	1235	1273
(In billions of euro)	10.4	10.3	10.0	10.0	10.0	10.1	10.2	10.4	10.7
Gross foreign reserves	1272	1271	1191	1184	1191	1200	1214	1239	1277
Gross reserve liabilities (-)	-8	-6	-4	-4	-4	-4	-4	-4	-4
Net domestic assets	-647	-663	-596	-638	-610	-594	-567	-558	-548
Net domestic credit	-305	-272	-298	-355	-341	-338	-324	-327	-329
Net credit to government	-228	-210	-215	-226	-231	-241	-249	-260	-270
Claims on government	1	4	4	4	4	4	4	4	4
Liabilities to government (-)	-229	-214	-219	-230	-235	-245	-253	-264	-274
Liabilities to government (-): local currency	-125	-95	-118	-118	-118	-118	-118	-118	-118
Liabilities to government (-): foreign currency	-103	-119	-101	-112	-117	-127	-136	-146	-156
Net credit to local governmens	-61	-43	-48	-50	-50	-50	-50	-50	-50
Net claims on banks	-30	-33	-45	-88	-70	-57	-34	-27	-18
Capital accounts (-)	-341	-391	-298	-283	-269	-256	-243	-231	-219
Reserve money	618	602	591	542	577	602	642	677	725
Currency in circulation	140	159	164	178	191	205	220	236	253
Commercial bank reserves	248	221	232	163	175	173	186	191	206
Required reserves	145	147	156	161	168	178	189	200	213
Excess reserves	103	73	76	2	8	-5	-3	-8	-7
FX deposits by banks, billions of euros	1.9	1.8	1.6	1.7	1.8	1.9	2.0	2.1	2.2

Sources: National Bank of Serbia; and IMF staff estimates and projections.
1/ Foreign exchange denominated items are converted at current exchange rates.

Table 8. Serbia: Banking Sector Financial Soundness Indicators, 2012–17

	2012	2013	2014	2015	2016	2017			
						Mar	Jun	Sep	Dec
Capital adequacy									
Regulatory capital to risk-weighted assets	19.9	20.9	20.0	20.9	21.8	22.3	22.4	22.5	22.6
Regulatory Tier 1 capital to risk-weighted assets	19.0	19.3	17.6	18.8	20.0	20.6	21.3	21.5	21.6
Nonperforming loans net of provisions to capital	31.0	32.7	31.0	25.9	17.6	17.1	15.2	14.3	12.9
Capital to assets	20.5	20.9	20.7	20.3	19.5	19.9	20.3	20.1	19.8
Large exposures to capital	61.9	52.8	72.1	68.2	86.0	85.1	82.1	72.9	69.3
Regulatory capital to total assets	12.2	12.2	11.4	11.9	12.7	13.2	13.5	14.2	14.4
Asset quality									
Nonperforming loans to total gross loans	18.6	21.4	21.5	21.6	17.0	16.8	15.6	12.2	9.8
Sectoral distribution of loans (percent of total loans)									
Deposit takers	0.3	0.3	0.8	0.1	0.5	0.1	0.4	0.6	0.3
Central bank	2.1	5.8	0.4	1.6	1.7	2.9	3.3	3.6	2.1
General government	3.0	2.3	2.3	1.7	1.5	1.5	1.5	1.4	1.3
Other financial corporations	1.6	1.6	0.5	0.7	0.9	0.7	1.0	0.9	0.9
Nonfinancial corporations	58.2	54.1	56.3	55.9	52.6	51.5	50.1	49.9	50.5
Agriculture	3.0	2.7	3.5	3.7	3.6	3.5	3.4	3.4	3.5
Industry	17.9	18.4	19.2	18.4	16.5	16.1	15.7	15.2	16.2
Construction	5.8	4.6	4.2	3.8	4.1	4.0	4.0	3.7	4.0
Trade	15.0	13.5	13.9	13.9	14.3	14.3	13.8	14.3	14.6
Other loans to nonfinancial corporations	16.5	14.9	15.6	16.2	14.1	13.6	13.3	13.2	12.2
Households and NPISH	33.0	34.8	38.3	39.1	41.5	41.9	42.3	42.2	42.9
Households and NPISH of which: mortgage loans to total loan	16.1	16.8	18.0	18.1	17.9	17.8	17.3	16.9	16.9
Foreign sector	1.9	1.1	1.4	0.9	1.4	1.3	1.5	1.4	2.0
Specific provision for NPLs to gross NPLs	50.0	50.9	54.9	62.3	67.8	68.1	68.9	62.2	58.1
Specific and general provisions for NPLs to gross NPLs	111.1	105.5	107.6	106.4	108.5	108.6	108.9	111.4	112.1
Specific and general provisions for balance sheet losses to NPLs	120.7	113.8	114.5	114.2	118.9	118.6	120.2	127.2	133.2
Specific and general provisions to NPLs	126.5	117.9	118.4	118.2	123.2	122.9	124.4	132.8	140.9
Specific provision of total loans to total gross loans	10.2	11.9	12.7	14.4	12.4	12.3	11.6	8.4	6.6
Earnings and Profitability									
Return on assets	0.4	-0.1	0.1	0.3	0.7	2.3	2.1	2.2	2.1
Return on equity	2.0	-0.4	0.6	1.5	3.3	11.4	10.6	11.0	10.5
Liquidity									
Customer deposits to total (noninterbank) loans	93.2	103.4	108.1	114.4	121.9	119.9	118.0	114.2	114.4
Foreign-currency-denominated loans to total loans	74.1	71.6	70.1	72.3	69.4	67.8	66.7	66.5	67.5
Average monthy liquidity ratio	2.1	2.4	2.2	2.1	2.1	2.2	2.2	2.2	2.0
Average monthy narrow liquidity ratio	1.6	1.8	1.7	1.7	1.7	1.8	1.8	1.8	1.7
Sensitivity to Market Risk									
Foreign-currency-denominated liabilities to total liabilities	80.1	76.7	74.7	72.7	71.1	71.7	71.2	70.3	69.7
Total off-balance sheet items to total assets	103.5	111.0	207.3	234.1	219.9	220.4	220.6	216.9	209.4
Classified off-balance sheet items to classified balance sheet asset	26.1	28.7	27.6	30.6	32.4	33.2	34.5	35.6	36.4

Source: National Bank of Serbia.

Table 9. Serbia: Schedule of Reviews Under the Policy Coordination Instrument, 2018–20

Program Review	Proposed Date
Board discussion of a PCI request	July 18, 2018
First Review	December 1, 2018
Second Review	June 1, 2019
Third Review	December 1, 2019
Fourth Review	June 1, 2020
Fifth Review	December 1, 2020

Source: IMF staff.

Annex I. Public Sector Debt Sustainability Analysis[1]

Staff assesses Serbia's public debt to be sustainable. Debt sustainability indicators and the outlook have improved significantly under the three-year precautionary SBA. The persistent increase in public debt in the aftermath of the global financial crisis reversed in 2016 and now debt and gross financing needs are falling rapidly. The Public Debt Sustainability Analysis (DSA) shows that vulnerabilities to macroeconomic shocks have also declined but downside risks remain elevated, associated with the large share of debt denominated in foreign currency and held by non-residents. In addition, maintaining the downward path in public debt requires continued fiscal discipline, and delivering on structural reforms that will contribute to higher real growth.

1. **The persistent upward trajectory of general government debt has been reversed starting with 2016, owing to sizable fiscal adjustment achieved under the 2015–18 precautionary SBA.** Following the global financial crisis, general government debt increased rapidly, due to expansionary fiscal policies, sluggish output growth, a rise in government guarantees to large SOEs and local governments, high real interest rates and significant exchange rate depreciation. Public debt peaked in 2015 at 76 percent of GDP. The upward trajectory reversed from 2016 owing to sizable fiscal adjustment under the SBA program, along with exchange rate appreciation in 2017. At end-2017, public debt stood at about 63 percent of GDP, with debt held by non-residents accounting for 60 percent of the total, and the share of debt denominated in foreign currencies for 76 percent (Figure A.1). As a mitigating factor, most external debt is owed to multilateral and bilateral creditors (59 percent of total external public debt), which has helped Serbia keep interest costs relatively low. Gross financing needs have also declined significantly since 2015, owing to strong fiscal adjustment observed under the program and extension of the debt maturity structure (Figure A.3).

2. **The DSA baseline reflects staff macroeconomic projections.** Real GDP grew by a modest 1.9 percent in 2017, less than projected in the last DSA, due to temporary supply shocks (a drought and electricity disruptions). Growth is expected to recover starting in 2018 and reach potential of 4 percent over the projection period, reflecting growth-friendly fiscal policy, confidence effects, and structural reforms. Inflation is expected to stay within the tolerance band of the NBS. The primary fiscal balance recorded a surplus of 3.9 percent of GDP in 2017, about 2 percentage points higher than envisaged under the last DSA, reflecting primary current spending containment and revenue overperformance (Figure A.3). Staff assumes that the authorities will continue building on the achieved macro stability under a new non-financial arrangement (PCI). In this context, the team envisages a small overall surplus in 2018 and an overall deficit target of about ½ percent of GDP for 2019 and onwards. The proposed target will aim to reduce public debt to about 50 percent of GDP by 2021 – and keep it under 50 percent thereafter – while allowing for adequate capital spending to address Serbia's large infrastructure needs.

[1] Public sector is defined as general government and includes public contingent liabilities.

3. Debt and gross financing needs (GFN) ratios are projected remain below the high-vulnerability benchmark thresholds over the projection period, but risks associated with external vulnerability indicators remain elevated. Under the baseline scenario, public debt will remain below the benchmark of 70 percent of GDP. Gross financing needs are also projected to remain below the benchmark of 15 percent and to fall to 6.5 percent of GDP by 2023, a significant improvement compared to the last DSA (13.1 percent in 2022), owing to the stronger than expected fiscal adjustment in 2017 and dinar appreciation (Figure A.3). The decline in public debt is expected to continue beyond the projection period as the projected primary balance in 2023 is well above the debt stabilizing level. Nevertheless, the heatmap displays continued vulnerabilities associated with the large share of debt held by non-residents and denominated in foreign currency, which could point to rollover problems in case of changes in global risk aversion or loss of confidence in the sovereign (Figure A.1).

4. Risks to debt sustainability have moderated significantly but the positive outlook remains dependent on continued fiscal discipline and growth. Debt dynamics and gross financing needs have become less vulnerable to macroeconomic shocks. Specifically, only under a real GDP shock would the GFN cross the high-vulnerability benchmark, while debt would remain below the benchmark under all shocks (Figures A.1 and A.5). The debt outlook, however, hinges on continued fiscal discipline, as illustrated in the historical scenario that shows debt and GFN projections if the 10-year average primary balance is used (Figure A.4). The debt fan charts also illustrate the risks related to different shocks with emphasis on the impact of interrupted fiscal adjustment as illustrated by the asymmetric distributions charts that results from assuming no positive shocks to the primary balance (Figure A.1).

5. Forecast errors are on average in line with other market access countries under a program. Real GDP forecast errors have been mainly caused by exogenous shocks (Figure A.2). Real GDP growth was lower than anticipated in 2009 due to a sharp output contraction amid the global financial crisis, and later in 2012, 2014, and 2017 due to severe weather shocks that affected agricultural and industrial output. Errors in primary balance projections have been positive in recent years, reflecting larger consolidation than budgeted. For comparison of growth and level of output in the absence of fiscal adjustment, the DSA assumes a medium fiscal multiplier of 0.5 which seems appropriate for Serbia as a relatively small and open economy. This assumption is also more in line with multipliers observed by other emerging economies in the region.[2]

[2] See 2014 FAD paper on "Fiscal Multipliers: Size, Determinants, and Use in Macroeconomic Projections".

Figure A.I.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

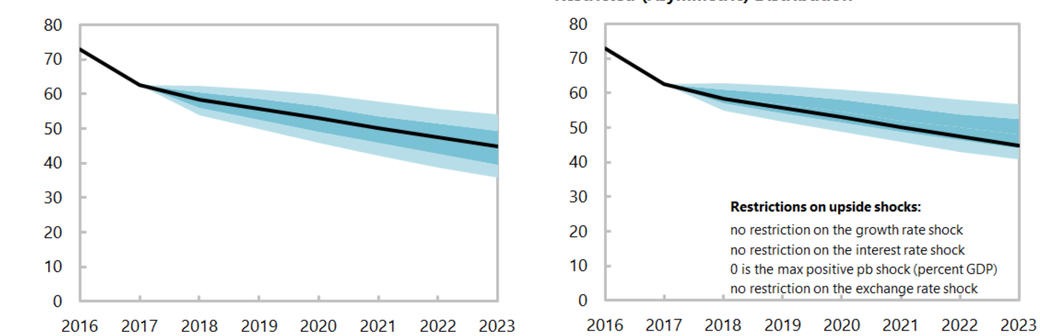
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)

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

Symmetric Distribution

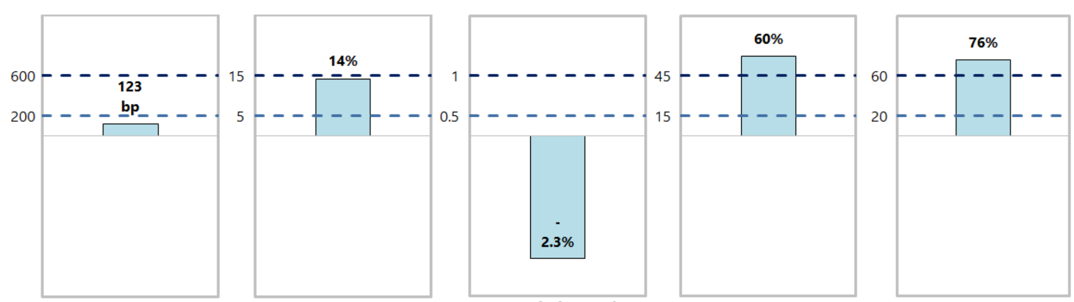
Restricted (Asymmetric) Distribution



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2017)

Serbia   Lower early warning   Upper early warning



Bond spread	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.

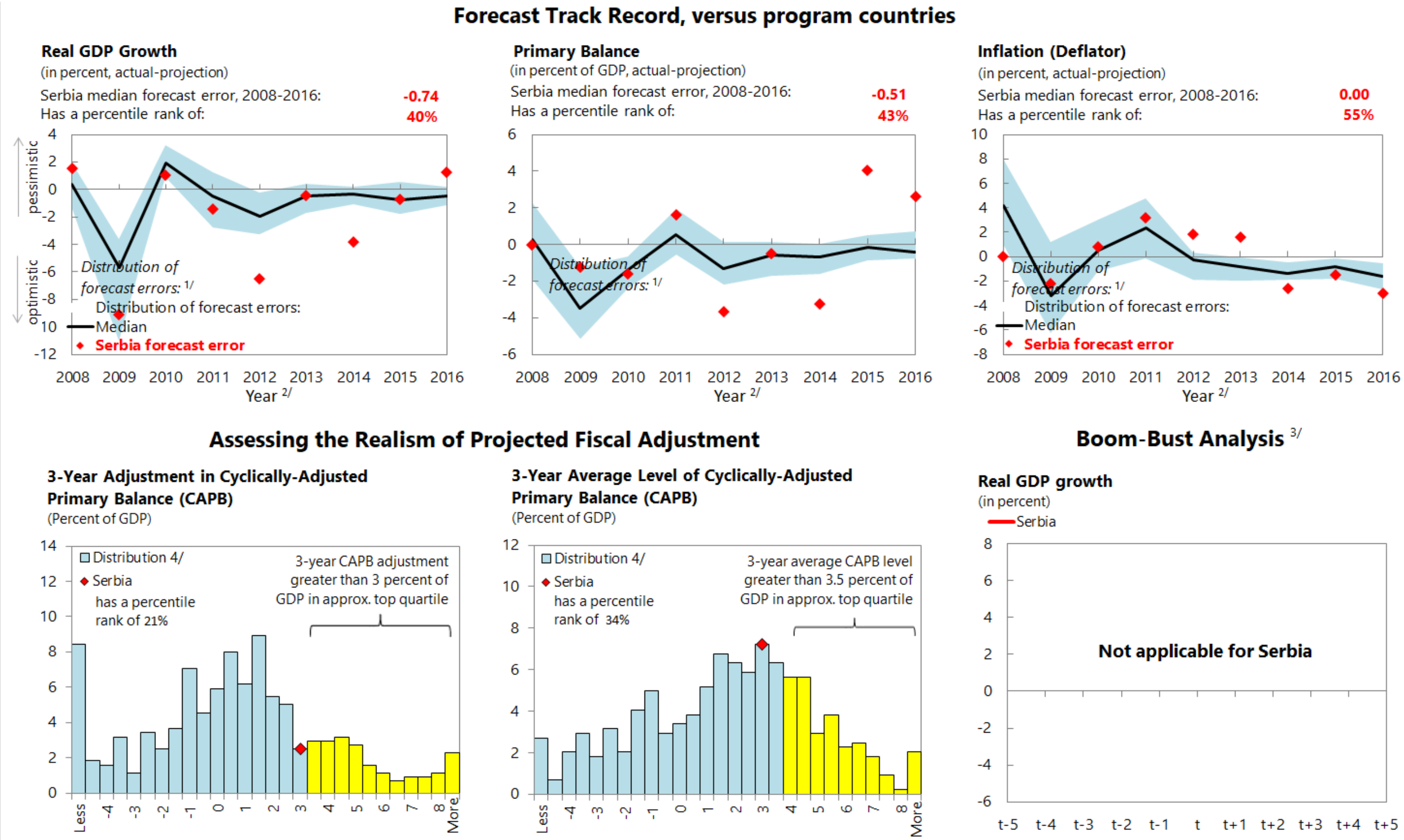
3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, 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/ Long-term bond spread over German bonds, an average over the last 3 months, 02-Jan-18 through 02-Apr-18.

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.I.2. Serbia: Public DSA-Realism of Baseline Assumptions



Source : IMF Staff.

1/ Plotted distribution includes program 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.I.3. Serbia Public Sector Debt Sustainability Analysis (DSA) – Baseline Scenario

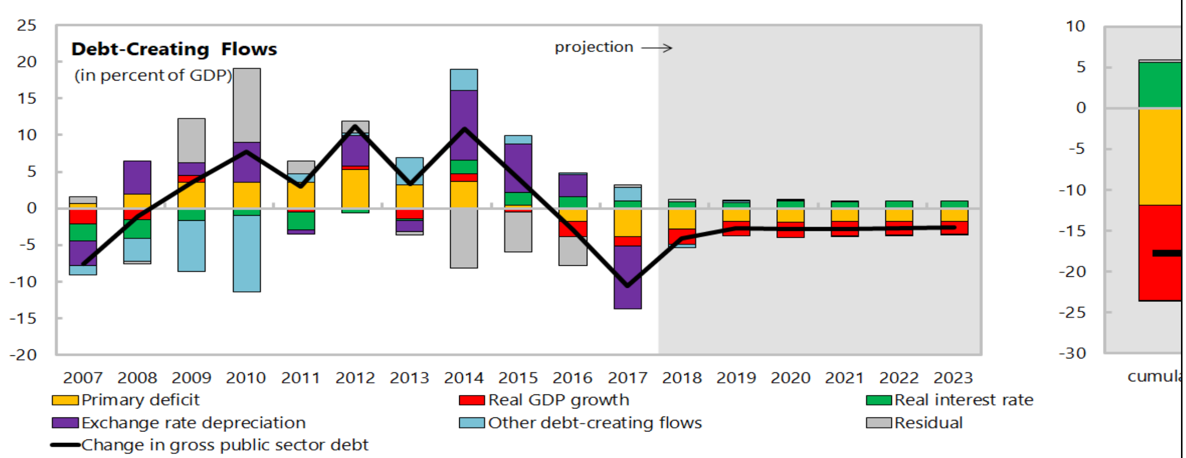
(in percent of GDP unless otherwise indicated)

Debt, Economic and Market Indicators [1]

	Actual			Projections						As of April 02, 2018	
	2007-2015 [2]	2016	2017	2018	2019	2020	2021	2022	2023		
Nominal gross public debt	51.0	73.1	62.5	58.4	55.8	53.0	50.1	47.5	44.8	Sovereign Spreads	
Of which: guarantees	5.3	6.9	5.7	5.1	4.8	4.4	4.1	3.9	3.6	EMBIG (bp) 3/	
Public gross financing needs	11.8	13.1	9.6	8.7	8.0	9.4	9.9	6.6	6.4	5Y CDS (bp)	
Real GDP growth (in percent)	1.2	2.8	1.9	3.5	3.5	4.0	4.0	4.0	4.0	Ratings	Foreign
Inflation (GDP deflator, in percent)	6.6	2.5	2.8	2.6	3.1	3.1	3.0	3.1	3.2	Moody's	Ba3
Nominal GDP growth (in percent)	7.9	5.4	4.8	6.2	6.7	7.2	7.2	7.2	7.3	S&Ps	BB-
Effective interest rate (in percent) [4]	3.9	4.8	4.3	4.2	4.6	5.1	5.0	5.4	5.6	Fitch	BB

Contribution to Changes in Public Debt

	Actual			Projections							
	2007-2015	2016	2017	2018	2019	2020	2021	2022	2023	cumulative	debt-stab
Change in gross public sector debt	3.9	-2.9	-10.5	-4.1	-2.7	-2.8	-2.9	-2.7	-2.6	-17.7	prima
Identified debt-creating flows	3.2	1.0	-10.9	-4.5	-2.7	-2.9	-2.8	-2.6	-2.6	-18.1	balanc
Primary deficit	2.9	-1.8	-3.9	-2.8	-1.8	-1.9	-1.8	-1.8	-1.7	-11.9	-0.8
Primary (noninterest) revenue and grant	41.5	43.2	44.2	43.3	42.2	42.0	41.8	41.7	41.5	252.5	
Primary (noninterest) expenditure	44.4	41.4	40.3	40.5	40.4	40.1	40.0	39.9	39.7	240.6	
Automatic debt dynamics [5]	1.7	2.5	-8.9	-1.2	-1.1	-1.1	-1.0	-0.8	-0.8	-6.1	
Interest rate/growth differential [6]	-1.2	-0.5	-0.3	-1.2	-1.1	-1.1	-1.0	-0.8	-0.8	-6.1	
Of which: real interest rate	-0.8	1.6	1.0	0.9	0.8	1.0	0.9	1.0	1.0	5.6	
Of which: real GDP growth	-0.4	-2.0	-1.3	-2.1	-1.9	-2.1	-2.0	-1.9	-1.8	-11.7	
Exchange rate depreciation [7]	2.9	3.0	-8.6	...	...	...	...	...	...	...	
Other identified debt-creating flows	-1.4	0.2	1.8	-0.5	0.3	0.1	0.0	0.0	-0.1	-0.1	
Privatization/Drawdown of Deposits (+	-2.2	-0.9	1.3	-0.2	0.1	0.2	0.1	0.1	0.1	0.4	
Contingent liabilities	0.8	1.1	0.6	-0.3	0.2	0.0	-0.1	-0.1	-0.1	-0.5	
Net lending outside budget	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8]	0.7	-3.9	0.4	0.3	0.0	0.1	0.0	0.0	-0.1	0.3	



Source: IMF staff.

1/ Public sector is defined as general government and includes public guarantees.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

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

5/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) 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 - π (1+g) and the real growth contribution as -g.

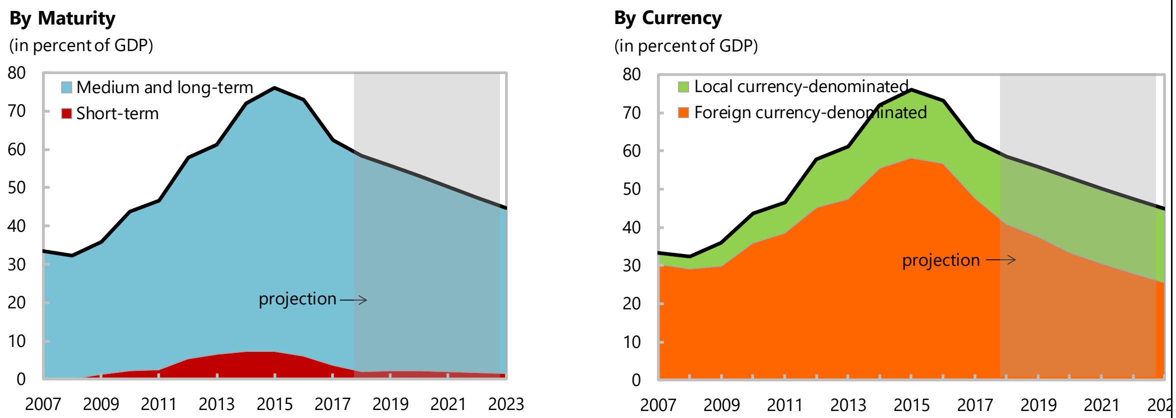
7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

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.

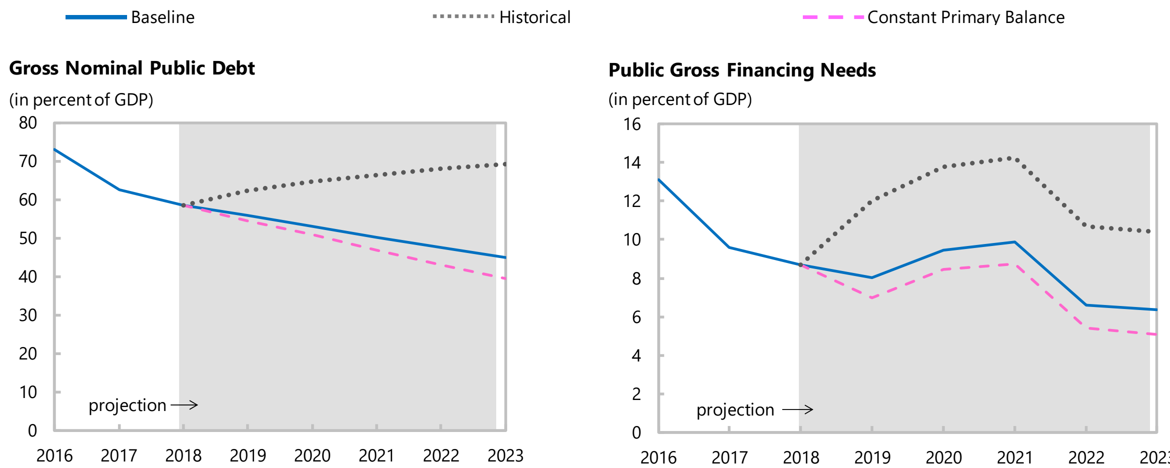
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure A.I.4. Serbia Public DSA – Composition of Public Debt and Alternative Scenarios

Composition of Public Debt



Alternative Scenarios



Underlying Assumptions
(in percent)

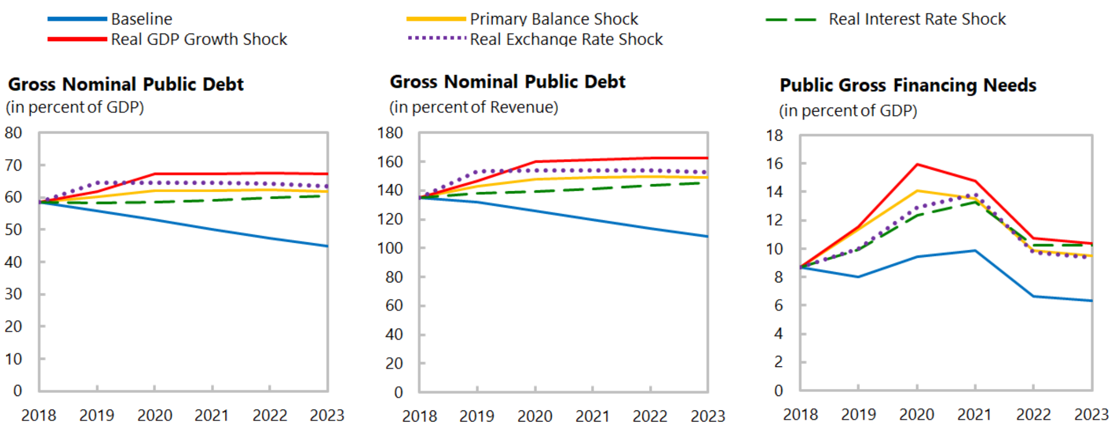
Baseline Scenario	2018	2019	2020	2021	2022	2023
Real GDP growth	3.5	3.5	4.0	4.0	4.0	4.0
Inflation	2.6	3.1	3.1	3.0	3.1	3.2
Primary Balance	2.8	1.8	1.9	1.8	1.8	1.7
Effective interest rate	4.2	4.6	5.1	5.0	5.4	5.6
Constant Primary Balance Scenario						
Real GDP growth	3.5	3.5	4.0	4.0	4.0	4.0
Inflation	2.6	3.1	3.1	3.0	3.1	3.2
Primary Balance	2.8	2.8	2.8	2.8	2.8	2.8
Effective interest rate	4.2	4.6	5.1	5.1	5.4	5.7

Historical Scenario	2018	2019	2020	2021	2022	2023
Real GDP growth	3.5	0.9	0.9	0.9	0.9	0.9
Inflation	2.6	3.1	3.1	3.0	3.1	3.2
Primary Balance	2.8	-2.0	-2.0	-2.0	-2.0	-2.0
Effective interest rate	4.2	4.6	4.3	3.6	3.2	2.8

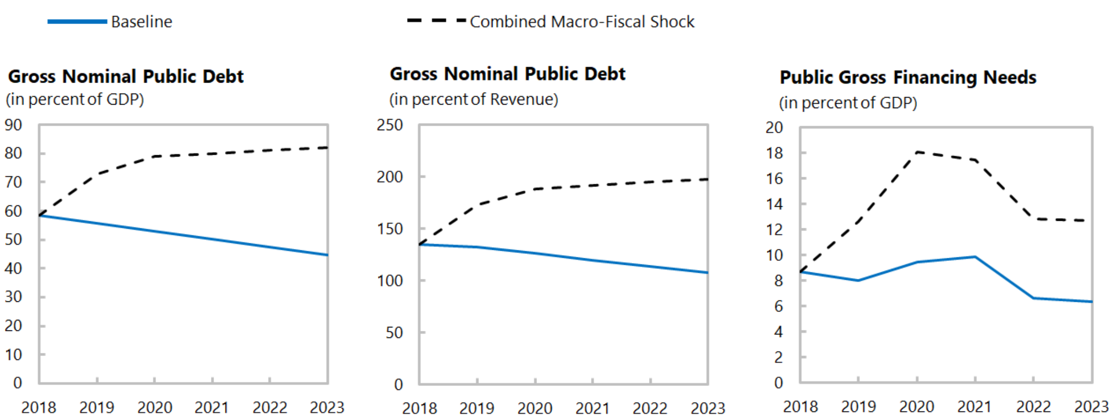
Source: IMF staff.

Figure A.I.5. Serbia Public DSA – Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(in percent)

Primary Balance Shock	2018	2019	2020	2021	2022	2023
Real GDP growth	3.5	3.5	4.0	4.0	4.0	4.0
Inflation	2.6	3.1	3.1	3.0	3.1	3.2
Primary balance	2.8	0.4	0.5	1.8	1.8	1.7
Effective interest rate	4.2	4.6	5.1	5.1	5.4	5.5
Real Interest Rate Shock						
Real GDP growth	3.5	3.5	4.0	4.0	4.0	4.0
Inflation	2.6	3.1	3.1	3.0	3.1	3.2
Primary balance	2.8	1.8	1.9	1.8	1.8	1.7
Effective interest rate	4.2	4.6	5.4	5.8	6.6	6.9
Combined Shock						
Real GDP growth	3.5	1.0	1.5	4.0	4.0	4.0
Inflation	2.6	2.5	2.4	3.0	3.1	3.2
Primary balance	2.8	0.4	-0.6	1.8	1.8	1.7
Effective interest rate	4.2	5.4	5.2	5.6	6.3	6.5

Real GDP Growth Shock	2018	2019	2020	2021	2022	2023
Real GDP growth	3.5	1.0	1.5	4.0	4.0	4.0
Inflation	2.6	2.5	2.4	3.0	3.1	3.2
Primary balance	2.8	0.6	-0.6	1.8	1.8	1.7
Effective interest rate	4.2	4.6	5.0	5.2	5.5	5.5
Real Exchange Rate Shock						
Real GDP growth	3.5	3.5	4.0	4.0	4.0	4.0
Inflation	2.6	9.6	3.1	3.0	3.1	3.2
Primary balance	2.8	1.8	1.9	1.8	1.8	1.7
Effective interest rate	4.2	5.4	4.9	4.9	5.1	5.2

Source: IMF staff.

Annex II. Serbia: External Sector Debt Sustainability Analysis

External debt is assessed to be sustainable over the medium term, but subject to risks. Under the baseline, the current account deficit would decline gradually and be fully financed by foreign direct investment inflows. This would allow the country to put external debt on a firm downward path over the medium term. The debt path is sensitive to real exchange rate shocks given that most of the external debt is denominated in foreign currency. A reversal in fiscal adjustment could also deteriorate debt dynamics through higher interest rates and current account deficit. Upside risks are related to a faster dinarization of financing from non-residents.

1. **Total external debt declined to 72 percent of GDP in 2017 from 81 percent in 2016, on account of substantial dinar appreciation and public sector debt reduction.** Since 2016, public external debt has reversed the upward trend started in 2008. Private external debt is also declining, even if the pace of debt decline has slowed starting in 2017 due to re-leveraging in the banking sector. These dynamics, together with exchange rate appreciation, resulted in a significant reduction of external debt in 2017. Baseline projections assume a continuation of these trends over the projection period. Consequently, total external debt and gross financing needs are expected to decline gradually over the medium term, reaching about 45 and 8 percent of GDP respectively by 2023.

2. **The main drivers of the projected reduction in total external debt are a gradual contraction in the current account deficit before interest payments and the change in composition of financing away from debt.** The current account deficit excluding interest payments rose to 3.3 percent of GDP in 2017 because of temporary factors (impact of weather conditions on agriculture exports and electricity imports and one-off dividend payments). The current account deficit (excluding interest payments) is projected to further increase in 2018 due to significant investment-related imports but to decline gradually over the medium-term. The current account deficit is expected to be fully financed by non-debt creating flows, contributing to the reduction in debt. Indeed, foreign direct investment is projected to remain at about 6 percent of GDP throughout the medium-term and economic growth to reach potential of 4 percent.

3. **The external debt path is sensitive to real exchange rate depreciation shocks.** As shown in the shock scenarios, a 30 percent real depreciation would cause external debt to reach 89 percent of GDP during the first year and to stabilize at 64 percent of GDP by 2023. It must be noted, however, that the stress test considers only the direct impact on external debt while the indirect effects of a depreciation would be positive by leading to an improved current account balance.

4. **A reversal of fiscal adjustment could have a significant impact on external debt dynamics but there are also upside risks.** As shown in historical scenarios, if the current account, growth, interest rates, and real exchange rate depreciation remain at historical levels,

external debt would remain on an increasing trajectory throughout the projection period, reaching 78 percent of GDP by 2023. Also, the combined shock scenario illustrates a situation where higher current account deficits, higher interest rates, and a slowdown in economic activity results in external debt reaching 52 percent of GDP by 2023. This situation would be consistent with a reversal of the policies undertaken under the 2015-18 precautionary-SBA. Upside risks relate to a faster dinarization of financing from non-residents. This situation could materialize if Serbia joins Euroclear, which increases transparency and can draw foreign investors into the local currency debt market, thus reducing debt vulnerability to exchange rate depreciation.

Table A.II.1. Serbia: External Debt Sustainability Framework, 2013-2023

(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2013	2014	2015	2016	2017			2018	2019	2020	2021	2022	2023	Debt-stabilizing non-interest current account 6/
Baseline: External debt	79.4	83.1	84.0	80.6	72.0			**65.2**	**61.0**	**56.7**	**52.5**	**48.6**	**44.5**	**-7.5**
Change in external debt	-4.8	3.6	0.9	-3.4	-8.6			-6.8	-4.2	-4.3	-4.2	-4.0	-4.0	
Identified external debt-creating flows (4+8+9)	-4.1	4.3	1.1	-5.1	-5.7			-3.0	-2.3	-2.7	-2.8	-2.8	-3.1	
Current account deficit, excluding interest payments	3.7	3.5	2.0	0.4	3.3			3.8	3.7	3.5	3.4	3.2	2.8	
Deficit in balance of goods and services	11.2	10.9	9.8	6.4	8.3			8.3	7.8	7.7	7.3	7.1	6.7	
Exports	40.7	43.4	46.7	50.2	52.6			53.9	56.0	57.9	59.7	61.6	63.4	
Imports	51.9	54.3	56.4	56.6	60.8			62.3	63.8	65.5	67.0	68.6	70.1	
Net non-debt creating capital inflows (negative)	-3.5	-3.7	-5.2	-5.4	-6.5			-6.6	-5.8	-5.8	-5.8	-5.8	-5.8	
Automatic debt dynamics 1/	-4.3	4.5	4.4	-0.1	-2.5			-0.2	-0.3	-0.4	-0.4	-0.3	-0.2	
Contribution from nominal interest rate	2.5	2.5	2.4	2.7	2.4			1.9	1.8	1.8	1.7	1.7	1.6	
Contribution from real GDP growth	-2.0	1.5	-0.6	-2.3	-1.4			-2.1	-2.1	-2.3	-2.1	-1.9	-1.8	
Contribution from price and exchange rate changes 2/	-4.8	0.5	2.6	-0.6	-3.5			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	-0.7	-0.6	-0.2	1.7	-3.0			-3.8	-1.9	-1.6	-1.4	-1.2	-1.0	
External debt-to-exports ratio (in percent)	195.0	191.6	179.9	160.4	136.9			120.9	108.8	98.0	88.1	78.9	70.2	
Gross external financing need (in billions of US dollars) 4/	9.7	8.0	4.3	4.6	5.9			8.4	7.5	9.5	10.0	8.1	8.0	
in percent of GDP	21.3	18.0	11.7	12.1	14.3	10-Year	10-Year	16.9	14.1	16.4	15.9	12.0	10.9	
Scenario with key variables at their historical averages 5/								**65.2**	**67.7**	**70.3**	**72.7**	**75.4**	**78.2**	**-3.6**
Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation							
Real GDP growth (in percent)	2.6	-1.8	0.8	2.8	1.9	1.6	2.8	3.5	3.5	4.0	4.0	4.0	4.0	
GDP deflator in US dollars (change in percent)	6.1	-1.0	-3.6	0.5	4.7	0.6	8.1	15.8	4.2	4.1	3.7	3.8	3.7	
Nominal external interest rate (in percent)	3.2	3.0	2.8	3.4	3.2	3.3	0.8	3.1	3.0	3.3	3.3	3.5	3.7	
Growth of exports (US dollar terms, in percent)	25.6	3.4	-9.5	10.9	13.2	7.3	15.6	23.0	12.2	11.7	11.2	11.3	11.1	
Growth of imports (US dollar terms, in percent)	8.3	1.6	-12.6	3.4	16.2	2.7	16.9	22.7	10.7	11.1	10.3	10.5	10.2	
Current account balance, excluding interest payments	-3.7	-3.5	-2.0	-0.4	-3.3	-5.5	5.1	-3.8	-3.7	-3.5	-3.4	-3.2	-2.8	
Net non-debt creating capital inflows	3.5	3.7	5.2	5.4	6.5	4.5	1.4	6.6	5.8	5.8	5.8	5.8	5.8	

1/ 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.

2/ 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 deflat

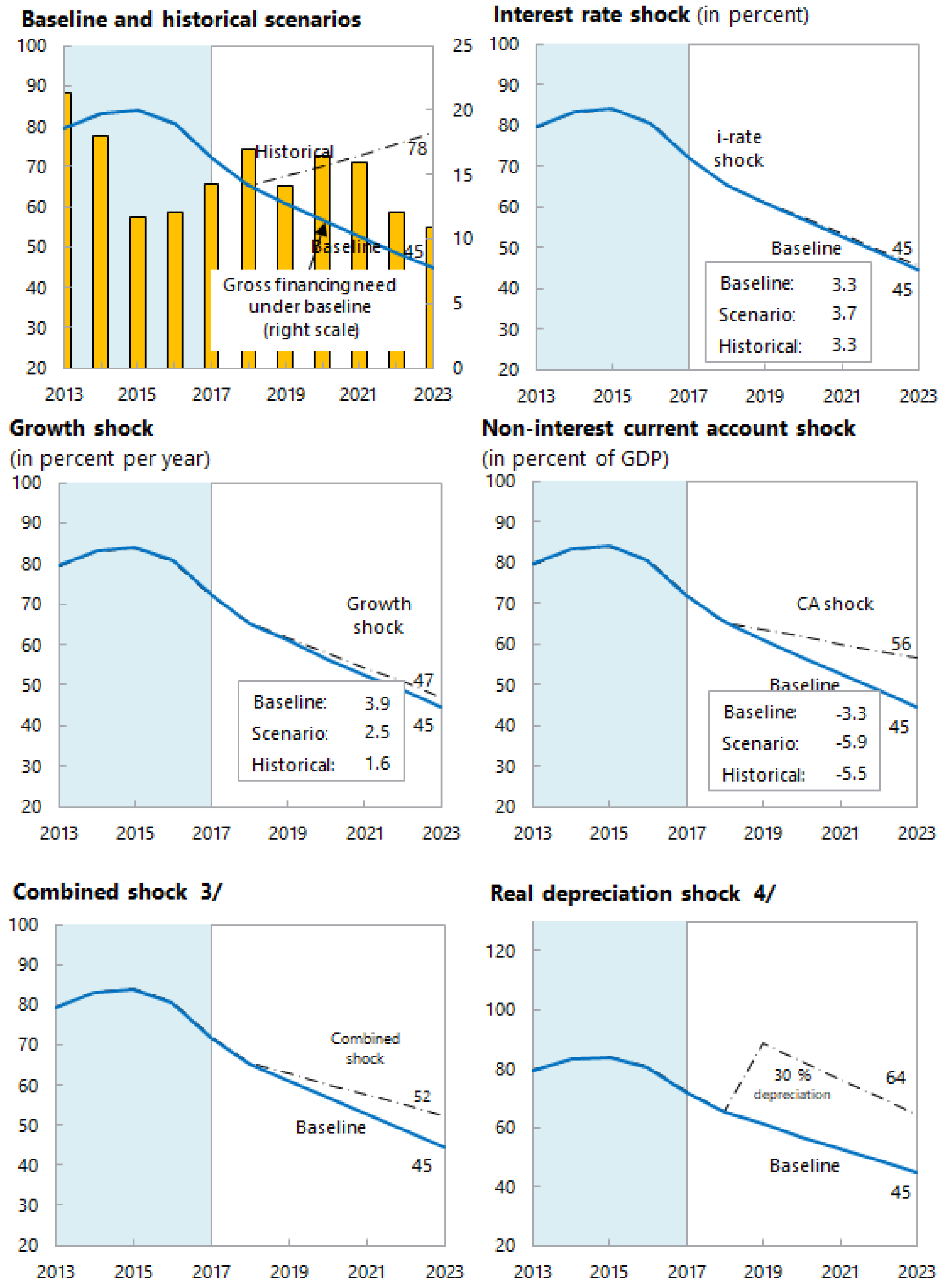
3/ For projection, line includes the impact of price and exchange rate changes.

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

5/ 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.

6/ 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.II.1. Serbia: External Debt Sustainability: Bound Tests 1/ 2/
(External debt in percent of GDP)



Sources: International Monetary Fund, Country 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/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
4/ One-time real depreciation of 30 percent occurs in 2018.

Annex III. External Sustainability Assessment

1. Serbia's external position has strengthened since the aftermath of the global financial crisis, but additional adjustment is needed over the medium term. The current account deficit has narrowed markedly since 2008 and the exchange rate has stabilized significantly in recent years. Nevertheless, Serbia's current account deficit increased in 2017 and is projected to remain above 5½ percent of GDP in 2018. As a positive, the deficit is mainly driven by investment-related imports and is fully covered by non-debt related flows. Meanwhile, private remittances remain high, at 9.2 percent of GDP in 2017.

2. Serbia's net international investment position (NIIP) is highly negative but its favorable composition mitigates external vulnerabilities. While declining, Serbia's negative NIIP remains high at -97.5 percent of GDP at end-2017, significantly above the average of countries in the region (-55 percent of GDP). There are, however, several mitigating factors: i) a favorable composition of gross liabilities, with FDI surpassing gross debt in 2017 (77 and 72 percent of GDP, respectively); ii) diversified FDI inflows in terms of origin and focused in export-oriented industries; iii) declining net foreign debt liabilities (26 percent of GDP in 2017 versus 27.4 in 2016); and iv) ample international reserve position around the top of the recommended bounds of the IMF reserve adequacy metric.

3. The EBA-Lite methodology suggests that the external position is broadly consistent with fundamentals and desirable policy settings, but subject to vulnerabilities. The exchange rate gap is narrowing and is now well within the margin of error under all approaches. Given Serbia's large negative NIIP position, staff considers the external sustainability (ES) approach the most relevant for the country.

4. The ES approach applied here focuses on the scenario where the goal is to bring the NIIP close to the regional average of -55 percent of GDP over a 20-year horizon. This would require a lower current account deficit of 2.9 percent of GDP and a slight depreciation of the exchange rate (2.3 percent). This assessment is in line with staff's view that a stronger current account position would help to mitigate external vulnerabilities.

5. The current account (CA) approach estimates Serbia's current account norm at -7.7 percent of GDP, suggesting an exchange rate undervaluation of 4.9 percent. The most significant contributors to the high current account norm are Serbia's (i) high old age dependency ratio; (ii) aging speed (interacted with the relative dependency ratio); and (iii) its low productivity relative to others. These fundamentals imply lower savings and a higher current account deficit. This underscores the importance of generating sufficient public savings now, as the fiscal costs of an aging population may further exacerbate the external vulnerabilities in the future. Staff's view is that a current account norm of -7.7 percent of GDP is not sustainable, as Serbia should lower its debt-related external vulnerabilities in the medium-term, and that the undervaluation indicated by the CA approach should be discounted accordingly.

6. Finally, **the real effective exchange rate (REER) approach** points to the need for a slight depreciation of exchange rate (2 percent), as in the ES approach.

EBA-Lite Estimates of Current Account Norm and Exchange Rate Gap

	CA Norm	CA Gap	REER Gap
	(% GDP)	*(% GDP)*	*(percent)*
Methodology			
CA Approach	-7.7	2.0	-4.9
REER Approach	n.a.	n.a.	2.0
ES Approach	-2.9	-0.9	2.3

Appendix I. Program Statement

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

Belgrade, June 29, 2018

Dear Ms. Lagarde:

Our 2015-18 economic program, supported by a precautionary Stand-By Arrangement (SBA), was instrumental in reducing Serbia's long-standing economic imbalances, restoring growth, and starting to address key structural weaknesses of the Serbian economy. The Government of the Republic of Serbia requests approval of a new macroeconomic and structural reform program supported by the Policy Coordination Instrument (PCI) for the period August 2018–January 2021. To support this request, this Program Statement (PS) outlines the government's objectives and sets out the economic policies that the Government and the National Bank of Serbia (NBS) intend to implement under this new program.

The new program is intended to maintain macroeconomic and financial stability and support the implementation of a comprehensive structural and institutional reform agenda, necessary to put Serbia on a faster, sustainable and inclusive income convergence path. With this aim, the program will seek to increase investment levels, and advance reforms to boost productivity, increase private sector employment, and reduce the informal economy. These goals are compatible with our aspirations to become an EU member, having started the accession process in January 2014.

The implementation of our program will be monitored through quantitative targets, indicative targets, reform targets, and an inflation consultation clause, as described in the PS and the attached Technical Memorandum of Understanding (TMU). There will be five reviews of the arrangement by the Fund, scheduled to be completed on a semi-annual 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 this PS are adequate to achieve the objectives of the PCI-supported program, and we will promptly take any additional 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 this PS. Moreover, we will provide all information requested by the Fund to assess implementation of the program.

In line with our commitment to transparency, we wish to make this letter available to the public, along with the PS and TMU, as well as the IMF staff report on the request for a PCI. 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/
Ana Brnabić
Prime Minister

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

/s/
Siniša Mali
Minister of Finance

Attachment: Technical Memorandum of Understanding

Program Statement

1. This program statement sets out our economic program for the next 30 months. The program aims to strengthen the foundation for healthy economic growth by addressing Serbia's short-term and medium-term economic challenges. To this end, the program focuses on policies to ensure macroeconomic stability, most notably by maintaining fiscal sustainability, bolster resilience of the financial sector, and improve competitiveness of the economy.

2. Serbia has succeeded in addressing macroeconomic imbalances and restoring growth. Supported by a three-year precautionary SBA successfully completed in February 2018, we have restored fiscal sustainability, put public debt on a firm downward path, and realigned the external position with fundamentals. Monetary policy has kept inflation under firm control, while supporting the economic recovery and maintaining broad exchange rate stability. The stronger confidence associated with the improved macroeconomic situation has been reflected in higher private investment and supported employment and growth.

3. Financial sector resilience has been strengthened. Financial sector reforms have resulted in improved financial soundness indicators and sharply reduced non-performing loans. The banking system is now on a stronger footing to support economic growth. Prudential and regulatory standards are becoming aligned with EU standards.

4. We have started to address key structural weaknesses of the Serbian economy. Employment in general government and local public utilities has been reduced. Steps have been taken to reduce losses and lower fiscal risks from some systemic SOEs. The business climate has strengthened with macroeconomic stability and an improved regulatory environment, and efforts to remove obstacles to private sector development and attracting new investments have started to pay off.

5. However, further efforts in implementing the structural and institutional reform agenda are needed to ensure Serbia is put on a faster convergence path. Our plans envisage measures to foster private sector-led growth, reduce the size of the shadow economy, and complete reforms in public administration and restructuring of state-owned utilities, enterprises, and financial institutions. We will continue to advance reforms in public finance, tax administration, judicial, and education reform, while public infrastructure needs remain large. Growth also needs to be made more inclusive through higher labor market participation, especially among women.

Recent Economic Developments and Outlook

6. Strong economic performance continues. After slowing down to 1.9 percent in 2017 mostly due to temporary supply shocks, growth has accelerated in 2018 (4.6 percent year-on-year in Q1) supported by continued recovery of private consumption and strong FDI. Labor market indicators continue to improve, with robust employment growth in the formal sector, and a declining unemployment. Private sector wages have picked up, the minimum wage was increased by 10 percent, and public wages increased by 7 percent on average in January, on the back of improved economic and labor market conditions.

7. Inflation remains low and relatively stable. Headline inflation temporarilly fell below the target band in March and April, but has since recovered. The decline is mainly due to low food prices and base effects from 2017. Core inflation remains low. Led by accomodative monetary policy, financial conditions became more favorable.

8. We expect the consistent implementation of the policy actions and reforms envisaged under our economic program to maintain the virtuous cycle of boosting confidence, improving private sector dynamism, and fostering economic growth.

- **Real GDP growth** is projected at 3½ percent in 2018-19 and to rise to 4 percent over the medium term. Full implementation of our structural reform agenda will further boost growth potential.
- **Headline CPI inflation** is projected to gradually increase but remain in the lower half of the inflation target band over 2018 and 2019, remaining at around 3 percent over the medium term.
- **The current account deficit** is projected to remain at about 5¾ percent of GDP in 2018, driven by investment-related imports and energy prices, and to decline to around 4 percent of GDP over the medium term. The current account deficit will continue to be fully financed by net FDI. External financing will continue to rely mostly on FDI, and bilateral and infrastructure project loans.

Economic Policies

A. Fiscal Policies

9. We are committed to preserve the hard-won fiscal gains to keep public debt-to-GDP ratio firmly on a downward path, while supporting economic growth. The estimated structural fiscal adjustment in 2015–2017 amounted to over 6½ percent of GDP. This sizeable adjustment was driven by stronger revenues and tight control of current spending. For 2018, we project a general government fiscal surplus of 0.6 percent of GDP, compared to a budgeted deficit of 0.7 percent of GDP. Public debt is projected to decline further in 2018, while the debt profile will continue to improve, with increased maturity and higher share of dinar-denominated debt.

10. For 2019 onwards, we will aim at an overall deficit of about ½ percent of GDP. This stance will imply a reduction of public debt to about 50 percent of GDP over the medium term. It will also allow an increase in capital spending to address Serbia's sizeable infrastructure needs and reduce the tax burden on businesses and labor. Moreover, this fiscal stance will accommodate the unwinding of the crisis-era temporary pension cuts and the transition to the new public wage system, while ensuring that the pension and wage bills do not increase in percent of GDP.

11. We will aim to further reduce fiscal risks and will prepare contingency measures as needed. We will maintain an adequate level of fiscal buffers and will not accumulate public sector external debt payment arrears (continuous target). We will also refrain from accumulating domestic payment arrears. Our efforts to contain public spending will be monitored through a ceiling on current primary expenditure of the Serbian Republican budget, excluding capital spending and interest payments (quantitative target).

B. Structural Fiscal Policies

12. We are committed to complete the general government employment and wage system reforms, which are critical for improving the efficiency of public services and containing current expenditure. The public wage bill has recently been reduced via administrative wage and employment restraints, which are not optimal over the medium-term.

- **General government employment framework.** The current framework is governed by (i) the annual Law on the Maximum Number of Employees, which sets the employment ceiling on permanent staff at the institution level; and (ii) an employment freeze, with exceptions managed through the government Employment Commission, considering individual institutions' employment ceilings, budgetary envelopes, and specialist staffing needs. This system, which includes public enterprises, has helped to reduce public employment, but also resulted in reliance on fixed-term and contractual positions and staffing shortages in some units. We will examine options to replace the existing framework with a more flexible system that will contain fiscal pressures from public sector wages, ensure adequate allocation of staffing across the public administration, and restrain hiring by public enterprises.

- **Public wage system reform.** The Law on Public Sector Employees Wage System approved in 2016 sets the stage for a new system where employees are granted equal pay for equal work across the government, in a more transparent and systematic manner. Secondary legislation for local governments and public services (health, education, culture, and social protection) was approved in December 2017. The decree specifying the coefficients under the new wage system will be adopted (**end-September reform target**). We are mapping employees to the new wage matrix and will adopt secondary legislation for all other sectors (including police and armed forces) by end-2018. We will set the base under the new wage system to contain the general government wage bill below 10 percent of GDP.

13. To improve execution and reduce gaps in quantity and quality of public infrastructure, we will strengthen public investment management frameworks. All project loans were included in the 2017–18 budgets and we adopted a government decree enhancing the project appraisal process in mid-2017. In April, we adopted the Planning System Law, which established a national planning framework and will lead to preparation of a national Development Plan and a corresponding Investment Plan. However, structural weaknesses in implementing public investment remain significant. We are committed to improve the public investment management framework in line with recommendations of recent IMF technical assistance. Specifically, we will:

- Issue a detailed guideline as a Rule Book to the 2017 decree on capital expenditure projects covering project appraisal and selection (**end-January 2019 reform target**), and publish summaries of feasibility studies of large and mega projects, as defined in the guideline.
- Establish the Capital Investment Commission (CIC) and update the 2017 decree on public investment project appraisal to (i) clarify the roles of the MOF, CIC, and Expert Commission; and (ii) remove the exclusion of IPA-funded projects as well as those financed through government-to-government agreements (**end-April 2019 reform target**).

14. To raise the efficiency of revenue collection and improve the business environment, we are committed to improve tax administration. This work is based on recommendations of IMF technical assistance and the Tax Administration Diagnostic Assessment Tool review.

- The new **Transformation Action Plan (TAP, 2018-23)** developed with IMF experts and approved by the government in December 2017 provides strategic guidance and timelines on actions needed to create a modern tax administration utilizing electronic business processes, improved taxpayer services, and a risk-based approach to compliance. We will implement a list of measures covering: (i) separation of core and non-core activities administered by the STA to be supported by separate organizational structures with their own program budget allocation, headquarters design, business plans, management structures, and reporting lines; (ii) consolidation of core tax administration functions into fewer sites (**end-June 2019 reform target**); and (iii) modernization of IT and records management systems and business process re-engineering. As a **prior action**, we launched a public tender for external consultants to assist with the implementation of the TAP.
- We will also introduce **measures to reduce the average processing-time for VAT refunds**. Refunds are processed according to the legally prescribed timelines and the STA takes a cautious approach to minimize fraud. We will monitor the stock of pending refunds with an aim to substantially reduce the processing time, with a specific target to be determined following the modification of the VAT-management software in July.

15. We will use existing fiscal space on measures to support growth and improve the business climate.

- **Tax policy** to support investment and employment. Guided by IMF technical assistance, we will examine the scope to: (i) review the *corporate income tax* legislation to incentivize investment; (ii) review the *personal income tax* legislation to simplify it and improve progressivity; (iii) reduce the labor tax wedge and regressivity by lowering *social insurance contributions*; and (iv) review *presumptive taxation* for self-employed to improve transparency and eliminate abuses.

- **Rationalizing parafiscal charges.** In March, we completed the public consultation on the draft Law on Charges, which aims to consolidate all charges and corresponding rates faced by businesses in one law to reduce uncertainty and increase transparency. We will also eliminate or merge some charges and support the reduction of non-core activities of the STA. We will submit the draft law to parliament **end-October reform target** with a view to be adopted by parliament by end-December.

16. We will strengthen the fiscal framework, anchored by a robust fiscal rule. We will revise the framework over the program period to achieve the following principles: (i) stronger institutional significance of the debt limit as the primary medium-term anchor for fiscal policy; (ii) a more transparent and credible operational rule to help achieve the objective, while also helping to improve accountability and facilitate transition towards the EU fiscal framework; and (iii) a retain a strong role of the Fiscal Council. We also intend to review, with a view to rationalizing, the systems of revenue sharing and transfers to local government.

17. We will continue implementing public financial management measures.

- To stop accumulation of arrears, we will continue the publication of monthly reporting of overdue receivables to Srbijagas and EPS of their top 20 debtors on the companies' websites.

- We have been strictly limiting issuance of state guarantees since 2015. We will not issue any new state guarantees for liquidity support, or state guarantees for any company in the portfolio of the former Privatization Agency. The Government will continue to refrain from issuing any implicit state guarantees.

18. To safeguard fiscal consolidation, limit risks, and strengthen institutions:

- We will continue to submit financial plans of social security funds with estimates for their indirect beneficiaries to the National Assembly, in parallel with Republican budget. We will include all indirect budget beneficiaries of the central government (except for indirect budget beneficiaries of the Ministry of Education, Science and Technological Development) in the Information System for Budget Execution (ISIB) gradually by end-2019. We have upgraded the budget execution system to be able to support the integration of new users. We have included institutions for the enforcement of penal sanctions and cultural institutions in ISIB since January 1, 2018. In 2019, social protection institutions will be integrated, having in mind that they are the most numerous and diverse and will continue to upgrade their capacities over 2018–2019.

- We are committed to ensure that a full assessment of all proposed Public-Private Partnerships (PPPs) is reviewed by the Ministry of Finance (MOF), including PPPs' key financing features, cost-benefit analysis, and risk sharing arrangements with the government. To improve control of fiscal implications and risks, we amended the existing Law on Public-Private Partnership and Concessions mandating that PPPs larger than EUR 50 million are submitted to the government for consideration only after receiving the MOF's consent. By end-2018, we will adopt additional amendments to the Law aimed at limiting overall fiscal exposure, ensuring a competitive tender process.

- We will ensure that the fiscal risks management unit at the MOF is fully staffed by September.

C. Monetary and Exchange Rate Policies

19. The current inflation targeting framework remains appropriate 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 (3±1½ percent). Inflation developments will continue to be monitored via a consultation clause with consultation bands set around the central projection (Table 1). In this context, we implemented two consecutive 25 basis points key policy rate cuts in March and April, on the back of subdued core inflation, reduction in the medium-term inflation outlook, and continued exchange rate appreciation pressures. We also narrowed the interest rate corridor to +/-1.25 percentage points (from +/-1.50) in April.

20. We will maintain the current managed float exchange rate regime in line with the inflation targeting framework. We believe that well-managed exchange rate flexibility provides a needed buffer against external shocks. Therefore, foreign exchange interventions will continue to be used to smooth excessive short-term exchange rate volatility without targeting a specific level or path for the exchange rate, while considering the implications for financial sector and price stability. The current level of gross international reserves is comfortable for precautionary purposes.

21. We have made significant progress in advancing our dinarization objective. The dinarization strategy adopted in 2012 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. Macroeconomic imbalances have been reduced significantly and inflation has remained low and stable, which should all support dinarization. We have introduced several measures to increase dinarization, such as higher reserve requirements on FX deposits and mandatory down-payment ratios for FX loans. We have also enhanced our communication to the public on the risks of unhedged FX borrowing, need of prudent management of FX risks, and availability of hedging instruments. Meanwhile, we have increased the share of public debt in local currency, issuing dinar securities at longer maturities. The recently adopted Law on Financial Collateral will remove legal impediments to the development of the repo and FX derivatives markets. By March 2018, deposit dinarization has increased to 30 percent, while household lending dinarization has also increased, reaching 50 percent.

22. We will update our dinarization strategy (**end-December reform target**) to facilitate dinarization, further strengthen liquidity management, and develop local currency debt and hedging markets. Specifically, we plan to:

- Continue efforts to (i) further instill awareness of two-way exchange rate movements (ii) further develop local and foreign currency markets, and (iii) encourage prudent pricing of credit risks of unhedged foreign currency borrowing.

- Strengthen public debt management by (i) updating by the Ministry of Finance the legal foundation of debt management (**end-December reform target**), (ii) establishing the primary dealer system and developing adequate supervisory framework, and (iii) improving the PDA's operational framework and setting up a Debt Market Committee comprising of representatives of the PDA, MOF, NBS, and primary dealers.

- Further strengthen the liquidity management framework by (i) formalizing the communication between the NBS and the Ministry of Finance through a Service Level Agreement concerning TSA management andinformation provision; and (ii) establishing a joint Consultative Committee on Liquidity Management aimed at strengthening the management and oversight of the Consolidated Treasury Account balance and improving the quality of liquidity forecasting by end-December.

23. During the period of the PCI we will not, without IMF 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

24. We will continue to strengthen financial sector regulatory and supervisory frameworks, to fully align them with international standards. Basel III-compliant regulatory standards on capital, liquidity, and risk management, as well as updated standards on disclosure and regulatory reporting have been implemented. Minimum capital requirements have been reduced from 12 percent to 8 percent, while additional capital buffers have been introduced—in line with the EU's Capital Requirement Directive. Further enhancements of the prudential framework for banks and insurance companies are being enacted to ensure full compliance with international standards and EU requirements.

25. We will further enhance financial safety nets. Significant progress has been achieved in strengthening the bank resolution, deposit insurance, and crisis management frameworks, and additional efforts will be made to further enhance them. We will complete the ongoing work on resolution procedures and further align the deposit insurance scheme with international standards. Specifically, we will (i) review the appropriate parameters of the deposit insurance fund, including the target level, premium, deposit base for calculation, and investment policy, and conduct an IADI core principles assessment by December, and (ii) submit to parliament amendments to the Law on Deposit Insurance Agency and the Law on Deposit Insurance to reflect the findings of the review and assessment and introduce risk-based premia (**end-June 2019 reform target**).

26. Results of the implementation of the NPL resolution strategy have been impressive, but SOBs still lag. As of March, the NPL ratio reached 9.2 percent, a decline of around 14 percentage points since the 2015 peak, but progress has been uneven. In private banks, sizeable NPL sales helped lower NPLs to below pre-crisis levels (8.7 percent in March). Although NPLs remain relatively high for some SOBs (13.9 percent in March, on average), they are fully covered by regulatory reserves for estimated losses and significant improvements have been made driven primarily by write-offs. We will update, with support of IFIs, our NPL resolution strategy by end-September, focusing on measures to accelerate NPL resolution in SOBs, while also broadening the scope to include the export promotion agency (AOFI), the Development Fund (DF), and the bad assets managed by the Deposit Insurance Agency (DIA) on behalf of the State and the bankruptcy estates of banks in liquidation. In line with the updated strategy, the government and the DIA, as an **end-December reform target**, will: (i) approve a time-bound action plan to resolve part of the DIA portfolio of bad assets by end-2020 through a tendering process implemented in two phases (portfolios of about EUR 145 million and EUR 830 million consisting of both bad assets managed on behalf of the state and on behalf of bankrupt banks, as agreed with the World Bank); and (ii) complete the first phase of the sale by end-December. The action plan will also propose options to resolve the residual portfolio of low-value assets. As a first step, the DIA has engaged consultants to prepare the first phase of the tender process based on the portfolio of bad assets agreed with the World Bank.

27. We will continue to implement our state-owned financial institutions reform agenda. We are strengthening our oversight over financial institutions with state-ownership.

- We are committed to implement the new strategy for Banka Postanska Stedionica (BPS), with the support of the Word Bank. The focus of the strategy is on (i) the bank's commercial reorientation towards retail banking, entrepreneurs, micro-enterprises and small enterprises, (ii) improvements of the bank's internal organization, corporate governance and risk management, (iii) enhancement of its IT infrastructure, and (iv) a business plan for the period 2018-20. BPS will sign contracts with external consultants for the implementation of the business plan and for the procurement and implementation support of a new core banking system by end-2018.

- We will adopt a decision to initiate privatization of Komercijalna Bank by end-February 2019, with a view to launch a privatization tender (**end-June 2019 reform target**) and complete the sale by end-December 2019. Meanwhile, the bank is implementing necessary measures to address corporate governance weaknesses.

- We are working on the implementation of strategic options for the smaller banks, based on the updated government strategy for state-owned banks. In April, we (i) withdrew the banking license of Jugobanka Jugbanka and approved a takeover of part of the bank's assets and liabilities to BPS, after protracted efforts to find a strategic investor to recapitalize the bank failed; and (ii) initiated procedures concerning the sale of the State's shares in Jubmes Bank.

- The DF and AOFI have continued to implement (i) the supervisory boards' decisions recognizing losses on their credit portfolios and (ii) the government conclusion to restrict the institutions' exposures to SOEs, enhance risk management frameworks and prevent further deterioration in asset quality, and establish a timeline to resolve impaired assets.

28. We are strengthening the AML/CFT framework in line with the FATF action plan. We are addressing shortcomings identified in the 2016 MONEYVAL AML/CFT mutual evaluation report through an inter-agency working group, with the aim to complete the work ahead of the January 2019 deadlines agreed with the FATF. The Law on Anti-Money Laundering came into effect on April 1 defining notaries as a new obliged entity and providing clear legal base for the STA to start inspection in two casinos. Targeted National Risk Assessment (NRA) was completed in June, with support from the World Bank. We are committed to implement all measures listed in the action plan to address the AML/CFT weaknesses identified by the FATF (**end-February 2019 reform target**). In this regard, competent institutions adopted relevant by-laws introducing significant improvements in accordance to FATF recommendations.

29. We will work on strategies for capital market deepening and development finance. Serbia's capital markets remain underdeveloped with limited stock-market activity, nascent domestic bond market volumes, and a virtually nonexistent corporate bond market. Alternative sources of financing such as private equity or venture capital, are negligible. With World Bank support, we will (i) develop an effective model for development finance; and (ii) undertake a diagnostic assessment focused on developing capital markets and diversifying sources of long-term financing. A working group will be created and a diagnostic report will be prepared with the support of the World Bank, with a view to inform the government's strategy to enhance capital markets.

E. Structural Policies

30. We will implement a comprehensive set of structural reforms to improve the business environment to support higher private sector-led growth. We focus on policies that improve the business environment and private investment climate, promote job creation, and complete the resolution of public and state-owned enterprises.

31. We are implementing measures to fight the grey economy. In December 2015, we adopted a National Program for Countering the Grey Economy and an Action Plan for the Implementation of the National Program for 2016-2017, which was updated in 2017 to cover 2018-19. Our priorities include improvements in the inspection system (better coordination and increased usage of IT systems), modernization of Tax Administration (risk based audits, trainings, reorganization, and better control of trading in excise goods), and strengthening of incentives for voluntary compliance. In this regard, we will amend the Law on Inspection Supervision (**end-September reform target**) and align all sectoral laws to permit supervision of unregistered activities. We will also improve coordination across inspections.

32. We will implement measures to further increase labor force participation:

- In June, we adopted the Law on Simplified Seasonal Employment in Specific Industries defining rights and obligations in the context of seasonal work and allowing simplified registration of seasonal workers.

- By end-2018, we will adopt the Law on Work Through Temporary Employment Agencies, which will contribute to improving labor conditions for agency employees working in beneficiary companies, eliminate unfair competition in this area, and increase employment.

- We have amended the Law on Financial Support for Families with Children to increase the bonuses for child birth aimed at raising fertility rates, completing the replacement of the previous entitlement to VAT reimbursement for baby food and equipment.

33. We are committed to continue restructuring large public utilities companies to enhance efficiency and contain fiscal costs. We are planning to fully implement the required corporate and financial restructuring in these companies over the medium term.

- **Elektroprivreda Srbije (EPS).** We have continued implementing the 2016–19 labor optimization plan. We have engaged the World Bank and the EBRD to support our plan to enhance corporate governance, management, and procurement and planning frameworks. We will complete a tariff review for 2018 by end-August with the assistance of the World Bank. In 2020, we will change the legal status of EPS to a joint stock company, in line with the ongoing corporate restructuring process and financial consolidation, aiming to improve the viability of the company and ensure its professional management.

- **Srbijagas.** Payment discipline has improved and an investment appraisal methodology proposed by the World Bank based on an economic and financial cost-benefit framework and including other relevant appraisal criteria, has been adopted in November 2017. We will adopt a capital expenditure plan in line with the new methodology by end-2018. These measures will help improve Srbijagas' financial position and put the company on a sustainable path. We will ensure phasing out Srbijagas' reliance on government support for servicing debt by the end of the program period.

34. We will make progress on the few strategic companies in the portfolio of the former Privatization Agency for which resolution is still pending:

- After the unsuccessful first tender to privatize MSK, we launched a second one in May and a third one, if necessary, will be launched by end-September.

- After failed attempts to find a strategic investor for Azotara by the end-March deadline stipulated in the government conclusion, the Ministry of Economy requested the State Attorney Office to initiate bankruptcy procedures (**prior action**).

- In July, we will launch the tender for a strategic partner for RTB Bor. Meanwhile, the company has been meeting all liabilities, including on taxes, wages, and electricity, as per the pre-pack agreement.

- Will launch the privatization tender for Petrohemija (**end-September reform target**).

- We will launch the privatization tender for PKB in July, with a view to finalize the process by end-2018.

- We are developing, with the assistance of the World Bank, an action plan for Resavica mines. By end-2018, we will (i) begin the closure procedures of two unviable mines; and (ii) update the closure timetables for at least two additional unviable mines, and (iii) develop a voluntary social program and labor optimization plans and ensure that sufficient resources are allocated in the 2019 budget.

35. We continue to resolve enterprises in the portfolio of the former Privatization Agency through either privatization or bankruptcy, in accordance with the revised Privatization Law. By April 2018, more than 300 companies entered bankruptcy, and more than 50 were privatized since end-2014. About 33,500 employees from around 320 companies have received severance payments. 114 companies with nearly 45,000 employees remain to be resolved.

36. We are working to improve the quality and transparency of our national statistics:

- We commit to comprehensive, timely, and automatic data sharing across relevant compiling agencies (including SORS and NBS) for statistical purposes (updating existing or signing new memorandum of understandings where necessary).

- In April 2018, we published the list of institutional units that are defined as part of the general government as well as other main sectors of the economy, in line with European System of Accounts (ESA) 2010 and GFSM 2014. By the end of the program, the Serbian Statistical Agency (SORS) will submit monthly GFSM 2014 fiscal accounts to the Enhanced General Data Dissemination System (eGDDS), covering the budgetary government and road funds.

- In June 2018, we subscribed to the IMF's eGDDS. We will continue to improve our data standards by publishing a 12-month ahead data release calendar for the Ministry of Finance by end-December 2018, to support our goal of achieving the top threshold of eGDDS by the end of the program period. In December 2018, we will also subscribe to the World Bank/IMF Public Sector Debt Statistics Database covering core debt of the budgetary central government. Public sector debt data will be transmitted quarterly for loans and debt securities covering budgetary central government units valued at face value.

- In conjunction with Eurostat and the IMF, we are working to upgrade our national accounts. In September 2018, we will release revised annual and quarterly GDP time series for the period 2015–17, with final revisions due in September 2019. We continue to develop and improve metadata to support compilation processes, in particular the informal economy, and will make new metadata available on the SORS website by December 2018. We are also developing supply and use tables (SUT) for 2015-17, to be disseminated by September 2019.

Program Monitoring

37. Progress in the implementation of the policies under this program will be monitored through quantitative targets (QTs) and indicative targets (ITs)—including an inflation consultation clause, continuous targets (CTs) and reform targets (RTs). These are detailed in Tables 1 and 2, with definitions provided in the attached Technical Memorandum of Understanding.

Table 1. Serbia: Quantitative Targets 1/

	2018				2019			
	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.
	Act.	Proj.	Prog. QT	IT 6/	Prog. QT	IT 6/	Proj.	Proj.
I. Quarterly Quantitative Targets (QT)/Indicative Targets (IT)								
1 Ceiling on the general government fiscal deficit 2/ 3/ (in billions of dinars)	-3.7	-22.8	-31.3	-27.3	11.8	2.5	7.5	24.1
2 Ceiling on current primary expenditure of the Serbian Republican Budget excluding capital expenditure and interest payments (in billions of dinars) 2/	198.8	428.1	648.7	921.3	234.1	484.8	726.4	1003.7
3 Ceiling on accumulation of domestic payment arrears by the consolidated general government except local governments, the Development Fund, and AOFI (in billions of dinars)	-0.2	…	0.0	0.0	0.0	0.0	0.0	0.0
II. Continuous Targets								
4 Ceiling on accumulation of external debt payment arrears by General Government, Development Fund, and AOFI (in billions of euros)	0.0	…	0.0	0.0	0.0	0.0	0.0	0.0
III. Inflation consultation band (quarterly) 4/								
Upper band limit (1.5 percent above center point)			3.0	3.4	4.1	3.9	4.4	4.2
End of period inflation, center point 5/	*1.4*	*1.6*	*1.5*	*1.9*	*2.6*	*2.4*	*2.9*	*2.7*
Lower band limit (1.5 percent below center point)			0.0	0.4	1.1	0.9	1.4	1.2

1/ As defined in the Program Statement and the Technical Memorandum of Understanding.
2/ Cumulative since the beginning of a calendar year.
3/ Refers to the fiscal balance on a cash basis, including the amortization of called guarantees.
4/ Staff level consultation is required upon breach of the band limits.
5/ Defined as the change over 12 months of the end-of-period consumer price index, as measured and published by the Serbian Statistics Office.
6/ Indicative targets are not monitored as part of the program conditionality.

Table 2. Serbia: Prior Actions and Reform Targets

Actions	Target Date	Status	Objective
Prior Actions			
Publish a public tender for external consultant to assist the implementation of the Tax Administration		Met	Advance reforms of the State Tax Administration.
Initiate bankruptcy procedures for Azotara.		Met	Reduce fiscal risks.
Reform Targets			
Fiscal			
Approve a government decree defining wage coefficients under the new Public Sector Employee Wage System for local governments, public services, public administration, and police.	End-September, 2018		Rationalize pay and improve incentives across public sector.
Submit to the National Assembly a draft Law on Charges.	End-October, 2018		Improve transparency and predictability, reduce parafiscal tax burden on businesses.
Issue a detailed rule book to the 2017 Capital Project Regulation, covering methodology for project appraisal and selection.	End-January, 2019		Unifies methodology for the project and cost-benefit analysis and raise transparency.
Establish Capital Investment Commission (CIC) and update Capital Project Regulation to (i) clarify roles of MoF, CIC, and Expert Commission, (ii) remove the exclusion of IPA-funded projects, and (iii) expand the coverage to government-to-government agreements.	End-April, 2019		Improve selection, appraisal, and implementation of public infrastructure projects.
Complete consolidation of core activities into fewer sites.	End-June, 2019		Advance reforms of the State Tax Administration.
Financial			
Approve a time-bound action plan to resolve part of the DIA portfolio of bad assets by end-2020 through a tendering process implemented in two phases (agreed with the World Bank); and complete	End-December, 2018		Resolve bad assets.
Approve an updated Dinarization Strategy in line with the IMF recommendations.	End-December, 2018		Strengthen financial stability and increase dinarization.
Submit to the National Assembly amendments to the Law on Public Debt with a view to update legal foundation of debt management.	End-December, 2018		Strengthen public debt management.
Implement items listed in Serbia's action plan to address the significant AML/CFT weaknesses identified by the FATF.	End-February, 2019		Remove Serbia from FATF listing and prevent pressures on capital inflows and correspondent banking relationships.
(i) Submit to the National Assembly amendments to the Law on Deposit Insurance Agency and the Law on Deposit Insurance to incorporate the findings of IADI assessment and update parametrization; and	End-June, 2019		Align deposit insurance scheme with international standards.
Launch a privatization tender for Komercijalna Banka.	End-June, 2019		Reduce state involvement in the financial sector and reduce fiscal risks.
Structural			
Adopt a government decision to launch a privatization tender for Petrohemija.	End-September, 2018		Reduce fiscal risks.
Approve amendments to the Law on Inspection Supervision.	End-September, 2018		Reduce gray economy.

Attachment I. 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 May 18, 2018, except as noted below.

A. Fiscal Conditionality

2. The general government fiscal deficit is defined as the difference between 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 (irrespective of the way they are recorded in the budget law) and total general government revenue (including grants). 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 financial transactions.

3. Current primary 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 takeovers if debt was previously guaranteed, and payment of arrears (irrespective of the way they are recorded in the budget law). It does not include capital spending and interest payments.

Adjustors

- The quarterly ceilings on **the general government fiscal deficit** will be adjusted downward (upward) to the extent that cumulative non-tax revenues of the General Government from dividends exceed (fall short of) programmed levels.

- The quarterly ceilings on **the general government fiscal deficit** will be adjusted downward to the extent that cumulative non-tax revenues of the General Government from debt recovery receipts, debt issuance premiums, and concession and Public Private Partnership (PPP) receipts recorded above-the-line exceed programmed levels. The IMF Statistics Department will determine the proper statistical treatment of any concession or PPP transaction signed during the IMF program.

Cumulative Programmed Revenues of the General Government from Dividends, Debt Recovery Receipts, and Debt Issuance at a Premium

(In billions of dinars)

	End-Sep. 2018	End-Dec. 2018	End-Mar. 2019	End-Jun. 2019	End-Sep. 2019	End-Dec. 2019
Programmed cumulative dividends	17.1	17.1	17.1	17.1	17.1	17.1
Programmed cumulative debt recovery receipts	0	0	0	0	0	0
Programmed cumulative debt issuance at a premium	0	0	0	0	0	0
Programmed concession and PPP receipts recorded above the line	0	0	0	0	0	0

- The quarterly ceilings on the **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 (the sale of buildings, land, and equipment) recorded as non-tax revenues exceed the programmed levels up to a cumulative annual amount of 2 billion dinars in each year. 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.

Cumulative Receipts from Earmarked Grants and Small-scale Asset Disposal
(In billions of dinars)

	End-Sep. 2018	End-Dec. 2018	End-Mar. 2019	End-Jun. 2019	End-Sep. 2019	End-Dec. 2019
Programmed cumulative ear-marked grants receipts	7.6	14.2	2.5	5.5	9.3	15.1
Programmed cumulative receipts from small-scale disposal of assets	0	0	0	0	0	0

4. 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 an indicative target on the change in total domestic arrears of (i) all consolidated general government entities as defined in ¶4 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.

5. Debt issued at a premium. For program purposes, debt issued at a premium refers to proceeds accruing to the government that are recorded as revenue when the government issues debt at a premium. It most commonly occurs when a bond with an above-market coupon is reopened ahead of a coupon payment.

B. Ceiling on External Debt Service Arrears

6. 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.[1] 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.

[1] Debt subject to rescheduling or restructuring includes the US$44.7 million in arrears to Libya.

7. Reporting. The accounting of external arrears by creditor (if any), with detailed explanations, will be transmitted on a monthly basis, within four weeks after the end of each month.

C. Inflation Consultation Mechanism

8. Inflation is defined as the change over 12 months of the end-of-period consumer price index (CPI), base index (2006=100), as measured and published by the Serbian Statistics Office (SORS). Where the official press release differs from the index calculation, the index calculation will be used.

9. Breaching the inflation consultation band limits (specified in Program Statement, 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.

D. Reporting

10. Net international reserves of the NBS will be submitted within one week of the end of the month.

11. General government revenue data and the Treasury cash position table will be submitted weekly; and the stock of spending arrears as defined in ¶6 45 days after the end of each quarter. General government comprehensive fiscal data (including social security funds) will be submitted by the 25th of each month.

12. The stock of spending arrears (> 60 days past due) as reported in the MOF e-invoice system will be submitted within 14 calendar days after the end of each month.

13. Gross issuance of new guarantees by the Republican budget for project and corporate restructuring loans will be submitted by the 25th of each month.

14. Cumulative below-the-line lending by the Republican budget will be submitted by the 25th of each month.

15. Borrowing by the Development Fund and AOFI will be submitted within four weeks of the end of each month.

16. New short-term external debt (maturities less than one year) contracted or guaranteed by the general government, the Development Fund, and AOFI will be submitted within four weeks of the end of each month.

17. Monthly average VAT refund time, stock of pending VAT refunds, and the value of the VAT refunds provided each month will be submitted by the Serbian Tax Administration within 14 calendar days after the end of each month.

18. Receivables of the top 20 debtors to Srbijagas and EPS will be submitted in the agreed-upon templates within 14 calendar days after the end of each month as well as published on the company websites.

Data Reporting for Quantitative Targets		
Reporting Agency	Type of Data	Timing
Statistical Office and NBS	CPI inflation	Within four weeks of the end of the month
Ministry of Finance	Fiscal deficit of the consolidated general government	Within 25 days of the end of the month
Ministry of Finance	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	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 general government (without local government, the Development Fund, and AOFI)	Within 45 days 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

Statement by Mr. Miroslaw Panek, Executive Director for Serbia, and Mr. Vuk Djokovic, Senior Advisor to the Executive Director
July 18, 2018

Serbia is requesting a 30-month Policy Coordination Instrument (PCI), and on behalf of Serbian authorities we would like to thank management and staff for supporting the request. The PCI is designed to help countries formulate and implement a macroeconomic policy program under close Fund monitoring, but without financing. Serbia strongly values the oversight, discipline and thoughtful advice that comes from a close engagement with the Fund. The engagement facilitates the achievement of the country's policy objectives, while signaling strong commitment. In that context, and given that at this juncture there is no need for Fund financing, our authorities consider that the PCI is a well-suited instrument to support Serbia's economic reforms.

Serbia has achieved much success in restoring macroeconomic stability under the recently completed three-year precautionary SBA. The Fund's support has been instrumental in achieving substantial fiscal adjustment, reverting the path of rising public debt and bringing debt to a more sustainable level, addressing vulnerabilities in the financial sector, and implementing structural reforms to buttress growth and employment. Strong performance under the SBA shows the strength of the authorities' ownership of the program, the traction that the Fund's advice has with policy makers, and is reflective of broad public support for prudent and necessary policies.

The proposed PCI-supported program builds on the strong reform momentum, and envisages the implementation of a critical set of policy reforms. With an overall goal to foster sound economic growth and employment, the program will concentrate on three key objectives: (i) to preserve hard-won fiscal gains and macroeconomic stability, (ii) to further strengthen resilience of the financial sector and (iii) to improve competitiveness.

Fiscal policy

Since 2015, Serbia has achieved a substantial fiscal adjustment of 6½ percent of GDP, placing public debt on a firm downward path. Strong fiscal performance continues in 2018, with an expected surplus of 0.6 percent of GDP at the end of the year, compared with the budgeted deficit of 0.7 percent. This improvement is the result of lower interest expenses, more realistic investment spending projections, and strong revenues. Public debt is in continuous decline since the 2015 peak; it will fall below 60 percent of GDP this year and decline to about 50 percent by 2021. Strengthened confidence, lower credit spreads, improved public debt management and a more favorable debt profile have led to a substantial decline in interest expenses—from 3.2 percent of GDP in 2015 to 2.2 percent in 2018. Over the same period, gross financing needs fell from 16.5 to 8.7 percent of GDP. The authorities agree with staff that over the program duration, fiscal policy should target a small deficit of about ½ percent of GDP. This will allow for the necessary fiscal space to support growth-oriented policies, including stepping up critical public infrastructure spending and incentivizing private sector investment and employment through tax policy measures.

The Serbian authorities are cognizant of the need to accelerate capital investment to lay the foundations for faster economic growth and income convergence. They are also aware that the sizable gap in the quantity and quality of infrastructure compared to peer countries is hindering investment and reducing growth potential. The authorities take a good note of the 2017 Article IV consultation finding that the execution of infrastructure projects already in the current pipeline would, in the long term, increase GDP per capita by close to 2 percentage points. The authorities agree that the increase in capital spending needs to be underpinned by a further strengthening of institutional frameworks for public investment management, to avoid delays and under-execution and improve investment efficiency. The public investment framework has been improved in 2017, by bringing all project loans into the budget, creating a single project pipeline and issuing the Capital Project Regulation to enhance project appraisal. The Planning System Law has been passed in early 2018. The law requires the preparation of a strategic National Development Plan to guide project planning. Under the program, the authorities will scale up infrastructure investment, review the PPP framework, and continue to strengthen investment planning and appraisal, guided by the PIMA findings and the recommendations of the recent PIM TA.

In the context of distributing fiscal policy gains to support growth and bolster private sector employment and investment, the authorities are weighing a number of tax policy options. These include reducing the labor tax wedge, reforming personal income tax to reduce the number of tax schedules and improve progressivity, reform the corporate income tax to increase depreciation rates and incentivize investment, and review presumptive taxation. Discussion with staff on appropriate tax policy measures to be implemented under the PCI will continue at the time of the first program review, and will be informed by FAD tax policy TA.

About a half of the hard-won fiscal gains were achieved by cutting primary current expenditures, and the authorities remain well aware of a need to carefully manage mandatory spending. They remain committed to keep public pensions and public wages constant as a share of GDP. The ongoing revision of the public wage system, and the planned changes of the public sector employment framework, will be helpful in that regard. To minimize fiscal risks going forward, the authorities plan to unwind the temporary cuts to higher income pensions that were made in the context of the 2015 fiscal consolidation.

The authorities remain committed to the modernization of the Serbian Tax Administration. They recognize the need for reforms to improve the efficiency of tax collection. The 2018-2023 Transformation Action Plan, developed with the support of FAD technical assistance, is aimed to guide, and provide additional impetus to, the reform process. Further strengthening of the PFM framework is ongoing, including gradually bringing most indirect budget users into the Information System for Budget Execution. The authorities, mindful of the staff's advice and in the context of the proposed PCI, believe that a major overhaul of the existing rules-based fiscal framework which, paired with the already operational Fiscal Council, will further strengthen the predictability and credibility of policy and ensure the sustainability of the fiscal position over the medium-term.

Monetary and exchange rate policy

The National Bank of Serbia (NBS) has lowered its reference rate in March and April consecutively, by a cumulative 50 bps, to 3 percent. At the same time, the NBS narrowed the interest rate corridor to +/- 1.25 percent. Headline inflation, which after undershooting in March and April returned to the inflation corridor, is projected to remain stable and within the target band. Core inflation remains low and stable at about 0.8 percent, indicating low inflationary pressures, while inflationary expectations of financial and corporate sectors remain well anchored within the corridor. The monetary policy stance remains accommodative. The NBS remains vigilant about global uncertainties, international financial and commodity market developments and risks of divergent monetary policies of major central banks. The achieved macroeconomic stabilization and reduced external and internal imbalances, paired with strengthened credibility of the central bank, are helping anchor expectations and facilitating the effectiveness of monetary policy.

Promoting the use of domestic currency remains a priority for the NBS. A reduction of euroization will reduce risks to financial sector stability and enhance monetary policy transmission. A range of measures has been implemented in the past to foster dinarization, including macro-prudential measures, tax incentives, development of dinar-denominated domestic sovereign market, extending sovereign bond maturities and building a dinar yield curve. Those efforts, paired with declining interest rate differentials and the relatively stable exchange rate, are delivering results. Deposit dinarization reached 30 percent in March, while about half of new loans to households in 2017 were dinar denominated. Under the PCI-supported program the authorities are preparing additional measures to further strengthen their dinarization strategy—including by institutionalizing communication and coordination between the NBS and Treasury, and strengthening the debt management framework. These efforts are informed by the findings and advice of recent Fund TA.

The Serbian authorities remain committed to the inflation targeting regime. The current level of international reserves is high by standard metrics. The central bank will maintain an adequate reserves level throughout the program. Further, given the high euroization of the economy, volatility of capital flows and financial stability concerns, the exchange rate regime continues to be a managed float, with foreign exchange interventions limited to smoothing excessive exchange rate volatility without targeting a specific level or path of the exchange rate.

Financial sector

The Serbian banking sector remains well capitalized, liquid, and profitable - the capital adequacy ratio stood at 22.7 percent at the end of the first quarter. Financial intermediation continues to improve. Provision of credit to the economy continues to grow, on the back of the strengthened banking sector balance sheets, improved credit conditions, accommodative monetary policy and increased confidence. NPLs continue to decline, driven by the implementation of comprehensive NPL Resolution Strategy. Gross NPLs fell to 9.2 percent of total loans from a peak of about 21 percent three years ago. The authorities have made noteworthy progress in implementing financial sector reforms to enhance resilience and stability. The regulatory and supervisory frameworks have been enhanced to comply with international standards, including via implementing the Basel III regulatory standards on capital, liquidity and risk management. The NBS is advancing the implementation of a risk-sensitive supervisory cycle and review of banks' recovery plans. The NBS has strengthened the framework for implementation of its macroprudential instruments, benefiting from Fund TA recommendations. Also, new macroprudential instruments are introduced as part of the implementation of Basel III. Further, the National Bank is continuing to upgrade its capacities for bank resolution. Under the program, the authorities aim to review the existing deposit insurance scheme, to align it better with international standards.

AML/CFT

Addressing the shortcomings identified in the 2016 MONEYVAL AML/CFT mutual evaluation report is of the outmost priority for the Serbian authorities. Serbia is committed to work with the FATF and MONEYVAL to strengthen the effectiveness of its AML/CFT regime and address any related technical deficiencies. An inter-agency working group was established to implement an action plan to accomplish these objectives, with the aim to complete its work before the January 2019 deadline. An overarching AML/CFT law has entered into force in April, strengthening the legal and institutional framework in line with international standards and best practices.

State-owned enterprises

Over the past years Serbia has made significant progress in implementing SOE reforms to improve their operational viability and contain fiscal risks, while substantially reducing state aid. At this point, the financial position of critical public network utilities, including Serbia Gas, the electricity generation company EPS, and Railways of Serbia has strengthened thanks to comprehensive financial and corporate restructuring, appropriate regulatory price adjustments, and enhanced revenue collection. Advances in improving their operational efficiency and reducing the number of employees are being made. Under the PCI-supported program, the authorities will continue to work decisively toward resolving most of the other big SOEs by privatization or bankruptcy, including Petrohemija, Azotara, MSK, and RTB Bor. The Fund's support remains instrumental in that regard.