**International Monetary Fund**

Republic of Serbia
and the IMF

**Press Release**:
IMF Executive Board Completes Second Review of Stand-By Arrangement with Serbia
October 23, 2015

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

October 6, 2015

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

# Appendix I. Letter of Intent

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

Belgrade, October 6, 2015

Dear Ms. Lagarde:

Our economic program, supported by the Stand-By Arrangement (SBA) approved by the IMF Executive Board on February 23, 2015, has been instrumental in reducing Serbia's long-standing internal and external economic imbalances and we remain fully committed to the policies envisaged in this program. The attached Memorandum of Economic and Financial Policies (MEFP) describes progress made so far and sets out the economic policies that the Government of the Republic of Serbia and the National Bank of Serbia (NBS) intend to implement under the SBA. Our program continues to be fully supported by all coalition partners in the government, indicating strong commitment to and ownership of envisaged policies.

Program performance has been good. All quantitative performance criteria (PCs) and indicative targets for end-June were met with a margin, and inflation was within the inner band of the inflation consultation clause. We have finalized the registry of public employees (end-June structural benchmark), except for the element of validation of SOE employment data. The National Assembly approved the changes to the Law on Payments in Commercial Transactions in July 2015 (end-June structural benchmark). The financial restructuring plan for Serbia railways (end-September structural benchmark) will be adopted by the Government Steering Committee in mid-October, with a slight delay due to the need for additional technical work. The special diagnostic studies of bank asset quality (SDS) (end-September structural benchmark) are expected to be completed by end-October, with a slight delay due to operational complexities. Adoption of the new Local Government Financing Law (end- September structural benchmark) is delayed due to the need for additional consultations; a draft is intended to be posted for public debate by end-October 2015 (new structural benchmark). Due to lack of availability of final data by the time of this review, we request waivers of applicability for the end-September 2015 PCs on (i) the net international reserves of the NBS, (ii) the general government fiscal deficit, (iii) the current primary expenditure of the Republican budget, (iv) issuance of new guarantees by the republican budget for project and corporate restructuring loans, and (v) contracting or guaranteeing of new short-term external debt by the general government, Development Fund and the Export Credit and Insurance Agency. We are confident that these PCs will be met, once data become available.

The policies under our program will continue to focus on reducing fiscal imbalances, pursuing a wide financial sector agenda, and implementing broad-based structural reforms. We will fine-tune our public communications to ensure that they are fully in line with the objectives of the program. In order to support our efforts to combat non-performing loans (NPLs), we specified additional structural benchmarks in this area for December 2015 and March 2016. We propose to make a minor revision to the inflation consultation clause for December 2015 to bring it in line with the NBS inflation tolerance band.

Given Serbia's comfortable international reserve position and continued access to external financing, we intend to treat the arrangement as precautionary. Therefore, we would not make the purchases when they become available upon completion of reviews. The implementation of our program will continue to be monitored through quantitative performance criteria, indicative targets, structural benchmarks, and an inflation consultation clause, as described in the attached MEFP and Technical Memorandum of Understanding (TMU).

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

We wish to make this letter available to the public, along with the attached MEFP and TMU, as well as the IMF staff report on the second review of the SBA. We therefore authorize their publication and posting on the IMF website, subject to Executive Board approval. These documents will also be posted on the official website of the Serbian government.

Sincerely,

/s/
Aleksandar Vučić
Prime Minister

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

/s/
Dušan Vujović
Minister of Finance

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

# Attachment I. Memorandum of Economic and Financial Policies

**1.** This memorandum sets out our economic program for 2015–17. The program aims to establish a foundation for healthy economic growth by addressing short-term as well as medium-term economic challenges that Serbia is facing. To this end, the program focuses on policies to ensure macroeconomic stability, most notably by restoring fiscal sustainability, bolster resilience of the financial sector, and improve competitiveness of the economy.

**2.** Significant progress has been made since the economic program started. Bold fiscal consolidation, which started in late 2014, is beginning to bear fruit, reforms in the financial sector are progressing as planned, and the initiation of comprehensive restructuring in the state-owned enterprises is starting to yield positive impacts on their efficiency and financial discipline.

**3.** The goals of the economic program are compatible with our aspirations to become an EU member, having started the accession process in January 2014. Implementing this program will allow Serbia to realize the significant potential for convergence towards EU income levels.

## Recent Economic Developments and Outlook

**4. The Serbian economy is emerging from the recession last year.** The recovery that started in 2014:Q4 continues, notwithstanding significant fiscal tightening. The somewhat better economic activity than projected earlier reflects the effects of lower oil prices and stronger private sector wages on domestic demand, and more favorable external environment. Despite the gradual monetary policy easing, headline CPI inflation has remained below the NBS inflation tolerance band most of the time since late 2013, mainly on account of weak demand, low prices of primary commodities (particularly energy prices) and delay in administered price adjustments. Inflation is expected to approach the lower bound of the tolerance band in December and reach the target by the end of 2016. The current account deficit declined with the recovery of exports to the level covered by FDI, and capital inflows increased amid ECB quantitative easing and improved risk premia for government debt.

**5. We will continue to consistently implement policy actions and reforms envisaged under our economic program.** We expect that this will give rise to a virtuous cycle of boosting confidence, improving growth and private sector vibrancy. Reflecting the recent developments, we envisage the following revisions to the macroeconomic scenario under the program:

- **Real GDP** is expected to grow at ½ percent in 2015, compared to zero growth projected previously. Despite sizeable fiscal consolidation, the decline of domestic demand is limited, and offset by stronger external demand. Growth will gradually accelerate over the medium term on account of smaller fiscal adjustment, recovering market confidence and credit growth, and positive effects of structural reforms.
- **Headline CPI inflation** is projected to remain below the inflation target of 4 percent through 2015, and annual average inflation is revised down to 1.6 percent, reflecting

price developments so far this year amid lower oil prices and favorable fruit and vegetable prices. In the medium term, inflation is expected to stay within the inflation tolerance band (4±1½ percent), supported by the inflation targeting regime.

- **The current account deficit** is expected to decline to 4 percent of GDP this year and remain broadly around this level over the medium term. External financing will rely mostly on FDI, but also on eurobond issuance, and bilateral and project loans.

6. **The program scenario continues to face downside exogenous risks, but the Serbian economy has considerable buffers to withstand them.** A resurgence of Greece-related turbulence could expose Serbia to spillovers through a confidence channel (Greek bank subsidiaries account for 13 percent of banking system assets) and an indirect real channel (slow growth in trading partners). However, as the first line of defense, Serbia has large foreign exchange reserves and a well-capitalized and liquid banking system. The Fund arrangement provides an additional buffer to help us cope with negative shocks, and we are prepared to further adjust policies as necessary.

## Economic Policies

### A. Fiscal Policies

7. **We remain committed to implementing a set of fiscal consolidation policies that will reverse the rise in public debt by 2017 and put it firmly on a downward path thereafter.** We believe that a credible three-year adjustment requires significant frontloading. To this end, we are implementing a structural fiscal adjustment of over 4 percent of GDP during 2015–17, about half of which is being achieved this year. The measures focus primarily on containing public expenditures, namely on scaling down public sector wage and pension bills towards our medium-term objectives of 7 and 11 percent of GDP, respectively, and reducing state aid to state-owned enterprises (SOEs).

8. **The fiscal outturn in the first half of 2015 was well within the program targets.** The general government fiscal deficit amounted to RSD 35.3 billion, well below the adjusted program target of RSD 90.8 billion, owing to both conservative projections and improved revenue collection (about 85 percent) and the under-execution of expenditure (15 percent). While current expenditures are broadly in line with the budget, we recognize that persistent under-execution of capital expenditure will be detrimental to Serbia's long-run potential growth. With support from USAID, we are working on new regulations and guidelines for public investment management. In particular, we will adopt a set of by-laws aimed at strengthening the project appraisal process by end-December 2015 (structural benchmark). Current expenditure measures effective since 2014—wage and pension cuts and the 5:1 attrition rule for general government permanent employees—have been implemented as committed, and the current primary expenditure of the Republican budget amounted to RSD 405.2 billion, below the adjusted program target of RSD 421.2 billion. We will tighten the fiscal deficit target for

2015, reflecting developments so far while keeping a reasonable fiscal buffer, to ensure that the improved revenue performance is assigned to our priority of reducing debt.

**9. We remain committed to the expenditure measures introduced so far, but will consider using part of the one-off fiscal windfall in 2015 to cover one-off expenses.** While revenues are over-performing earlier projections, the government has been implementing the measures as envisaged in the 2015 budget, with a view to reducing the general government deficit (quantitative performance criterion) to about 4.0 percent of GDP this year, below the original target of 5.9 percent of GDP:

- We have suspended the indexation of public sector wages and pensions, according to the Budget System Law and Pension Insurance Law modified in December 2014.
- We amended the Procurement Law in early February 2015 to lower the mark up on public procurement from domestic suppliers from 15 percent to 5 percent in 2015, and eventually plan to eliminate it by 2018. This has supported the savings in goods and service expenditures envisaged in the 2015 budget. This will also help reduce the cost of capital spending.
- We eliminated agricultural subsidies for land over 20 hectares and for land leased from the Government of Serbia. We modified the Law on Agriculture accordingly in December 2014.
- We reduced state aid to SOEs, including subsidies, net lending, and payments from the budget for guaranteed and nonguaranteed debt of the SOEs, and will continue to do so during the program period. We adjusted network fees on natural gas distributed by Srbijagas to generate €60 million on an annual basis, effective from February 1, 2015, until the government finds alternative measures with the same revenue effects, in consultation with the IMF staff. This additional revenue will enable Srbijagas to pay a part of its debt obligations, and will correspondingly reduce the payments of its called guarantees from the budget.
- Railways of Serbia are implementing cost saving measures in line with the reduced subsidies and payments for the electricity bills this year.
- The Law on Excises was amended in June 2015 to introduce an electricity excise of 7.5 percent on total electricity charge (excluding VAT) effective from August 1, 2015 in order to reduce inefficiency of consumption.
- We reduced budget allocations for subsidies to public broadcasting companies in 2015 and will eliminate them in 2016.
- We have introduced an excise tax on electronic cigarettes.

- To ensure proper protection of the vulnerable segments of the population, the existing social safety net will be maintained.

- We have received one-off dividend receipts from SOEs of RSD 22 billion in 2015. We will consider using some of this for certain one-off expenses that would be agreed with IMF staff in the context of the third review, without any implications for future spending. If necessary, in the third review, we will add adjustors to expenditure and deficit performance criteria for end-December 2015 to cover these expenses.

**10. We are progressing in reforms of the general government employment and wage system in 2015.** We recognize that employment reduction and the wage system reform will be key for achieving savings envisaged in the 2015 budget and beyond. The preparation of these reforms is being supported by the World Bank.

- To strengthen the control of the public sector wage bill, we created a task force in early June 2015, consisting of representatives from the Ministry of Public Administration and Local Self-Government, MOF, and other relevant institutions to improve the coverage and reliability of the public sector employee registry. We adopted the Law on Registry on July 31 setting out the necessary data submissions and all responsible agencies. We have adopted a legal framework necessary to ensure full coverage of public sector employees. We finalized and validated the general government employment and wage data in the registry in July (end-June structural benchmark). The registry also includes employment and wage data for key SOEs, but not separately validated. These will be addressed in individual restructuring plans for major SOEs (¶¶ 35).

- We will continue applying the attrition rule throughout 2015, and based on the Law on the Ceiling on Public Sector Employees approved on July 31, we will finalize the first round of targeted separations by end November 2015. In the first half of 2015, general government permanent employment was reduced by about 3,000 via attrition, which is expected to continue in the second half. With about 5,000 more early retirements than usual bunched at end-2014 due to the introduction of an early retirement penalty in January 2015, targeted separations of 9,000 in the second half will be consistent with the budgeted savings in the annual wage bill—equivalent to the reduction of general government employment by 5 percent. The Law on Ceilings on the Number of Employees adopted in July laid the legal basis for an annual capping (2015–18) of the number of employees in individual institutions, in line with expected advancements in their productivity to be accomplished through reorganization. Severance payments for both targeted and voluntary separations have been determined in line with the current Civil Service Law and Labor Law.

- We have initiated a comprehensive public wage system reform intended to improve transparency, efficiency and manageability of the currently unwieldy system. A job catalogue reducing the number of jobs and titles from several thousand to around 500 for all state employees other than the Armed forces was completed by end-September, with the mapping of jobs reflected in the Registry by end-November. This will make it possible to compare the current remuneration of state employees across general government sector entities. An umbrella Law on Wages of State Employees establishing the key principles of the new system and setting out a timeline for its gradual adoption will be posted to public debate by mid-October with the intention for the Law to be effective from January 1, 2016. The base for all wages will be unified and the structure of coefficients and elements of pay will be partly simplified by year-end. By April 2016, we will adopt separate wage laws and other necessary legislation for large sectors of the general government, which will operationalize transition to the new job classification, unification of pay grades across comparable jobs and alignment of base wages beginning by June 2016. The timeframe and modalities for the full transition to the new system will be determined in the course of 2016. Any wage increases proposed for 2016 would be targeted to sectors with the largest wage gaps, such as medical staff in the health sector and teaching staff in the primary and secondary education.

**11. For 2016-17 our primary focus remains the continued reduction of mandatory expenditures through the following measures**:

- We will continue reducing the cost and increasing the efficiency of the general government, through its organizational and functional restructuring, in accordance with the Public Administration Reform Strategy, adopted by the government in January 2014. As a first step, we conducted in April a benchmark review of the public administration system based on relevant comparative countries, which suggests that the health, local government, police, judiciary and compulsory social insurance organizations have the highest potential for efficiency gains and employment reduction. Most of these will then undergo in-depth functional reviews, producing estimates of additional savings to be attained through restructuring by end-December 2015. We are thus committed to attaining a further reduction of the general government wage bill by 5 percent in both 2016 and 2017 (excluding the impact of severance payments and any wage increases agreed as per para 12). This can be achieved via wage reductions and reductions of other labor-associated costs budgeted in goods in services. Throughout 2015, we will also advance the data and legal infrastructure necessary to accomplish additional savings in 2016 and 2017 by introducing e-government.

- The National Assembly will adopt the new Local Government Financing Law, which will rationalize transfers and the revenue-sharing mechanism to local governments and provide incentives to raise their own revenues (end-September structural benchmark). Given the complexity of aligning numerous stakeholders and conducting public debate, we need to further extend the timeframe for finalization of the law. As a new structural benchmark, we will post the draft law for public debate by end-October. Partial adjustment of transfers will be implemented from January 1, 2016, in line with expected savings from targeted rightsizing at the local levels, and full implementation of the new law will start from January 1, 2017.

**12. We intend to explore the possibility of using a small part of the structural revenue gains in 2015 to relax expenditures in 2016**. The total envelope for additional spending will be confirmed in the 2016 budget in consultation with Fund staff, after further careful analysis of a few more months of revenue data. Possible areas for increased expenditures include targeted wage increases consistent with convergence under the wage system reform, a one-off pension increase, a subsidized SME lending program, and high-priority public investment. Any additional spending would remain consistent with our goals for debt reduction and for reducing wage and pension expenditures as a share of GDP.

**13. We will aim to reduce fiscal risks and will prepare contingency measures as needed.** In this regard, we will not rely on short-term external debt financing (quantitative performance criterion), and we will not accumulate public sector external debt payment arrears (continuous performance criterion). We will also refrain from accumulating domestic payment arrears (indicative target). Our efforts to reduce public spending will continue being monitored through a ceiling on the current primary expenditure, excluding capital spending and interest payments, of the Serbian Republican budget (quantitative performance criterion). If revenues are reduced due to an exogenous shock, we will consider contingency measures, such as raising the VAT rate and gasoline excise tax.

## B. Structural Fiscal Policies

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

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

- We will review and clearly define the coverage of general government to be compatible with European System of Accounts (ESA) 2010. We will submit financial plans of social security funds with all their indirect beneficiaries to the National Assembly, in parallel with Republican budget. We will include all indirect budget beneficiaries of the central government in the Financial Management Information System gradually by end-2017. More specifically, we will include courts, public prosecutors and other judicial institutions by end 2015. Prisons, cultural institutions and social protection institution will be included by end 2016. Education and local governments will be included by end 2017, taking into account their technical and technological capacity. This will accommodate more realistic planning of indirect budget beneficiaries' revenues and expenditure in the central government budget.

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

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

- We re-established the Liquidity Committee in March 2015, to strengthen cash management of the government. The Committee includes representatives of the MOF (the Treasury, Tax Administration, Public Debt Administration, Budget Preparation Department and, Macro-Fiscal Analysis and Projections Department) and the NBS.

- We will 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. We will also include a fiscal risk statement on all PPPs in the Medium-Term Fiscal Strategy from the 2016 budget onwards. In this regard, we set up a special fiscal risks management unit at the MOF in March 2015, supported by the World Bank. Further technical assistance for analytical capacity building will be provided by IMF. Furthermore, to improve control of fiscal implications and risks, we will amend the existing Law on Public-Private Partnership and Concessions by September 2015 to mandate that all PPPs are submitted to the government for consideration only with prior approval of the MOF.

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

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

- We are creating a strong and stable institutional framework for monitoring SOEs. As a first step, we adopted a government decree that regulates the roles and responsibilities of the MOF, Ministry of Economy (MOE), and line ministries with respect to monitoring, supporting best governance practices, financial reporting, and transparency of SOEs, in April 2015 (end-March structural benchmark). We started quarterly provision of financial statements of SOEs to both the MOE and MOF from 2015:Q1. We will continue to strengthen the SOE monitoring unit in the MOE, which will, in collaboration with the relevant line ministries, focus on corporate strategy and governance, and operational efficiency of SOEs. In agreement with the MOE, the SOE financial monitoring function has been created in the fiscal risks management unit in the MOF (see also ¶14), which focuses on reviewing and compiling the financial reports and statements of SOEs and evaluate the fiscal implications.

- To enhance the payment discipline between public sector entities, we broadened the scope of the Law on Payments in Commercial Transactions, to include transactions between public entities (including SOEs) in July 2015 (end-June structural benchmark). This law defines monitoring and enforcement mechanisms for improving payment discipline in the public sector, to be implemented from January 2016, including the conditions under which transfers from the budget can be reduced and administrative penalties for responsible individuals applied. Between the adoption and the implementation of the Law, the MOF will raise awareness and publicly promote the importance of the Law urging all budget users to respect the payment obligations, especially to SOEs, including the utility companies.

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

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

**16. In order to raise the efficiency of revenue collection, we are committed to improving tax administration based on recommendations of the September 2014 IMF technical assistance mission.** We confirmed the Director of Serbia's Tax Administration in June 2015. We adopted in early June, and have started to implement, the *Tax Administration Transformation Program 2015–20* as the official medium-term reform program (prior action for the completion of the first review). Our priorities are to (i) strengthen the Tax Administration's governance, (ii) streamline organizational structures of headquarters and field offices, including by reallocating employees to facilitate compliance efforts, (iii) phase in a modern compliance risk management approach, (iv) strengthen arrears management, including write-off procedures, (v) modernize information technology systems and business processes, and (vii) improve coordination and information exchange with other government agencies. We are acutely aware of the need to recruit and train new staff (for example, in the Large Taxpayer Office) and will finalize a staff recruitment and retention plan which will be approved by government by end-March 2016, with overall staffing remaining consistent with the public sector right-sizing objectives.

## C. Monetary and Exchange Rate Policies

**17. We see the current inflation targeting framework as the most viable option for maintaining stable inflation and protecting the economy against external shocks.** We remain committed to the objective of keeping inflation within the inflation tolerance band (4±1½ percent). Inflation developments will be monitored via a consultation clause with consultation bands set under the original program, although we propose to make a minor revision of the inflation consultation clause for December 2015 to bring it in line with the NBS inflation tolerance band (Table 1). As the fiscal adjustment takes hold and external financing conditions stabilize, we have reduced the policy rate, in line with the inflation outlook and financial stability. Further easing, however, will be gradual and will depend on macroeconomic environment, including external financing conditions.

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

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

**20.** During the period of the SBA 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

**21. Our policies will support financial sector stability and enhance the banking sector's ability to cope with shocks, while improving financial intermediation.** Priority will be given to: (i) addressing the overhang of nonperforming loans (NPLs); (ii) assessing asset quality and provisioning practices via special diagnostic studies (SDS); (iii) strengthening the supervisory and regulatory framework in line with EU standards; (iv) operationalizing the new bank resolution framework; and (v) implementing the strategy for state-owned banks.

**22. We finalized our comprehensive strategy for addressing the NPL overhang.** The strategy, published on August 13, 2015, was prepared by an inter-institutional Working Group that included representatives from the Ministries of Finance, Economy and Justice, the NBS and Deposit Insurance Agency (DIA), with staff of the IMF, IFC, WB, and EBRD participating as observers. By the end of December 2015, we will, among others (i) submit amendments to tax legislation to the National Assembly to remove disincentives for timely NPL resolution; (ii) introduce a new legal and operational framework for transparent real estate appraisals and improved regulation of the appraisal profession; and (iii) prepare amendments to the Bankruptcy Law that, in line with recommendations from IMF technical assistance, strengthen safeguards for secured creditors and allow for better value maximization and more predictable and swift disposal of assets where assets are not strictly necessary for rehabilitation (all structural benchmarks). In addition, the NBS will prepare more granular NPL reporting requirements for banks, together with enhanced supervisory standards for restructured receivables and distressed asset management by end-March 2016 (structural benchmark). While we remain committed to removing potential impediments to, and providing incentives for, timely NPL resolution, we will continue to focus on market-based solutions.

**23. We have largely completed the detailed assessment of asset quality and provisioning practices of banks operating in Serbia** In order to assure quality of the exercise, and in view of operational complexities, the original timeframe for the SDS has been slightly extended. Banks whose SDS-adjusted capital ratios fall short of the applicable regulatory minimum are expected to provide, within two weeks of the presentation of the results of the exercise, remedial actions for addressing such shortfalls in line with SDS Terms of Reference. We expect banks to have implemented such actions by end-March 2016 or in exceptional circumstances by end-June 2016 (conditional on prior approval of IMF and NBS) and will closely monitor progress. To maintain a conservative application of International Financial Reporting Standards (IFRS) following the SDS, the NBS will prepare, by end-December 2015, supervisory guidance for loan loss provisioning under IAS 39, in consultation with IMF staff and relevant domestic stakeholders (structural benchmark). In parallel, the NBS will embed methodological aspects of the SDS in its supervisory procedures and strengthen its analytical capacity in the area of IFRS.

**24. We will enhance the microprudential supervisory and regulatory framework.** Effects to strengthen financial sector supervision continue apace. Preparations for the implementation of the Basel III framework are progressing, aided by a gap analysis that compared the current regulatory framework to the new Basel standards, as well as quantitative impact studies on capital, risk weighted assets, leverage and liquidity. The NBS has finalized plans for strengthening its prudential oversight over the insurance sector, benefiting from IMF technical assistance, and will prepare proposals for strengthening its practices for banking supervision. As part of the latter, the NBS will introduce a more risk-sensitive supervisory cycle that will help increase the intensity of supervision for systemically important banks and institutions with the highest risk rating. To ensure sufficient resources are available to carry out its duties, the NBS will continue to hire additional staff. Finally, the preparation of contingency measures for banks whose viability is at risk will help to buttress financial stability.

**25. The NBS continues to develop its macroprudential policy framework.** Systemically important banks have been identified using the internally developed methodological framework, based on the final EBA Guidelines. A proposal for the determination of capital surcharges for such institutions has been prepared. The necessary regulatory amendments for the introduction of other macroprudential instruments will be adopted in accordance with the transposition of the Basel III framework. Our aim is to use the new regulatory opportunities to maintain and strengthen financial stability without losing current advantages in terms of the banking sector high capital and liquidity position.

**26. The NBS continues to implement the amended bank resolution framework and financial sector safety net.** The new Bank Resolution Department is operational and information- and data-sharing arrangements with other NBS functions, as well as the DIA, are in place. Banks have submitted their initial recovery plans, and a decision on reporting for resolution planning purposes has been adopted by the NBS' Executive Board, following a public consultation process. Resolution plans for systemically important banks are expected to be available by end-December 2015. In addition, the NBS has updated its policy framework for Emergency Liquidity Assistance.

**27. Implementation of the strategy for state-owned banks is progressing.** We are strengthening our oversight over financial institutions that are, in whole or in part, state-owned. We will reorient the business strategy of Banka Postanska Stedionica towards retail activities, for which a new business plan will be adopted by the Government (structural benchmark). In parallel, we will identify measures to strengthen the bank's risk control framework, in line with international best practices. The privatization advisor for Komercijalna Banka, the second-largest bank, has been appointed and the privatization process for Dunav Osiguranje, Serbia's largest insurance company, will be initiated once the privatization advisor has been selected. Decisions on the course of action for the remaining small state-owned banks will be taken by December 2015, as part of the update of the strategy for state-owned banks.

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

**29. We will support credit to SMEs.** Given the importance of SMEs for Serbia's economy and the limited access to credit by this sector, we will support lending to SMEs through EIB's credit lines ("Apex loans"). To improve Apex program efficiency, the Ministry of Economy has prepared guidance – developed in accordance with EIB criteria – regarding prioritization of loan allocations. Beginning from the October 2015 tranche, financing proposals in line with this guidance will be submitted for EIB's approval without pre-approval by Steering Committee. Instead, the Committee will perform ex-post review of loan utilization. We intend to prepare a detailed analysis of past subsidized lending programs, with a view towards assessing their effectiveness and additionality in consideration of a potential reintroduction (subject to the availability of fiscal space) in 2016.

## E. Structural Policies

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

**31. Job creation is a central element of our economic policies.** In 2014, we made legislative changes to support labor market flexibility and job creation, including amendments to the Labor Law in July and adoption of National Employment Action Plan for 2015 (NEAP 2015) in October. We also aligned public sector collective agreements and a decision on social programs for redundant employees in SOEs for 2015 with the new Labor Law. Many of the programs under NEAP 2015 and 2016 will continue to be developed in close consultation with the World Bank and EU partners. To support implementation of NEAP, we amended the Law on Employment in April 2015, which better aligns the disbursement of social benefits for the unemployed with specific training programs. Further, with the aim of improving the social dialogue, we conducted an analysis of the Labor Law and other regulations, and decided to legislate a new Law on Social Partnership and Collective Bargaining in 2016.

**32. We have initiated wide-ranging reforms of socially-owned and state-owned enterprises to improve their operational viability and limit fiscal risks.** A clear priority is to significantly reduce state aid to SOEs through (i) curtailed direct or indirect subsidies, (ii) limited issuance of new guarantees, and (iii) enhanced accountability, transparency and monitoring of these enterprises. To this end, we started implementing strategies for two broad categories of state-owned companies. First, we are addressing companies in the portfolio of the Privatization Agency, a large number of which were protected under a bankruptcy moratorium until end-May 2015. For a small group of 17 companies the moratorium was extended for up to one year in late May. We are committed to resolve at least 7 of these through either privatization or bankruptcy by end-2015 (structural benchmark), with the rest to be resolved by the end-May 2016 deadline. The second group includes other large SOEs including the electricity, gas, railways, and road companies. The reforms of the socially-owned and state-owned enterprises are supported by the World Bank and EBRD.

**33. We started the resolution of over 500 enterprises in the portfolio of the Privatization Agency through either privatization or bankruptcy, in accordance with the recently revised Privatization Law.** Since August 2014, we have collected letters of interest for these companies, and we have adopted an action plan for bankruptcy procedures for 188 companies in early February 2015. As of end-August, the court has opened bankruptcy proceedings for 133 companies with little privatization prospects, and initiated the public tenders for privatization of 98 companies. We intend to finish the bankruptcy process of about an additional 40 companies by end-2015, and privatization procedures for an additional 40 companies under restructuring by end-October 2015, through either bankruptcy or privatization. Adequate resources for social benefits for the redundant workers are provided in the 2015 budget and are being disbursed to the eligible recipients. These benefits are consistent with severance payments in the Labor Law.

**34. We aim to privatize or find strategic partners for a number of SOEs and concession projects.** We will use the proceeds primarily for reducing the stock of public debt but possibly also for funding future financially viable and high return investment projects. The size of investment funding will be determined in consultation with IMF staff. To support the operation of the telecommunication sector on a strictly market basis, we have launched an invitation for non obligatory offers for the privatization of Telekom Serbia in July 2015, and we are in the process of evaluating the offers. We also selected a privatization advisor for Komercijalna Bank, the second largest bank in Serbia, with a view to completing the privatization in 2017. We entered a management contract for Železara Smederevo, a steel producer, with HPK engineering, a Netherlands-based company in March 2015. This has ensured the operation of the steel company without state aid this year—including budget subsidies, government guarantees, lending from the budget or any other forms of public support—and without further accumulation of arrears. Going forward, we will continue preparations for privatization of the company complying with the EU requirements. At the same time, we have hired advisors to explore long-term concession partnerships for managing the Belgrade airport and continue to explore options for operating Corridor XI.

**35. We are committed to continue restructuring the large SOEs to contain the additional fiscal costs that would arise without a change in policies.** We will also ensure adequate service provision. In particular, we have focused on the electricity, gas, railways, and road companies which are among the largest public enterprises. To implement the needed corporate and financial restructuring in each of these companies over the medium term, we have taken the following steps:

- **Elektroprivreda Srbije (EPS).** In July 2015, a new organizational structure consisting of subsidiaries for electricity generation, distribution and supply, as specified in the corporate restructuring plan adopted in November 2014, became effective. This aims to streamline the organizational structure and management as a first step to enable a financially self-sustaining EPS in the future, thus avoiding the need for state aid. In consultation with the World Bank and EBRD, we adopted the financial restructuring plan for EPS in early June 2015. The plan includes: (1) increases in revenues through enhanced bill collections, reduced technical and commercial losses, and a regulated tariff increase of 4.5 percent from August 1, 2015, and (ii) a reduction of operational cost including through increased efficiency, optimization of the supply mix, and staff rightsizing. Achieving EPS financial sustainability will require the implementation of this full package of measures. We established an inter-ministerial working group to identify bottlenecks arising during implementation and take corrective action requiring concerted Government efforts. As a first tangible step in the implementation of the plan, the tariff increase and a new excise tax on electricity became effective from August 1, resulting in a total price increase of 12 percent for the consumers in the regulated market. Additional tariff adjustments will follow in 2016 and 2017 as needed to allow electricity prices to further converge to the market levels to facilitate the transition to a competitive market, in accordance with the Energy Law. By end-2015, we will finalize the amendment to the collective agreement in order to allow for the implementation of the rightsizing identified in the restructuring plans, in consultation with the World Bank (structural benchmark). We will fully implement the new management structure specified in the corporate restructuring plan adopted in November 2014 by eliminating one layer of management in all three lines of business (generation, mining and distribution) by the end of 2015. Following the ongoing corporate restructuring process and financial consolidation, we will change the legal status of EPS to a joint stock company by July 1, 2016, with an aim to attract minority private investment participation that could further enhance the corporate governance and viability of the company and ensure its professional management. These and other measures set out in the plan will continue to be implemented through 2016–2017.

- **Srbijagas.** A new organizational structure consisting of subsidiaries for transmission and distribution, following the corporate restructuring plan adopted by government in December 2014, became effective in August 2015. In line with the fiscal program, we have divested part of Srbijgas' non-core assets and continue pursuing a permanent resolution for the companies which were a major source of arrears in the past: Azotara, MSK, and Petrohemija. These companies have been operating without state aid or further accumulation of arrears this year, and the government is fully committed to no state aid to those companies going forward. More generally, payment discipline of Srbijagas' clients has improved. We hired an independent consultant to develop a financial restructuring plan based on improving collection, increasing the transit and network fees, addressing the large stock of historical debts, and improving the corporate governance and viability of the company. The plan will be adopted by end-January 2016 (structural benchmark moved from end-October), with delay due to the need to prepare a more comprehensive restructuring plan. The terms of reference for the financial restructuring plan have been prepared. These measures will ensure that Srbijagas' financial position does not deteriorate further, and put the company on a sustainable path, thus containing the need for additional state aid in line with the fiscal program.

- **Railways of Serbia**. We established a Railway Reform Steering Committee, led by the Deputy Prime Minister and including senior representatives from relevant Ministries and entities, IFIs, and EU, to provide overall direction of the reforms. The unbundling of the company into separate passenger, freight, infrastructure, and a fourth company was approved by the Railway Assembly and the government in May 2015, and became effective from July 2, 2015. In consultation with the World Bank, Railways has identified and is implementing measures to generate savings to compensate for the reduction of subsidies (€15 million) and servicing of electricity bills. The corporate restructuring plan will be centered on asset disposal, network re-optimization, and staff rationalization. Importantly, the freight section will receive no further subsidies and will operate on a purely commercial basis from January 2018. The freight section will make its best efforts to avoid state subsidies even before the mentioned date. To support market competition, an infrastructure usage fee will be introduced by end-December 2015. We will also continue the reorganization and improvement of business plans for the state-owned passenger and infrastructure companies and the fourth company, to strictly limit the amount of state aid disbursed over the medium term. We are cooperating closely with the World Bank, EBRD and EU in determining the optimal corporate and financial restructuring plans, with the help of independent consultants, who started the consultancy in early May on the Project of reform of railways. These plans will be adopted with a slight delay by the Government Steering Committee by mid-October 2015, due to the need for additional discussion with IFIs (end-September structural benchmark). The restructuring targets in the plans, including redundancy programs during 2016, 2017, and 2018-2020, will be set in agreement with the World Bank and IMF staff. We will start implementation of labor retrenchment immediately after adoption of these plans by the Government Steering Committee.

- **Roads of Serbia.** We will take action on the revenue side by revisiting the adequacy of toll rates and on the expenditure side by adopting a plan for removing rigidities in pricing maintenance contracts in the second half of 2016 and implementing it for 1,000 km. The savings should result in lower budget support in the future. We will also explore concession options for the construction and maintenance of Corridor XI. The corporate and financial restructuring plans for Roads of Serbia will be developed during 2016 in close consultation with the World Bank.

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

- The Law on Planning and Construction, with the goal of significantly speeding up the issuance of construction permits, was adopted in December 2014, and a unified procedure is applicable since March 1, 2015. We also adopted the Law on Conversion for a Fee of the Right of Use of Construction Land into Ownership in July 2015 and will adopt amendments to the Law on State Survey and Cadastre by end-2015. Since these legislative changes, the issuance of the construction permits has been expedited significantly and we are preparing for the full implementation of the electronic permit issuance starting from 2016.

- To enhance predictability and reduce corruption and the grey economy, we adopted a new Law on Inspection Oversight in April 2015, and improved labor inspection has already started contributing to the reduction of informal jobs and increases in social contribution collections.

- We will adopt a new Investment Law in September2015, which will replace and broaden the scope of the Foreign Investment Law to include domestic investment. We have initiated reform and consolidation of our investment and export promotion agencies and programs. With the adoption of the new Investment Law, we will establish new Serbian Development Agency, by merging the Serbia Investment and Export Promotion Agency (SIEPA) and National Agency for Regional Development (NARD), integrating and streamlining their operations. The new Law will also put in place a clearer legislative framework for administering investment incentives. By the end of the year, we also plan to reform the Development Fund, and the Serbian Export Credit and Insurance Agency (AOFI). These agencies will be either reorganized or replaced with new institutions performing similar functions in a more efficient manner.

- We will amend the Law on Consensual Financial Restructuring and Law on the Agency for Bankruptcy Administrators Licensing by end-September 2015 to centralize all bankruptcy procedures and administration. We will establish a new bankruptcy agency by May 2016 following the amendment to the Bankruptcy Law in December 2015.

- We will adopt by end-2015 a new Law on Fees and Charges, which will replace existing laws and by-laws to regulate fees at all levels of government, to ensure greater predictability and transparency. The Law will be effective from January 1, 2017.

- We will adopt a new Company Law by end-2015 to include the public enterprises, which is currently governed by a separate Law on Public Enterprises.

- We have established a working group to implement the action plan to improve the business environment for SMEs based on the SME strategy for 2015–20 prepared by the MOE, which was adopted by the Government in March 2015.

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

- As part of our job creation initiatives, we are expanding the coverage of active labor market policies and will start reforming the National Employment Service, supported by the Competitiveness and Jobs project, to improve the efficiency of its programs and enhance the quality of services provided both to unemployed and employers.

## Program Monitoring

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

## Table 1. Serbia: Quantitative Program Targets 1/

| | 2015 | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Mar | | | Jun | | | Sep | | Dec | |
| | Prog. | Adj. Prog. | Act. | Prog. | Adj. Prog. | Act. | Proj. CR 15/20 2/ | Prog. | Proj. CR 15/20 2/ | Prog. |
| **I. Quantitative performance criteria (quarterly)** | | | | | | | | | | |
| 1 Floor on net international reserves of the NBS (in millions of euros) | 6,290 | ... | 7,155 | 6,063 | ... | 7,122 | 5,718 | 5,718 | 5,835 | 6,266 |
| 2 Ceiling on the general government fiscal deficit 3/ 4/ (in billions of dinars) | 55.7 | 53.2 | 21.1 | 96.3 | 90.8 | 35.3 | 153.1 | 153.1 | 232.1 | 165.0 |
| 3 Ceiling on current primary expenditure of the Serbian Republican Budget excluding capital expenditure and interest payments (in billions of dinars) 3/ | 207.4 | 203.5 | 195.4 | 429.2 | 421.2 | 405.2 | 657.2 | 657.2 | 906.3 | 906.3 |
| 4 Ceiling on gross issuance of new guarantees by the Serbian Republican Budget for project and corporate restructuring loans (in millions of euros) 3/ | 0 | ... | 0 | 121 | ... | 0 | 401 | 401 | 481 | 481 |
| 5 Ceiling on contracting or guaranteeing of new short-term external debt by the General Government, Development Fund, and AOFI (up to and including one year, in millions of euros) | 0 | ... | 0 | 0 | ... | 0 | 0 | 0 | 0 | 0 |
| **II. Continuous performance criteria** | | | | | | | | | | |
| 6 Ceiling on gross issuance of new guarantees by the Serbian Republican Budget and the Development Fund for liquidity support (in billions of dinars) | 0 | ... | 0 | 0 | ... | 0 | 0 | 0 | 0 | 0 |
| 7 Ceiling on accumulation of external debt payment arrears by General Government, Development Fund, and AOFI (in billions of euros) | 0 | ... | 0 | 0 | ... | 0 | 0 | 0 | 0 | 0 |
| **III. Indicative targets (quarterly)** | | | | | | | | | | |
| 8 Ceiling on accumulation of domestic payment arrears by the consolidated general government except local governments, the Development Fund, and AOFI (in billions of dinars) | 0.0 | ... | -0.66 | 0.0 | ... | -0.56 | 0.0 | 0.0 | 0.0 | 0.0 |
| 9 Ceiling on borrowing by the Development Fund and AOFI (in billions of dinars) | 0.0 | ... | 0.0 | 0.0 | ... | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| 10 Ceiling on new below-the-line lending by the Republican Government (in millions of euros) 3/ | 176 | ... | 4.2 | 250 | ... | 128 | 314 | 314 | 384 | 384 |
| **IV. Inflation consultation band (quarterly)** | | | | | | | | | | |
| Outer band (upper limit, 2.5 percent above center point) | 4.2 | ... | ... | 5.5 | ... | ... | 5.1 | 5.1 | 6.7 | 6.5 |
| Inner band (upper limit, 1.5 percent above center point) | 3.2 | ... | ... | 4.5 | ... | ... | 4.1 | 4.1 | 5.7 | 5.5 |
| *End of period inflation, center point 5/* | *1.7* | ... | *1.9* | *3.0* | ... | *1.9* | *2.6* | *2.6* | *4.2* | *4.0* |
| Inner band (lower limit, 1.5 percent below center point) | 0.2 | ... | ... | 1.5 | ... | ... | 1.1 | 1.1 | 2.7 | 2.5 |
| Outer band (lower limit, 2.5 percent below center point) | -0.8 | ... | ... | 0.5 | ... | ... | 0.1 | 0.1 | 1.7 | 1.5 |

1/ As defined in the Letter of Intent, the Memorandum of Economic and Financial Policies, and the Technical Memorandum of Understanding.
2/ Original program targets as specified in IMF Country Report 15/20.
3/ Cumulative since 01-01-2015.
4/ Refers to the fiscal balance on a cash basis, including the amortization of called guarantees.
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.

## Table 2. Serbia: Structural Benchmarks

| Measures | Target date | Status |
|---|---|---|
| **Structural Benchmarks** | | |
| **Fiscal** | | |
| 1 Adoption by the Government of a decree that regulates the role and responsibility of the Ministry of Finance, Ministry of Economy and the line ministries with respect to monitoring SOEs and PPPs (MEFP ¶14). | March 31, 2015 | Not met, implemented with a delay in April, 2015. |
| 2 Adoption of the Tax Administration Transformation Program 2015-20 developed by the MoF as the official medium term reform program (MEFP ¶16). | March 31, 2015 | Not met, implemented with a delay as a prior action for the 1st review. |
| 3 Adoption of the EPS financial restructuring plan by the Government (MEFP ¶35). | March 31, 2015 | Not met, implemented with a delay as a prior action for the 1st review. |
| 4 Finalization and validation of a full registry of public employees, including all employees at the republican and local government levels, in public agencies and institutions, and relevant SOEs (MEFP ¶10). | June 30, 2015 | Not met. Fully implemented for the general government. |
| 5 Approval by the National Assembly of changes to the Law on Payments in Commercial Transactions to include transactions between public entities including SOEs (MEFP ¶15). | June 30, 2015 | Not met, implemented with a delay in July, 2015. |
| 6 Adoption by the National Assembly of a new Local Government Financing Law (MEFP ¶11). | September 30, 2015 | Not met. New structural benchmark on posting of a draft law to public debate is set for end-October, 2015. |
| 7 Adoption by the Government Steering Committee of a corporate and financial restructuring plan for Railways of Serbia, to be prepared by an independent consultant (MEFP ¶35). | September 30, 2015 | Not met, expected to be implemented in October 2015. |
| 8 Adoption by the Government of a financial restructuring plan for Srbijagas, to be prepared by an independent consultant (MEFP ¶35). | October 31, 2015 | Proposed to be reset to January 2016. |
| 9 Posting of draft Local Government Financing Law for public debate (MEFP ¶11). | October 31, 2015 | New benchmark |
| 10 Adoption by the government of by-laws aimed at strengthening the project appraisal process (MEFP ¶8). | December 31, 2015 | New benchmark |
| 11 Resolution through either privatization or bankruptcy of at least 7 of the 17 strategically important companies that received protection from debt enforcement until May 2016 (MEFP ¶32). | December 31, 2015 | New benchmark |
| 12 Amendment to the EPS collective agreement to allow for the implementation of the rightsizing identified in the restructuring plans (MEFP ¶35). | December 31, 2015 | New benchmark |
| **Financial** | | |
| 13 Completion of special diagnostic studies of banks (MEFP ¶21). | September 30, 2015 | Not met, implemented with a delay in October, 2015. |
| 14 Preparation of supervisory guidance setting forth expectations for loan loss provisioning under IAS 39, in consultation with IMF staff and relevant domestic stakeholders (MEFP ¶23). | December 31, 2015 | |
| 15 Introduction of a new legal and operational framework for transparent real estate appraisals, including: (i) legislation setting clear appraisal standards; (ii) development of a database, accessible to banks and appraisers, for detailed records on real estate valuations filed according to pre-established criteria; and (iii) legislation providing proper supervision of the licensed appraisers. (MEFP ¶22). | December 31, 2015 | |
| 16 Conduct of a review of the corporate insolvency law and submission of proposed amendments to the National Assembly, in line with recommendations from IMF technical assistance, aimed to ensure: (i) adequate safeguards for the secured creditors rights; and (ii) better value maximization and more predictable and swift disposal of assets where assets are not strictly necessary for rehabilitation (MEFP ¶22). | December 31, 2015 | |
| 17 Submission to the National Assembly of tax law amendments to remove disincentives for timely NPL resolution (MEFP ¶22). | December 31, 2015 | New benchmark |
| 18 Adoption by the Government of retail-oriented business plan for Banka Postanska Stedionica (MEFP ¶27). | December 31, 2015 | New benchmark |
| 19 Develop enhanced supervisory standards for restructured receivables and distressed asset management by banks (MEFP ¶22). | March 31, 2016 | New benchmark |

# Attachment II. Technical Memorandum of Understanding

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

## A. Floor for Net International Reserves of the NBS

| | In Millions of Euro |
|---|---|
| Outstanding stock: | |
| End-December 2014 | 7,008 |
| Floor on international reserves: | |
| End-March 2015 (performance criterion) | 6,290 |
| End-June 2015 (performance criterion) | 6,063 |
| End-September 2015 (performance criterion) | 5,718 |
| End-December 2015 (performance criterion) | 6,266 |

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

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

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

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

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

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

Source: NBS

**6.** Adjustors. For program purposes, the NIR target will be adjusted upward by the value of long-term assets and foreign-exchange-denominated claims on resident banks and nonbanks as well as Serbian commercial banks abroad, recovered by the NBS since December 31, 2014. The NIR floor will be adjusted upward by the full amount of proceeds from any eurobond issuance and external bilateral budget loans to the General Government since September 30, 2015. External bilateral budget loans, in this context, are loans to the Republican budget provided without any pre-specified purpose other than satisfying funding needs of the public sector. The NIR floor will also be adjusted upward by the value of domestically acquired gold for which certification was obtained after December 31, 2014. The NIR floor will also be adjusted upward by any privatization revenue in foreign exchange received after December 31, 2014. Privatization receipts are defined in this context as the proceeds from sale, lease, or concession of all or portions of entities and properties held by the public sector that are deposited in foreign exchange at the NBS either directly or through the Treasury.

## B. Inflation Consultation Mechanism

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

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

## C. Fiscal Conditionality

9. **The general government fiscal deficit** (previously referred to as the general government augmented fiscal deficit, see IMF Country Report 15/20, p. 70), on a cash basis, 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 the proceeds from sale, lease, or concession of all or portions of entities and properties held by the public sector.

10. **Government primary current expenditure of the Republican budget (without indirect budget beneficiaries)** includes wages, subsidies, goods and services, transfers to local governments and social security funds, social benefits from the budget, other current expenditure, net lending, payments of called guarantees, cost of bank resolution and recapitalization, cost of debt takeover if debt was not previously guaranteed, repayments of debt 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 and the primary current expenditure of the Republican budget** will be adjusted upward (downward) to the extent that cumulative severance payments by the general government for the former and the Republican budget level for the latter (including payments from the Transition Fund) exceed (fall short of) the programmed levels up to the yearly budgeted amount.

**Cumulative Programmed Severance Payments**
(In billions of dinars)

| | End-Mar. 2015 | End-Jun. 2015 | End-Sep. 2015 | End-Dec. 2015 |
|---|---|---|---|---|
| Programmed cumulative severance payments by the general government fiscal deficit) | 3 | 10 | 19 | 29 |
| Programmed cumulative severance payments (of the Republican budget) | 3 | 10 | 15.6 | 25.6 |

- 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 2015. For the purposes of the adjustor, grants are defined as noncompulsory current or capital transfers received by the Government of Serbia, without any expectation of repayment, from either another government or an international organization including the EU.

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

| | End-Mar. 2015 | End-Jun. 2015 | End-Sep. 2015 | End-Dec 2015 |
|---|---|---|---|---|
| Programmed cumulative ear-marked grants receipts | 2.5 | 5 | 7.5 | 10 |
| Programmed cumulative receipts from small-scale disposal of assets | 0 | 0 | 0 | 0 |

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

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

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

**14. 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 ¶9 above, except local governments; (ii) the Development Fund, and (iii) AOFI. Arrears to be covered include outstanding payments on wages and pensions; social security contributions; obligations to banks and other private companies and suppliers; as well as arrears to other government bodies.

## D. Ceilings on External Debt

**15. Definitions.** The ceilings on contracting or guaranteeing of short-term external debt (with maturities up to one year) consolidated general government, the AOFI, and the Development Fund applies not only to debt as defined in point 8 of the Guidelines on Performance Criteria with Respect to External Debt in Fund Arrangements, Decision No. 6230-(79/140), as amended, but also to commitments contracted or guaranteed for which value has not been received. Excluded from this performance criterion are normal short-term import credits. For program purposes, debt is classified as external when the residency of the creditor is not Serbian. For new debt to budgetary users, the day the debt is contracted will be the relevant date for program purposes. For new debt to non-budgetary users, the day the first guarantee is signed will be the relevant date. Contracting or guaranteeing of new debt will be converted into euros for program purposes at the program cross exchange rates described in this TMU.

## E. Ceiling on External Debt Service Arrears

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

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

## F. Reporting

**18.** General government revenue data and the Treasury cash position table will be submitted weekly; updated cash flow projections for the Republican budget for the remainder of the year fourteen calendar days after the end of each month; and the stock of spending arrears as defined in ¶16 45 days after the end of each quarter. General government comprehensive fiscal data (including social security funds) would be submitted by the 25th of each month.

| Data Reporting for Quantitative Performance Criteria | | |
|---|---|---|
| Reporting Agency | Type of Data | Timing |
| NBS | Net international reserves of the NBS (including data for calculating adjustors) | Within one week of the end of the month |
| Statistical Office and NBS | CPI inflation | Within four weeks of the end of the month |
| Ministry of Finance | 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 | Gross issuance of new guarantees by the Republican Government for (i) project and corporate restructuring loans and (ii) gross issuance of new guarantees by the Serbian Republican Government for liquidity support | Within three weeks of the end of the month |
| Ministry of Finance | New short-term external debt contracted or guaranteed by the general government, the Development Fund and AOFI | Within four weeks of the end of the quarter |
| Ministry of Finance | External debt payment arrears by general government, Development Fund and AOFI | Within four weeks of the end of the month |
| Ministry of Finance | Gross accumulation of domestic payment arrears by the general government (without local government, the Development Fund, and AOFI) | Within 45 days of the end of the quarter |
| Ministry of Finance | Borrowing by the Development Fund and AOFI | Within four weeks of the end of the month |
| Ministry of Finance | Cumulative below-the-line lending by the Republican Government | Within 25 days of the end of the month |
| Ministry of Finance | Severance payments by general government, with a breakdown by government level. | Within four weeks of the end of the quarter |
| Ministry of Finance | Earmarked grants and receipts from small-scale disposal of assets | Within four weeks of the end of the quarter |