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Federal Republic of Yugoslavia: Request for a Stand-By Arrangement--Staff Report; Staff Statement; Press Release on the Executive Board Discussion; and Statement by Authorities of the Federal Republic of Yugoslavia

In the context of the request for a Stand-By Arrangement with the Federal Republic of Yugoslavia, the following documents have been released and are included in this package:

- the staff report for the Request for a Stand-By Arrangement, prepared by a staff team of the IMF, following discussions that ended on **April 30, 2001** with the officials of the Federal Republic of Yugoslavia on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on May 25, 2001.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of **June 11, 2001** updating information on recent economic developments.

- a Press Release summarizing the **views of the Executive Board as expressed during its June 11, 2001 discussion** of the staff report that completed the request.

- a statement by the authorities of the Federal Republic of Yugoslavia.

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

Letter of Intent by the authorities of the Federal Republic of Yugoslavia*
Memorandum of Economic and Financial Policies by the authorities of the Federal Republic of Yugoslavia*
Technical Memorandum of Understanding*

*May also be included in Staff Report.

The policy of publication of staff reports and other documents by the IMF allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

FEDERAL REPUBLIC OF YUGOSLAVIA

Request for a Stand-By Arrangement

Prepared by the European I and the Policy Development and Review Departments

(In consultation with other departments)

Approved by Jacques R. Artus and G. Russell Kincaid

May 25, 2001

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I. Introduction

1. The authorities of the Federal Republic of Yugoslavia (FRY) have requested a stand-by arrangement (SBA) in the amount of SDR 200 million, or 43 percent of quota, with an expiration date of March 31, 2002. This request and the accompanying Memorandum of Economic and Financial Policies (MEFP), dated May 25, 2001, appear as Appendix IV.

2. **Following the political changes of October 2000, the FRY authorities have worked closely with the Fund in addressing their economic problems.** Upon becoming a Fund member on December 20, 2000, FRY made a post-conflict emergency purchase of SDR 117 million (25 percent of quota), which both facilitated the clearance of arrears to the Fund and supported a short-term program covering the period through end-March 2001. The post-conflict program focused on bringing inflation under control and improving the country's institutional capacity, thereby paving the way for a comprehensive program that could be supported by the Fund under a SBA. Discussions on such a comprehensive program for 2001 were held in Belgrade and Podgorica (February 2–14 and March 13–28) and in Washington (April 29–30), leading to agreement on the authorities' letter of intent and MEFP.[1]

3. **As of May 25, all but two of the preconditions for Board consideration of the stand-by arrangement have been met** (Annex B, section I, of the MEFP). In particular, prior policy actions in the areas of fiscal, pricing, foreign trade, and banking sector policies have been adopted so far as envisaged; agreement has been reached on an arrears clearance plan for the World Bank; and the Paris Club creditors have provided adequate financing assurances. The remaining preconditions refer to (a) a further 40 percent increase in

[1] The Fund staff met: (a) at the federal level, Deputy Prime Minister Labus (with overall responsibility for international economic relations), Finance Minister Pesic, and National Bank of Yugoslavia (NBY) Governor Dinkic; (b) in Serbia, Prime Minister Djindjic, Deputy Prime Minister Covic, Finance Minister Djelic, Social Affairs Minister Matkovic, Labor Minister Milovanovic, Privatization Minister Vlahovic, and International Cooperation Minister Pitic; and (c) in Montenegro, Prime Minister Vujanovic, Finance Minister Ivanisevic, and Chairman of the Central Bank Council Krgovic. At the initial and concluding meetings in Belgrade, the FRY authorities were represented by a joint delegation of the federal, Serbian, and Montenegrin governments. Mr. Szczuka, Alternate Executive Director for FRY, attended some of the policy discussions.

The staff team comprised Messrs. Zervoudakis (Head), Mr. Herderschee, Ms. Udovicki (all EU1), Mr. Szekely (FAD), Mr. Halikias (PDR), and—in the March visit—Mrs. Ricasa (assistant, EU1). The team was assisted by Mr. Charap, the Fund's resident representative, and cooperated with overlapping FAD and STA missions (to offer technical assistance on tax reform, expenditure management, and money and banking statistics) and World Bank staff.

electricity prices scheduled for June 1 and (b) agreement on a plan to clear arrears to the European Investment Bank (EIB). The EU is to decide on the latter issue, including the provision of related balance of payments assistance, at the ECOFIN meeting of June 5.

4. **Upon approving FRY's Fund membership and a post-conflict emergency purchase on December 20, 2000, Executive Directors stressed that the authorities faced a challenging task in reviving the economy.** Directors noted that, in addition to prudent macroeconomic policies and bold structural reforms, achievement of a viable external position would require a restructuring of FRY's external debt on appropriate terms—including early resolution of arrears to the World Bank—and substantial support, following the regularization of arrears, from external donors and creditors. Directors welcomed the authorities' early focus on the need to bring inflation under control and their intention to adopt a comprehensive program of stabilization and reform that could be supported by the Fund under an upper credit tranche program. This would need to be preceded by progress in stabilizing the economy and in strengthening institutional and administrative capacities.

5. **FRY became a member of the World Bank recently.** On May 8, 2001, the World Bank Board approved a plan to clear FRY's arrears to the Bank, the country's membership in the Bank, and its three-year (FY 2002–04) eligibility for IDA lending under exceptionally hardened terms (shorter grace and maturity periods). World Bank lending operations are expected to start following the settlement of the arrears of US$1.7 billion to the Bank in the coming months, through the extension of a consolidation loan. Envisaged program lending of US$540 million (depending on policy performance) during FY 2002–04 would be sufficient to generate a positive net resource transfer to FRY. The World Bank has provided pre-membership assistance through a US$30 million trust fund. In addition, the Bank has been actively involved in mobilizing external support for FRY and preparing an Economic Recovery and Transition Report (in collaboration with the Fund, the European Commission, and bilateral donors) to serve as a basis for a Donor Pledging Conference scheduled for June 29, 2001.

6. **The reformists have consolidated their power in Serbia, while the situation in Montenegro remains unclear.** A victory of the reformist opposition in the federal elections last September 2000, together with popular protests, permitted the overthrow of the Milosevic regime on October 5, 2000 and the formation of a federal government dominated by reformists. Early parliamentary elections in Serbia were comfortably won by the reformists, who formed a new government in late January. Meanwhile, the status of Montenegro—which has effectively operated as an independent country in many respects—continues to remain unclear, following the slim victory of the pro-independence governing coalition in elections held on April 22 and the indefinite postponement of plans to hold a referendum on independence.

Box 1. Political Structure

FRY was constituted in April 1992, as a federation of the republics of Serbia and Montenegro, after four other republics of the Socialist Federal Republic of Yugoslavia (SFRY) formed independent states. Montenegro accounts for 6 percent of the total population of about 10½ million, while the populations of Vojvodina and Kosovo, provinces of Serbia, each amount to about 2 million. (Population figures exclude refugees from Bosnia and Herzegovina and Croatia, estimated at about ½ million.)

The Federal Assembly consists of the Chamber of Citizens (with Montenegrins accounting for about one fifth of its members) and the Chamber of Republics (with Montenegrins accounting for one half of its members). Montenegro is now represented in the federal parliament entirely by parties that are in opposition in Montenegro, since the governing coalition parties abstained from last September's federal elections. With Mr. Kostunica, a Serb, having been elected federal President, the post of the federal Prime Minister has been reserved for a Montenegrin (Mr. Zizic).

The FRY constitution limits federal responsibilities mainly to foreign relations, defense, monetary/exchange rate policy, and customs. At present, the federal government exercises these authorities only over the territories of Serbia proper and Vojvodina, since Kosovo is under temporary UN administration (UN Security Council Resolution No. 1244 of 1999), and Montenegro has effectively taken over the responsibilities for foreign relations, monetary/exchange rate policy, and customs.

7. **The quality of statistics is improving with technical assistance (TA) from the Fund and others.** FRY officials have shown keen interest in improving the quality of statistics, and have received TA from FAD, MAE, and STA, in addition to collaborating closely with EU1 missions on program monitoring requirements. As a result, considerable progress has been made since late 2000 in producing useful monetary and external accounts and ensuring that the fiscal accounts broadly comply with internationally accepted norms. Despite these improvements, considerable weaknesses remain—in the aforementioned areas as well as the national accounts—which may complicate the staff's assessment of current developments. Continued efforts to strengthen the statistical base will therefore be required during the program period.

II. Background

8. **Ten years of regional conflicts, isolation, and economic mismanagement have left a dire legacy in FRY.** Output stands at about 50 percent of its 1989 level; the industry and public infrastructure are in disrepair reflecting war destruction as well as under-investment and neglect over the past ten years; the recorded unemployment rate amounts to about 30 percent; refugees and internally displaced persons are estimated at about 600,000 people; annual inflation runs at well over 100 percent; and the external position is nonviable, owing to a crushing debt burden and large reconstruction needs. Within FRY, the economic

situation is somewhat better in Montenegro, which has been exempted from the international sanctions in recent years and has benefited from foreign financial and technical assistance.

9. **Economic activity remains weak but some progress has been made in lowering inflation in recent months, under the post-conflict program.**[2] 2000 was a year of modest economic recovery (5 percent) from the Kosovo war, weighted down by the effects of a drought that is still affecting the food processing industry (Text Table 1). The removal of the sanctions has yet to yield visible results in terms of GDP and export growth, probably because of managerial uncertainties, capacity constraints, and tighter policies. Real wages were kept artificially high in 2000 through price controls. The lifting of the controls in October 2000 resulted in an acceleration of year-on-year inflation to 115 percent by December, eroding real wages. Since then, underlying inflation appears to be subsiding: monthly core inflation (annualized) was around 20 percent in early 2001, after correcting for administered price increases.

Text Table 1. Key Indicators, 1999–2001

	1999	2000	2001	
Real GDP growth (percent)	-15.7	5.0	5.0	
Inflation (retail prices)				
End of period	49.9	113.5	30–35	
Of which: Montenegro in DM	...	25.0	6.6	
Period average	42.2	71.8	86–89	
Current account balance (before grants, US$ million)	-764	-671	-1,818	
In percent of GDP	-7.5	-8.3	-17.7	
Export growth (percent)	-44.7	14.7	7.3	
Import growth (percent)	-32.0	14.4	19.4	
Real wage growth (percent)	-13.5	16.0	0.0	
Wages (annual average, DM per month)	109.3	99.1	150.0	
	(In percent of GDP)			
Fiscal deficit, before grants (commitment basis) 1/	...	3.0	6.1	2/
Accumulation of arrears (increase -)	...	-2.1	0.0	
Fiscal deficit, before grants (cash basis) 1/	...	0.9	6.1	
Foreign grants and loans, net	...	0.8	4.1	
Privatization receipts	...	0.0	1.4	
Bank, financing, net	...	0.1	0.6	

1/ Consolidated general government in FRY.
2/ 3.9 percent of GDP, excluding Serbia's supplementary Budget for Reconstruction and Recovery, which is contingent on the availability of foreign financing.

[2] All data from 1999 onwards—with the exception of external debt figures—refer to the territory of FRY excluding Kosovo.

10. **The external accounts feature large imbalances and a depressed level of foreign trade.** The current account deficit (before grants, excluding most of the interest payments that are due but not paid) amounted to an estimated US$0.7 billion (8¼ percent of GDP) in 2000, compared with US$0.8 billion in 1999 (Table 2).[3] Exports and imports in 2000 recovered only partially from the effects of the Kosovo war, remaining well below their 1998 levels in U.S. dollar terms (by 40 and 25 percent, respectively). Data for 2001 Q1 point to 13 percent and 11 percent increases in recorded exports and imports, respectively, but this at least partly reflects a decline in the under-recording of foreign trade owing to the exchange rate unification. Gross official reserves rose to about US$607 million at end-April (1.5 months of projected 2001 imports), up from US$516 million at end-2000. FRY's external debt—largely in arrears—is tentatively estimated at US$11.7 billion at end-2000, equivalent to about 145 percent of GDP.

11. **Confidence in the dinar remains low, notwithstanding a considerable tightening of monetary policy since October 2000, while the banking system is largely insolvent.** Despite the continuing accumulation of foreign reserves by the NBY, the exchange rate for the dinar has depreciated only very slightly against the DM, following the adoption of a managed float at the beginning of this year. However, judging from developments in real reserve money and the sources of NFA growth, confidence in the dinar has yet to recover. The accumulation of NFA appears to be the result of foreign aid, the unification of the exchange rate last October that shifted foreign exchange sales from the gray market to the NBY, and a hitherto restrictive import regime. The imminent liberalization of the trade regime, therefore, could exert some downward pressures on the foreign exchange market. Meanwhile, a recent NBY survey of the banking sector, prepared with the assistance of foreign experts, has confirmed that it is largely insolvent and unable to perform its intermediation function.

12. **Cash fiscal deficits have been kept at very low levels, but only through unsustainable means**. The consolidated general government cash deficit (before grants) was around 0.9 percent of GDP in 2000, and was financed by foreign grants; Montenegro accounted for almost the entire deficit and for the entire amount of the grants (equivalent to 10½ percent of its own GDP).[4] The overall fiscal deficit in FRY would have been considerably larger but for some unsustainable developments: (i) a drastic compression of real government spending over the past two years, by a cumulative 40 percent; (ii) the non-servicing of a large government debt (over 100 percent of GDP); (iii) the accumulation of nondebt arrears amounting to 2.1 percent of GDP in 2000, bringing the stock of such arrears to 10.8 percent of GDP by year-end; and (iv) the toleration of large quasi-fiscal deficits. Indeed, bank financing of the quasi-fiscal deficits in agriculture and the energy sector fueled

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[3] These figures incorporate an adjustment for under-recording of current account receipts (by US$0.7 billion in 2000).

[4] Including the federal and republican governments, the republican social security funds, the Serbian local governments, and the special extrabudgetary programs in Serbia; excluding the local governments of Montenegro. All fiscal data exclude Kosovo.

monetary expansion and inflation until September 2000. Fiscal performance in the first quarter of 2001 was satisfactory overall. Entirely on account of developments in Serbia, the consolidated general government in FRY recorded a small cash surplus and, based on available information, there was no significant further accumulation of arrears. Fiscal developments in Montenegro were less favorable. Owing to a considerable increase in government spending in the run-up to the elections in late April, Montenegro's general government deficit in January–April 2001 amounted to an estimated 5 percent of Montenegro's annual GDP (0.3 percent of FRY's annual GDP), almost equivalent to the republic's deficit target for the whole year. The deficit was financed equally by foreign grants and by short-term borrowing from banks and enterprises.

III. Report on the Discussions

13. **The policy discussions in Belgrade highlighted the importance of fast and decisive policy action.** Against the background of a devastated domestic economy, a crushing external debt burden, and popular expectations of improving living standards, the authorities in Belgrade stressed that early economic achievements were key to establishing market confidence, building broad support for reform, and ensuring its sustainability. They were thus keen to adhere to prudent macroeconomic policies, advance economic restructuring, and intensify efforts to catalyze external assistance, including debt relief. They also recognized that, even with generous debt relief and a strong policy adjustment effort, the economic outlook would remain difficult over the medium term. In this regard, the mission stressed that, while the authorities' policy achievements so far augured well for the future, the success of the overall stabilization and reform effort would critically depend on the authorities' ability to tackle decisively the challenge of economic restructuring.

14. **In Montenegro, the policy discussions focused on the severity of the fiscal situation and the need to accelerate reform.** The authorities noted that the introduction of the DM as legal tender had contributed to financial stability and that key legislation to facilitate bank and enterprise restructuring had been already adopted. However, they were faced with a severe fiscal imbalance, which was no longer amenable to superficial correction through inflation, and the need to directly address economic restructuring. The authorities explained that the relatively high deficit in January–April reflected, to a significant extent, accelerated spending on subsidies and material costs, which would be correspondingly lower in the latter part of the year, and that they were prepared to reduce discretionary spending as needed to meet the deficit target without accumulation of expenditure arrears. In light of the uncertainties, it was agreed that the first program review would focus on budgetary policies. (The Montenegrin authorities participated in the program discussions in Belgrade and agreed to a joint MEFP with the federal and Serbian authorities. However, issues related to the two republics are generally treated separately, with the main exception of the balance of payments and external debt issues.)

A. Economic Objectives and Policies for 2001

15. **Macroeconomic policies in Serbia will be constrained by the severe demonetization and new burdens on the budget.** Fiscal and monetary policies will impose strict limits on credit expansion to the government and the rest of the economy. Specifically, the fiscal program emphasizes reliance on foreign assistance and privatization receipts to

meet the new burdens on the budget, and limits the government's recourse to the banking system to the equivalent of 0.6 percent of GDP in 2001. Similarly, the monetary program cautiously assumes a gradual recovery of confidence in the dinar. While external cost competitiveness now appears to be adequate, exchange rate policy will be reviewed on a quarterly basis owing to uncertainties about underlying external sector developments; in the meantime, the dinar will be allowed to depreciate slowly to help safeguard competitiveness and avoid exit problems. Along with limits on the NDA of the NBY, wage policy in the state sector (government and major state enterprises) will serve as a nominal anchor under the program.

16. **On the structural front, the program for Serbia provides for major reforms, including important upfront measures.** Specifically, a major budget and tax reform to enhance fiscal efficiency and transparency has been implemented; the hitherto very restrictive foreign exchange and trade systems have been liberalized; most prices have been freed, public utility tariffs have been generally raised, and a series of large increases in electricity prices has been initiated; a bank resolution strategy has been formulated and its implementation has begun; and steps have been taken toward adopting an improved legal and regulatory framework for privatization, in line with World Bank recommendations. On this basis, significant progress in bank restructuring and enterprise privatization is envisaged during the program period.

17. **For Montenegro, the program also includes important policy measures.** On the fiscal front, these include expenditure cuts in the areas of subsidies, investment, and other discretionary spending; and on the structural front, progress in enterprise privatization and bank restructuring, and further fiscal and trade reforms. Montenegro's reliance on the DM as the sole legal tender will contribute to financial discipline.

18. **Consistent with the above policies, the program aims at rapid disinflation and a moderate recovery in output.** Specifically, the program aims at lowering 12-month (retail price) inflation, by end-2001, to around 30–35 percent in Serbia and 6½ percent in Montenegro. In Serbia, this is consistent with underlying inflation of 15–20 percent, broadly in line with recent trends, and large adjustments in utility prices.[5] Real GDP is expected to rise by around 5 percent in 2001, owing mainly to a rebound in agricultural output after last year's drought. The rest of the economy will probably grow by 2–3 percent, with the positive effects from the removal of the economic sanctions being moderated by the effects of enterprise restructuring—owing to the elimination of quasi-fiscal deficits, the removal of tax exemptions, and the general tightening of policies—as well as capacity constraints.

19. **Despite the envisaged strong policy effort and considerable commitments of external assistance so far, FRY faces a sizable financing gap in 2001, reflecting both large import needs and external debt servicing obligations.** FRY's current account deficit (*before* grants) is projected to widen to about US$1.8 billion (17½ percent of GDP) in 2001, from US$0.7 billion (8¼ percent of GDP) in 2000. This is explained by a surge in foreign-

[5] Owing to a large carryover, this implies an annual average inflation rate in Serbia of 86–89 percent in 2001.

financed imports and interest payments due on foreign debt, in conjunction with a relatively modest export recovery reflecting the onset of a rebound in the second half of the year in response to the removal of international sanctions.[6] Taking into account official grants and capital account inflows on the basis of existing commitments, the overall balance of payments is projected to register a deficit of US$0.9 billion. To achieve a targeted increase in foreign reserves by US$0.2 billion and a reduction in external debt arrears of US$9.6 billion, an external financing gap of about US$10.7 billion would need to be filled.

20. **The financing gap could be filled partly by program and project assistance of about US$0.8 billion.** This includes (a) US$290 million from the Fund, World Bank, and EBRD, on the basis of the proposed stand-by arrangement and announced lending plans of the other two institutions; (b) US$300 million of balance of payments/budgetary support from the EU/G-24, which is expected to be secured by the time of Board consideration of the proposed arrangement;[7] and (c) some US$230 million in the form of project loan disbursements on the basis of expected commitments at the June Donor Conference (Text Table 2).

Text Table 2. Financing Requirements, 2001-2002
(In billions of U.S. dollars)

	Projections	
	2001	2002
Financing gap	10,666	1,667
To be filled by:		
Program and project assistance	821	1,190
World Bank/IMF/EBRD	287	369
Other, including June Donor Conference	534	...
Of which: EU/G-24 balance of payments support	300	...
Project assistance	234	...
Residual gap (possibly to be filled by debt relief)	9,845	477
Arrears	9,369	...
Current maturities	476	...

Sources: National Bank of Yugoslavia and Fund estimates.

[6] The current account deficit *after* debt relief is projected to rise by 6 percentage points to 15 percent of GDP in 2001. This broadly corresponds to a projected increase in the cash general government deficit (before grants and privatization receipts) by 5 percentage points and higher imports financed through extrabudgetary grants and loans.

[7] Of this, about US$220 million is expected to become available from the EU, with a view to facilitating the repayment of the EIB arrears and payment of current maturities. The remaining amount of US$80 million has been largely committed (and, to a smaller extent, is expected to be secured) from bilateral donors, with a view to providing budgetary support (partly in the form of counterpart funds).

21. **The estimated residual financing gap of US$9.8 billion could be filled through debt relief.** This could include rescheduling/rollover of arrears (except those relating to the EIB) and of current maturities, and capitalization of moratorium interest if needed. On May 16, the Paris Club creditors indicated their intention to provide debt relief to FRY consistent with the program's external financing requirements. Taking into account FRY's situation, they also indicated that they would be ready to consider a successor Paris Club agreement in the context of the next IMF arrangement; in this regard, Paris Club creditors did not take a decision on the issue of debt reduction. Comparable treatment will be required from FRY's other bilateral and commercial creditors. The FRY authorities have initiated contacts with the London Club and have arranged a first (non-negotiating) meeting with the banks' steering committee in June 2001. In light of these efforts, the Fund could support the program under its lending into arrears policy.

B. Medium-Term Outlook and External Viability

22. **Even with generous debt relief, FRY's external viability hinges crucially on the capacity of exports to rebound strongly in the new environment.** The staff has considered two debt sustainability scenarios, based—for illustrative purposes—on alternative assumptions about debt rescheduling (Naples terms, similar to those granted to Bosnia, and graduated Houston terms). Under the Naples terms scenario, the average annual debt service for 2002–2005 would increase to 6½ percent of GDP from 1 percent in 2000. Fresh external assistance is expected to help finance a portion of the increased debt service, but the bulk of this assistance is expected to be in the form of humanitarian aid and project financing, resulting in a concomitant increase in imports. To keep the current account deficit within limits, total export volumes will need to reach 1998 levels by late 2002 and to continue to grow at an average rate of 16 percent per year over the subsequent three years, almost doubling by 2005 compared to 2000. Even under these assumptions, the debt service ratio is projected to rise to almost 30 percent by the end of this decade and the debt/GDP and debt service ratios would remain very high until the middle of the next decade. Debt sustainability over the medium term is weighed down by the high initial levels of external debt—73 percent of GDP in 2001, even on the assumption of debt reduction on Naples terms—and the high share of multilateral debt which limits the scope for restructuring. Under the Houston terms scenario, the external position would be clearly unsustainable. The external debt/GDP ratio would remain very high (above 100 percent in 2010) over the long run, while the debt service ratio would rise steadily, reaching about 40 percent by 2010.

23. **Strong export performance would require a major policy effort.** FRY was unable to replace the markets that it lost with the disintegration of SFRY, because of the international trade sanctions and the failure to restructure its economy. As a result, FRY's current foreign trade shares, even after adjustment for estimated underreporting, stand well below levels typical of more mature transition economies. Initially export recovery can rely on the boost from the removal of the sanctions to traditional export industries, such as textiles manufacturing and food processing; and there are indications that this is happening already. However, over the medium term, the maintenance of export growth will require a radical restructuring of other manufacturing industries, as well as considerable foreign direct investment and a friendly business environment.

C. Fiscal Policy

24. **The budget discussions were guided by an assessment of FRY's fiscal sustainability.** There was broad agreement that achieving fiscal sustainability will be a challenging task. In addition to pre-existing pressures, new burdens on the budget of around 5 percent of GDP will stem from the resumption of external debt servicing, the scheduled repayment of frozen foreign currency deposits, the elimination of monetary financing of quasi-fiscal deficits, the restructuring of the banking system, and the social costs of economic reforms (Box 2). The staff discussed with the authorities two fiscal sustainability scenarios based on alternative assumptions about external debt rescheduling (Figure 3 and Table 11). On the illustrative assumption of external debt restructuring on Naples terms, the public sector's indebtedness would remain high, and the fiscal situation would continue to be difficult over the long run.[8] Quasi-fiscal deficits in the banking sector, the obligation to repay households' frozen foreign currency deposits, and infrastructure needs inhibit improvement in the primary balance, which continues in deficit. To restore fiscal sustainability, primary expenditure will have to decline significantly in relation to GDP over the longer run, leaving little room for lowering the tax burden. On the assumption of rescheduling on graduated Houston terms (involving no debt reduction), the public sector's external indebtedness will remain extremely high, and the fiscal position would be clearly unsustainable despite a significant decline in primary expenditure (similar to that assumed in the Naples terms scenario). Against this background, the authorities and the staff discussed wide-ranging expenditure and tax reform measures that would help secure fiscal sustainability in addition to alleviating the budget pressures this year.

25. **Notwithstanding new expenditure burdens, the fiscal program for 2001 strictly limits recourse to the domestic bank financing.** The deficit of the consolidated general government in the FRY, before grants, excluding Serbia's supplementary Budget for Reconstruction and Recovery, is to be limited to 3.8 percent of GDP in 2001; this compares with commitment and cash deficits of, respectively, 3.0 and 0.9 percent of GDP in 2000 (Text Table 3). With privatization receipts and foreign grants and loans expected to finance the bulk of the targeted fiscal deficit, domestic bank financing will be limited to 0.6 percent of GDP (¶13).[9] [10] In addition, a large portion of investment and economic restructuring programs in Serbia has been explicitly identified as contingent on external financing and will be presented at the June Donor Conference as Serbia's supplementary "Budget for

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[8] The public sector's indebtedness is higher than FRY's external indebtedness by the equivalent of about 40 percent of GDP (22½ percent in NPV terms). Besides the bulk of the external debt, the public sector's liabilities include the obligation to repay foreign currency deposits, quasi-fiscal deficits in the banking sector, and other domestic debt.

[9] In evaluating the impact of fiscal policy on domestic demand, it should be taken into account that about at least one percentage point of the increase in the deficit corresponds to the incorporation into the budget of quasi-fiscal deficits previously financed through the banking system.

[10] ¶ refers to relevant paragraph in the MEFP.

Reconstruction and Recovery," with a view to attracting foreign assistance. According to tentative estimates, disbursement of such project-related assistance could reach 2.3 percent of GDP this year, raising the overall fiscal deficit in FRY to 6.1 percent of GDP.[11] As the projects involved will have a large import content and will generate demand mainly for idle resources in the construction industry, their direct inflationary impact should be negligible, while they should help raise potential output by easing infrastructure bottlenecks. In contrast with FRY as a whole, the fiscal deficit in Montenegro is targeted to narrow, in line with an expected lower level of foreign grants, by 0.2 percentage points to 0.5 percent of FRY's GDP in 2001.[12]

Box 2. Frozen Foreign-Currency Deposits

In 1991, the Yugoslav Government suspended withdrawals from households' foreign exchange balances with domestic banks. The deposits were redeposited with the NBY, whose foreign reserves were run down. A 1998 law converted the deposits into public debt, capitalized the interest (based on a government-set interest rate of 2 percent per annum) and established an ambitious repayment schedule for these deposits, without giving due consideration to the fiscal implications. The total public debt assumed by this law amounted to DM 7.4 billion, equivalent to 35 percent of GDP in 2001. Based on this law, the repayment started in 2000 and the federal government issued a decree in January 2001 on two special state bonds to be issued to the holders of such deposits.

The servicing of these bonds would have placed a heavy burden on the budget starting in 2005. With a view to alleviating these pressures, the federal and Serbian governments have decided to modify the original repayment schedule to ensure that annual payments will be limited to no more than 0.9 percent of projected GDP in 2005 and subsequent years, compared to over 2 percent of projected GDP in 2005–11 on average under the original repayment schedule. In light of uncertainty about the overall size of the obligation—as indicated by the limited withdrawals in 2000 and so far in 2001—the government will issue bonds only up to amounts corresponding to repayments of DM 10,000 per account in 2001, and will discuss with the Fund staff the revised repayment schedule for 2005 and subsequent years in the context of the second review under the stand-by arrangement (¶15).

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[11] Of this, 4.1 percentage points of GDP would be financed by foreign grants and loans, 1.4 percentage points by privatization receipts, and 0.6 percentage points by domestic borrowing (Text Table 3).

[12] This is equivalent to a decline in the fiscal deficit by 4 percentage points to 6½ percent of *Montenegro's* GDP (Table 7D).

Text Table 3. Consolidated General Government, 2000-2001 1/
(In percent of FRY's GDP, unless otherwise indicated)

	2000 Estimated	2001 Projected	Difference
Total revenue	38.8	39.9	1.1
Tax revenue	35.0	36.6	1.6
Non-tax revenue	3.8	3.1	-0.7
Capital revenue	0.0	0.2	0.2
Total expenditure and net lending	39.7	45.9	6.2
Wages and salaries	10.0	10.3	0.3
Purchases of goods and services	8.4	9.0	0.6
Interest payment	0.6	1.0	0.4
Subsidies	2.2	3.3	1.0
Transfers to households	15.1	17.1	2.1
Capital expenditure	3.3	3.6	0.3
Repayment of foreign currency deposits	0.1	1.1	1.0
Overall cash balance	-0.9	-6.1	-5.2
Financing	0.9	6.1	5.2
Domestic financing	0.1	0.6	0.5
Foreign grants	0.8	1.2	0.4
Foreign debt financing	0.0	2.9	2.9
Privatization receipts	0.0	1.4	1.4
Accumulation of expenditure arrears	2.1	0.0	-2.1
Overall commitment balance	-3.0	-6.1	-3.1
Memorandum items:			
Overall cash balance of:			
General Government in Serbia	-0.2	-5.6	-5.4
General Government in Montenegro	-0.7	-0.5	0.2
Overall cash balance of general government of:			
Montenegro (in percent of Montenegro's GDP)	-10.6	-6.5	3.9

1/ Consolidated general government includes the federal, the republican and local governments, the social security funds, and the extrabudgetary programs. Local governments in Montenegro are, however, excluded.

26. **General government expenditure is targeted to rise significantly in 2001, notwithstanding savings within several categories.** Specifically, the general government expenditure/GDP ratio is projected to rise by 6.2 percentage points to 45.9 percent of GDP in 2001, including Serbia's supplementary budget. This reflects in large part higher spending in Serbia on subsidies owing to the incorporation of quasi-fiscal deficits into the budget, higher targeted social spending, and the servicing of inherited obligations to foreign creditors and holders of frozen foreign currency deposits (¶19). In Montenegro, spending on subsidies and material expenses and investment will be cut, and social benefits will be better targeted (¶26). Meanwhile, wage policy will be strict at all levels of government. The general government wage bill—accounting for 400,000 employees or 17 percent of employment in FRY—will be contained to 10.3 percent of GDP in 2001, representing an increase of

0.3 percent of GDP from the previous year. This reflects a nominal freeze of wages by the federal and Montenegrin governments at their levels in early 2001, which will nevertheless permit some year-on-year increase in real terms; and a broadly constant real wage bill in the Serbian government on the basis of the targeted rate of inflation. Reflecting the wage freeze in the military (as part of the freeze in the federal government) as well as cuts in spending on military equipment, defense spending is budgeted to decline by 0.7 percentage points to 4 percent of GDP (¶16).

27. **The program incorporates a significant revenue effort, in the context of a major tax reform** (¶17). The tax revenue/GDP ratio is projected to rise by 1.6 percentage points to 36.6 percent of GDP in 2001, reflecting a major tax reform in Serbia (Box 3). This reform involves a sharp reduction in the number of taxes, a widening of the tax base through elimination of numerous exemptions, and a lowering of tax rates. These measures—provided that they are strictly implemented—should not only increase total tax revenue but also simplify the tax system, alleviate the high tax burden on employment, and support efforts to improve tax administration. In addition, major reforms in the areas of tax and customs administration are being undertaken in both Serbia and Montenegro, with support from the Fund and bilateral donors.

Box 3. Tax Reforms in Serbia

A far-reaching tax reform has been implemented in Serbia. The new Serbian government inherited a tax system that was described by tax experts as one the most distorted and difficult-to-administer in the world, with over 200 different taxes and numerous ad hoc exemptions. High standard rates and compliance cost gave strong incentive—and the cobweb of exemptions created ample room—for tax avoidance and evasion. The tax reform approved by parliament in conjunction with the 2001 Serbian budget took the first step towards creating a modern tax system, in line with the recommendations of a recent FAD technical assistance mission.

The sales tax and the different surtaxes on sales were unified into a single-rate, final-stage consumption tax (17 percent) with a narrow set of exemptions. The federal government resisted the abolition of a federal surtax on sales, but agreed to turn it into a single-rate surtax (3 percent) levied on the same tax base as the Serbian tax. Similarly, excises and surtaxes on excisable goods were unified into specific excises. In both cases, effective tax rates were increased, resulting in a sizable shift towards indirect taxes and creating some room for reducing wage-based taxation. The combined revenue from sales tax and excises in Serbia is targeted to increase by 1.3 percentage points to 12.1 percent of GDP in 2001.

Effective June 1, 2001, the tax bases for personal income tax and social security taxes will be widened to include all types of cash benefits previously exempted, and the rates on social security contributions will be reduced to lower the effective tax burden on employment by some 10 percent. As a result, social security taxes are targeted to decline by 0.6 percentage points to 10.4 percent of GDP in 2001.

Financial transaction taxes have also been unified and property taxes have been simplified and assigned to local governments. The implementation of a federal law on VAT has been further postponed pending clarification of the status of Montenegro. Future tax reforms will therefore have to include the introduction of VAT as well as the overhaul of personal income taxation.

28. **Besides the tax reforms mentioned above, the authorities have made impressive progress in fiscal transparency and management.** Specifically, in Serbia all extrabudgetary programs, accounting for 7 percent of GDP, have been integrated into the Serbian budget (¶18); the entire defense spending has been included in the federal budget and become subject to civilian control (¶16); and the budget execution system will be overhauled with Fund technical assistance (¶20). In Montenegro, some progress has already been made in improving budget execution, and a new budget system law is to be adopted (¶27).

D. Quasi-Fiscal Deficits and Enterprise Financial Discipline

29. **Quasi-fiscal deficits in the state enterprise sector are being addressed.** Specifically, the authorities have ceased the monetary financing of quasi-fiscal deficits in the state enterprise sector in Serbia (mainly electricity company), turned earmarked extrabudgetary tax revenues of state-owned companies into budget transfers, and reduced the need for budgetary subsidies through administered price increases and wage restraint. The electricity tariffs were raised by 60 percent on average on April 15, 2001 and will be increased further by 40 percent on June 1 and another 40 percent on October 1, 2001, with a view to alleviating electricity shortages as well as budgetary pressures (¶30).[13] Moreover, the Serbian government has adopted measures to strengthen financial discipline in the state-owned enterprise sector, focusing in particular on the eight largest state-owned companies that account for 6 percent of registered employment and provide key inputs to the rest of the economy (¶31). To encourage rationalization in employment and cost control, pending the preparation of restructuring programs, the wage bills for these enterprises for 2001 have been generally frozen at their January level, consistent with their remaining roughly unchanged in real terms in 2001.

E. Monetary and Exchange Rate Policy

30. **Monetary policy will be geared to lowering inflation**. The monetary program takes into account the severe demonetization of the economy and the likelihood that confidence in the dinar and the banking system will be restored only gradually (¶32).[14] The problems stem

[13] The April and June price adjustments will bring the price to a level estimated by World Bank staff as sufficient to cover most operational costs this year, thereby substantially limiting the need for budgetary subsidies, while US$80 million (0.8 percent of GDP in 2001) in donor assistance will be needed to cover capital repair and maintenance costs. The October price adjustment will be the next step toward bringing the electricity price closer to medium-term economic cost.

[14] The dinar monetization of the FRY is extremely low, as reflected in very low currency/GDP and broad money/GDP ratios in relation to other countries in the region. (Dinar currency in circulation accounts for some 2 percent of GDP in FRY, compared with some 4½ percent in the Former Yugoslav Republic of Macedonia and Croatia. Dinar- and foreign exchange-denominated bank deposits amount to about 4 percent and 5 percent of GDP, respectively.) Foreign exchange cash holdings—over DM 2 billion, or 5 times higher

(continued)

from the freezing of households' foreign exchange deposits in 1991, the erosion of dinar savings through the 1993 hyperinflation, and the insolvency and illiquidity of the bulk of the banking system. In these circumstances, especially without adequate safeguards for prudent lending decisions, the injection of central bank liquidity would risk re-igniting inflation. Accordingly, the monetary program was based on the assumption of an unchanged broad money velocity. However, in the event of a larger than projected increase in NFA that is attributable to a strengthening of confidence, reserve money could be allowed to rise faster. The authorities also agreed to rely more on market-instruments to conduct monetary policy and to accept the resulting interest rates. This—together with an overhaul of the monetary policy instruments and the required reserves—would be facilitated by the clean-up of the banking system in the coming months and the development of a proper money market (¶35).

31. **The managed float of the dinar will be implemented with a view to safeguarding external competitiveness and preventing exit problems in the future.** While agreeing with the staff that announced exchange rate targeting was not appropriate in the current circumstances—not least because of the low level of reserves—the monetary authorities nevertheless favored a broadly unchanged exchange rate of the dinar against the DM (euro) as a means of subduing inflation expectations. In this regard, they noted that, notwithstanding the recent sharp real appreciation of the dinar, external competitiveness still appeared to be adequate, judging from recent developments in the NFA of the NBY and the historical levels of the real exchange rate of the dinar. The staff cautioned against an effective pegging of the exchange rate, pointing to the still high rate of price and wage inflation, the normal lags in the response of trade flows to changes in external competitiveness, and the general uncertainty about the underlying external position. In the event, it was agreed that the NBY would let the dinar depreciate against the euro slowly in the coming months—with a view to preventing a significant weakening of external competitiveness and exit problems associated with adhering to a fixed exchange rate—and that exchange rate policy will be reviewed quarterly under the program (¶33).

F. Foreign Exchange and Trade Regimes

32. **The monetary authorities indicated their readiness to adopt further measures to liberalize the exchange system as needed to achieve Article VIII status.** It was noted, in particular, that the exchange system has undergone a radical reform since last October, with the unification of multiple exchange rates at the level prevailing in the gray market and the abolition of numerous exchange restrictions (¶36).

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than local currency holdings, according to official estimates—are used for transactions purposes as well as a store of value.

33. **A key part of the authorities' reform program is the liberalization of the trade system.**[15] The discussions highlighted the excessive restrictiveness of the previous regime, which had been associated with widespread rent-seeking and inefficiencies. The authorities noted that the recently adopted federal legislation abolished almost all non-tariff import restrictions, limited quantitative export restrictions to some basic food items, and introduced a new import tariff schedule featuring tariff bands with a simple average of below 10 percent (¶37).[16] The authorities noted that the remaining licensing restrictions were intended to protect the local steel company, which is uncompetitive and a large employer (20,000 people) in a region of especially high unemployment, and that they would remove them in the context of the WTO membership discussions. They would also remove export quotas for food products gradually, as domestic food availability improved.

G. Bank Reform

34. **The discussions focused on ascertaining the condition of the banks and the appropriate strategy for resolving insolvent ones.** Reflecting the dire conditions of the enterprise sector, poor corporate governance and inadequate banking supervision over many years, the banking system is largely insolvent and unable to perform its intermediation function. A survey of the banking system found that about 30 banks (including the six largest banks) out of about 90 banks in Serbia—jointly accounting for about 80 percent of the assets of the banking system and employing 24,000 people—are insolvent. The authorities favored the rehabilitation of the six largest banks on the grounds that they are "systemically" important, both as providers of banking services to the enterprise sector and as large employers. However, based on a preliminary analysis of follow-up inspections of the problem banks, Fund and World Bank staff argued that, with the exception of one or two large banks, all other insolvent banks should be probably liquidated. In the event, agreement was reached that bank rehabilitation will be undertaken only if it is expected to produce a viable bank with good prospects for privatization through a sale to a private strategic investor at a reasonable price; and can be implemented with identifiable fiscal resources. Moreover, if this does not appear to be achievable based on performance during the first six months of a rehabilitation program, the banks will be closed and liquidated (¶39–41 for details).

35. **The mission cautioned the authorities that the costs of rehabilitation could be significant.** To the extent that the route of rehabilitation—rather than liquidation—is chosen, the costs of bank restructuring will be significant, especially in light of the fiscal constraints.

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[15] Montenegro and Kosovo have their own trade policies, rated "4" and "3", respectively, on the Fund's index of trade restrictiveness, thus necessitating checkpoints at administrative borders.

[16] As a result, FRY's s rating on the Fund's 10-point index of trade restrictiveness has improved from "8" to "4".

According to preliminary estimates, the uncovered accumulated losses of the insolvent banks—excluding liabilities related to the Paris Club, London Club, and households' frozen foreign currency deposits—amount to at least US$1.1 billion (11 percent of GDP in 2001). The mission noted that, in the event of liquidation and compulsory haircuts of creditors, this amount could probably be covered almost entirely without budgetary resources; this was less certain in the event of rehabilitation, which relied on the negotiation of partial creditor haircuts. Moreover, the cost of rehabilitating the six largest banks is preliminarily estimated at about US$3 billion, which cannot be justified considering the limited prospects for their privatization and the scarcity of fiscal resources.[17]

36. **The program aims to strengthen bank supervision, with support from the Fund and bilateral donors.** The program includes a review of prudential regulations, strengthening of off-site reporting and analysis, introduction of on-site risk-based supervision, development of enhanced supervision and enforcement measures, and strengthening of loan classification and provisioning regulations (¶42).

37. **Bank restructuring is also being pursued in Montenegro** (¶43). Montenegro's central bank has become operational recently, and banking legislation and accompanying regulations have been adopted with technical support from donors (the EU and the U.S.). Against the background of a largely insolvent banking sector, the authorities are committed to the resolution of Montenegro's largest bank, which is insolvent and seriously illiquid, on an expeditious basis. They intend to restructure it operationally and financially with a view to selling it to a strategic investor but will not devote scarce fiscal resources for its rescue or rehabilitation.

H. Enterprise Reform

38. **In Serbia, in a break with the past, the new authorities' privatization strategy calls for clearly defined ownership with a dominant owner as well as measures to improve the business environment.** Immediately after coming to power, the new Serbian authorities halted privatization under the 1997 law, which effectively imposed management/employee buyouts as the only means of privatization for socially owned enterprises (¶44). With a view to improving corporate governance, they intend to put in place a new regulatory and administrative framework for privatization by mid-July, with technical assistance from the World Bank. According to the new framework, privatization will generally rely on tenders offering at least 70 percent of ownership to strategic investors;

[17] The Serbian budget for 2001 provides YUD 600 million (0.1 percent of GDP) for bank restructuring costs incurred by the BRA. In addition, some funds are expected to be available from multilateral institutions (including a portion of the World Bank's US$30 million trust fund to support TA for bank resolution), the EU, and bilateral donors.

the remainder will be distributed free of charge between enterprise employees and a privatization register (for the benefit of the citizens at large). The new privatization framework will be supplemented by new legislation on labor relations, the rights of unemployed, and bankruptcy (¶46–47).

39. **The authorities envisage some early progress in privatization.** First, the Serbian government is in the process of selling three cement factories and a few other enterprises to strategic investors with transparent procedures, under the authority granted to it by the 1997 law. The authorities expected to generate budgetary financing of about US$150 million from these privatization sales during 2001. In addition, in cooperation with the World Bank, the authorities have started the process of selecting 31 strategic enterprises—to be grouped into seven pools—for early privatization under the new law. Progress in the privatization process will be monitored with structural benchmarks (¶45 and Annex B) with a view to ensuring that they are offered for sale by early next year.

40. **In Montenegro, where a new privatization framework is already in place, the authorities intend to accelerate their privatization program and to further improve legal and regulatory environment for business.** Privatization of the majority of shares in all enterprises will be conducted by international tender to attract strategic investors and improve corporate governance, while minority shares will be preserved for a mass voucher privatization program that is set to begin this year (¶48). Also, new legislation on companies, bankruptcy, and foreign investment is to be adopted in the course of 2001, with the technical support of foreign donors.

IV. Modalities of the Proposed Stand-By Arrangement

41. Proposed **access** under the prospective (10-month) stand-by arrangement through end-March 2002 is SDR 200 million (43 percent of quota, equivalent to annual access of 52 percent). This takes into account FRY's relatively low indebtedness to the Fund, the need to rebuild foreign reserves, and a debt sustainability analysis, which points to a viable external position on the basis of sustained implementation of prudent policies as well as substantial debt relief (Table 12). There would be four equal **purchases,** of which one would be available upon Board approval of the arrangement. The three-phased purchases would be linked to the observance of performance criteria at end-June, end-September and end-December 2001, and to the completion by the Board of associated quarterly **reviews** in September 2001, December 2001, and March 2002 (Table 13). Box 4 contains an assessment of structural conditionality streamlining under the proposed program.

Box 4. Structural Conditionality Streamlining Assessment

1. Coverage of Structural Conditionality in the Current Program

Conditionality in the program covers:

- *Fiscal policy, through (i) prior actions (parliamentary adoption of a tax reform in Serbia; and wage freeze in the government) and (ii) structural benchmarks (measures in the area of tax administration and expenditure management). The conditionality is relevant for the macroeconomic objectives of the program, including external viability.*

- *Foreign trade policy, through a prior action (adoption of federal legislation to liberalize the foreign trade regime in Serbia). The conditionality is macro-relevant, as it is intended to remove important impediments to growth and external viability.*

- *Electricity pricing policy, through a prior action and structural performance criteria. This is macro-relevant, owing to its implications for budget subsidies and ensuring adequate energy supplies.*

- *Banking sector, through (i) a prior action (on the appointment of an administrator of the largest bank in Montenegro) and (ii) structural benchmarks (formulation and implementation of a bank resolution strategy in Serbia).This conditionality is macro-relevant, as it is intended to remove impediments to growth (lack of financial intermediation) and monetary policy implementation (lack of a developed money market).*

- *Private sector development, through structural benchmarks (adoption of a legal and regulatory framework for privatization in Serbia). This is macro-important, as it is intended to remove impediments to growth.*

2. Relevant Structural Conditions not Included in Current Program

FRY has not had an earlier upper credit tranche program. A number of policy undertakings—mainly relating to the reform of the health system and labor markets— have been included in the MEFP—since they are an integral part of the authorities' economic strategy—but are not part of Fund conditionality. This reflected the need to focus mainly on areas that are within the Fund's core competences.

3. Status of Structural Conditionality from Earlier Programs

Under the Fund-supported emergency post-conflict program, which was approved last December, progress has been made in strengthening FRY's institutional and administrative capacity, with a view to enabling it to formulate and implement policies under an upper credit tranche program

4. Structural Areas Covered by Bank Lending and Conditionality

At the time of the program was negotiated, FRY was not a member of the World Bank. In areas where the Bank traditionally takes the lead (pricing policy, foreign trade reform, and privatization), the Fund staff has relied on Bank advice. In the area of bank restructuring, initially the Fund took the lead in the formulation of the bank resolution strategy. As the focus of the work has shifted to the implementation of the bank resolution strategy, the World Bank has taken the lead.

42. **Preconditions/prior** actions for Board consideration of the proposed program (listed in Annex B, section I, of the MEFP) have been met/implemented.

43. The **quantitative performance criteria** under the proposed program include: (i) quarterly ceilings on net domestic assets of the NBY; (ii) quarterly ceilings on net credit of the banking system to the consolidated general government; (iii) quarterly floors on net foreign assets of the NBY; (iv) quarterly ceilings on the contracting or guaranteeing by the government of non-concessional external debt; (v) quarterly ceilings on the level of external debt with a maturity of up to one year contracted or guaranteed by the government; (vi) quarterly ceilings on the assumption by the government of enterprise debt to banks and guaranteeing of bank loans to enterprises by the general government; and (vii) quarterly ceilings on the stock of external debt servicing arrears other than those expected to be rescheduled (Annex A, MEFP). In addition, there will be a continuous performance criterion on the non-accumulation of new external payments arrears.

44. The **indicative targets** under the proposed program include: (i) quarterly ceilings on the net domestic assets of the banking system; (ii) quarterly ceilings on changes in government arrears; and (iii) quarterly ceilings on nominal wage bills and arrears for several large loss-making state-owned companies (Annex A, MEFP).

45. **Structural performance criteria** under the program include a timetable for adjustments in electricity prices (Annex B, MEFP).

46. **Structural benchmarks** under the program include policy actions in the areas of fiscal policy, banking, and privatization (Annex B, MEFP).

47. FRY is subject to a full stage-one **safeguards assessment**. The authorities have provided some information to the staff and have committed to providing the remaining documentation required under the safeguards framework as soon as it becomes available. Pursuant to the safeguards framework, the NBY is required to publish annual financial statements that are independently audited in accordance with internationally accepted standards (the "external audit"). The authorities have appointed KPMG as their external auditors and have authorized them to cooperate with staff. Staff will monitor progress regarding the timely publication of the audited financial statements. In addition, as part of the stage one safeguards assessment, which is expected to be completed before the first review of the program, the staff will ascertain that the quality and effectiveness of the external audit meets internationally accepted standards.

V. Staff Appraisal

48. **Faced with the difficult task of reconstructing their devastated economy, the new FRY authorities have formulated and started to implement an ambitious program of stabilization and reform with impressive speed and commitment.** This augurs well for the future, since—as the authorities themselves fully appreciate—evidence of early success is the best way to build support for reform and ensure its sustainability.

49. **The program provides for macroeconomic policies designed to reduce inflation and support reconstruction coupled with bold reforms.** The fiscal and monetary policies

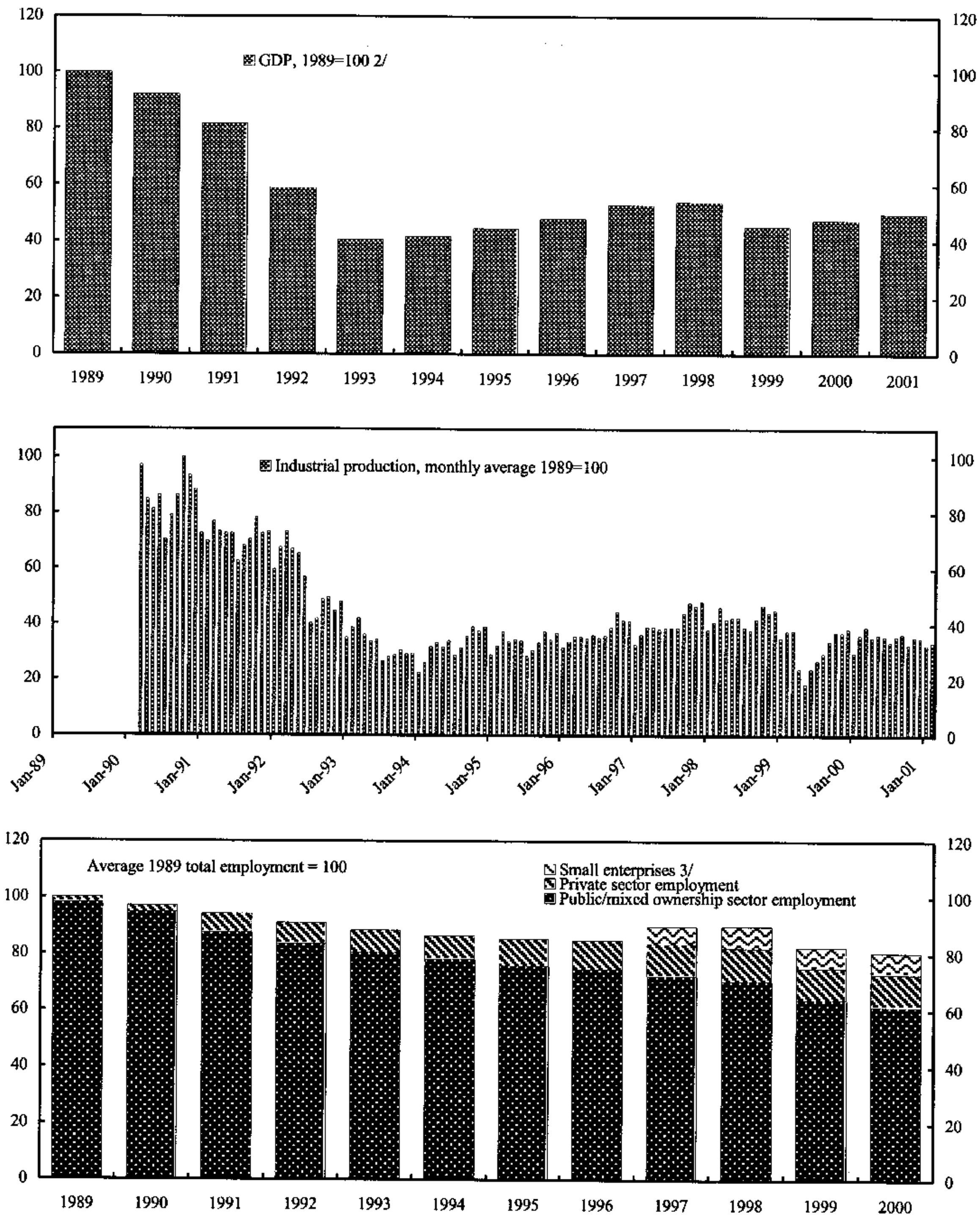
impose strict limits on credit expansion to the government and the rest of the economy, with a view to reducing inflation and creating an environment that is supportive of reform. Some key structural measures are appropriately implemented upfront. A major fiscal reform has been put in place, involving the streamlining of an extremely complex tax system, the integration of a large number of extrabudgetary programs with earmarked revenues into the Serbian budget, and the bringing of military spending under civilian control. The hitherto very restrictive foreign exchange and trade systems have been almost completely liberalized. A bank resolution strategy has been formulated and its implementation has begun. A new privatization framework is to be adopted in the coming weeks. Montenegro, which adopted institutional reforms over the past several years, will press ahead with important policy measures in the fiscal area—primarily expenditure cuts to alleviate severe budgetary pressures—as well as in bank restructuring and privatization.

50. **The authorities' policy achievements so far have been impressive, but are only the preamble to tackling an extremely difficult restructuring agenda.** As the failure of several initially successful stabilization attempts—both in FRY and other countries in the region—has demonstrated, it is imperative to address the root causes of the macroeconomic imbalances by restructuring the banking and enterprise sectors, improving financial discipline in the economy, and restoring fiscal sustainability. This in turn requires that the authorities maintain the momentum of reform, by taking hard decisions on economic restructuring, including decisions affecting employment in insolvent banks and enterprises. The authorities appear to be aware of the challenges ahead, and have appropriately emphasized the development of a proper social safety net as a means of maintaining broad support for their reform policies.

51. **In FRY's exceptionally difficult circumstances, prudent policies alone cannot ensure progress toward sustainable growth and external viability.** The international community has recognized this, as evidenced by its considerable assistance so far, especially in the form of humanitarian aid. However, in light of FRY's debt burden and large reconstruction needs over the medium term, strong support from creditors and donors will be required. In this regard, it is clear that FRY will not achieve external debt sustainability without concessional debt relief from its bilateral official and commercial creditors. Moreover, it will be important that, in the context of the forthcoming Donor Conference in June, the international community demonstrate its support by committing program and project assistance in line with FRY's estimated needs.

52. **The FRY authorities' program sets the basis for the country's achieving sustainable output growth and a viable external position, and it deserves the support of the Fund.** Considering the initial conditions, the medium-term economic outlook will inevitably remain difficult. The adopted prudent policies will need to be implemented on a sustained basis, in close cooperation with the international community. The international community, in turn, will need to remain generous in its support, at least through the intensive restructuring effort envisaged over the medium term. Nevertheless, FRY is a country with considerable potential and, with continued political support for the reforms, it could, before too long, become a major contributor to regional welfare.

Figure 1. Federal Republic of Yugoslavia: Selected Economic Activity Indicators, 1989-2001 1/



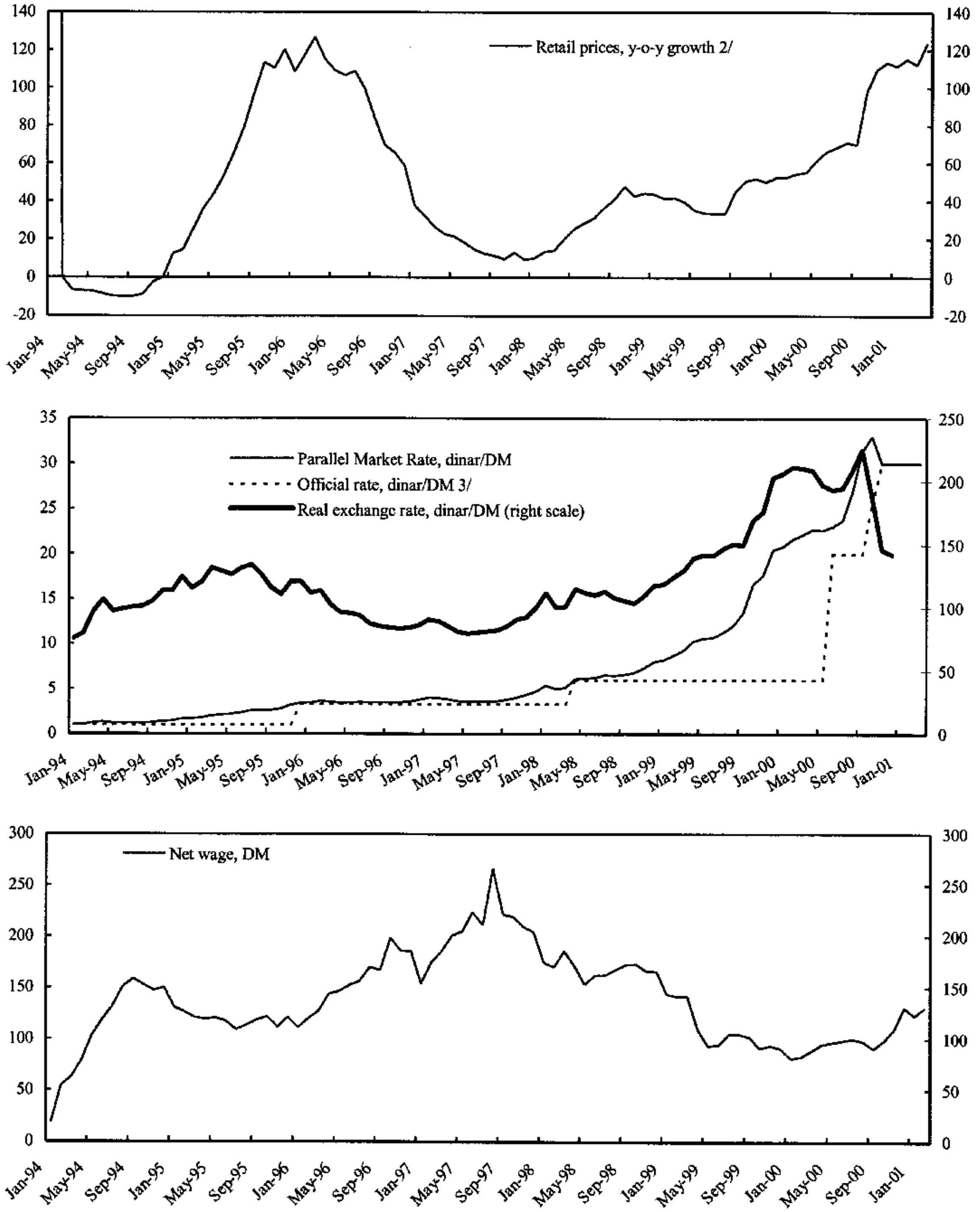
Sources: Federal Institute of Statistics and National Bank of Yugoslavia.

1/ Data before 1991 refer to the territory of the Republics of Serbia and Montenegro; after February 1999 indicators refer to the territory excluding Kosovo and Metohia.

2/ Growth rates for 1990-94 refer to Gross Social Product (GSP), which is about 15-20 percent smaller than GDP as it excludes public and other services.

3/ In 1997 the official statistics begun to track employment in small enterprises excluded from other surveys.

Figure 2. Federal Republic of Yugoslavia: Prices, Exchange Rates, and Wages
January 1994-January 2001 1/



Sources: Federal Institute of Statistics; National Bank of Yugoslavia; and Fund staff calculations.

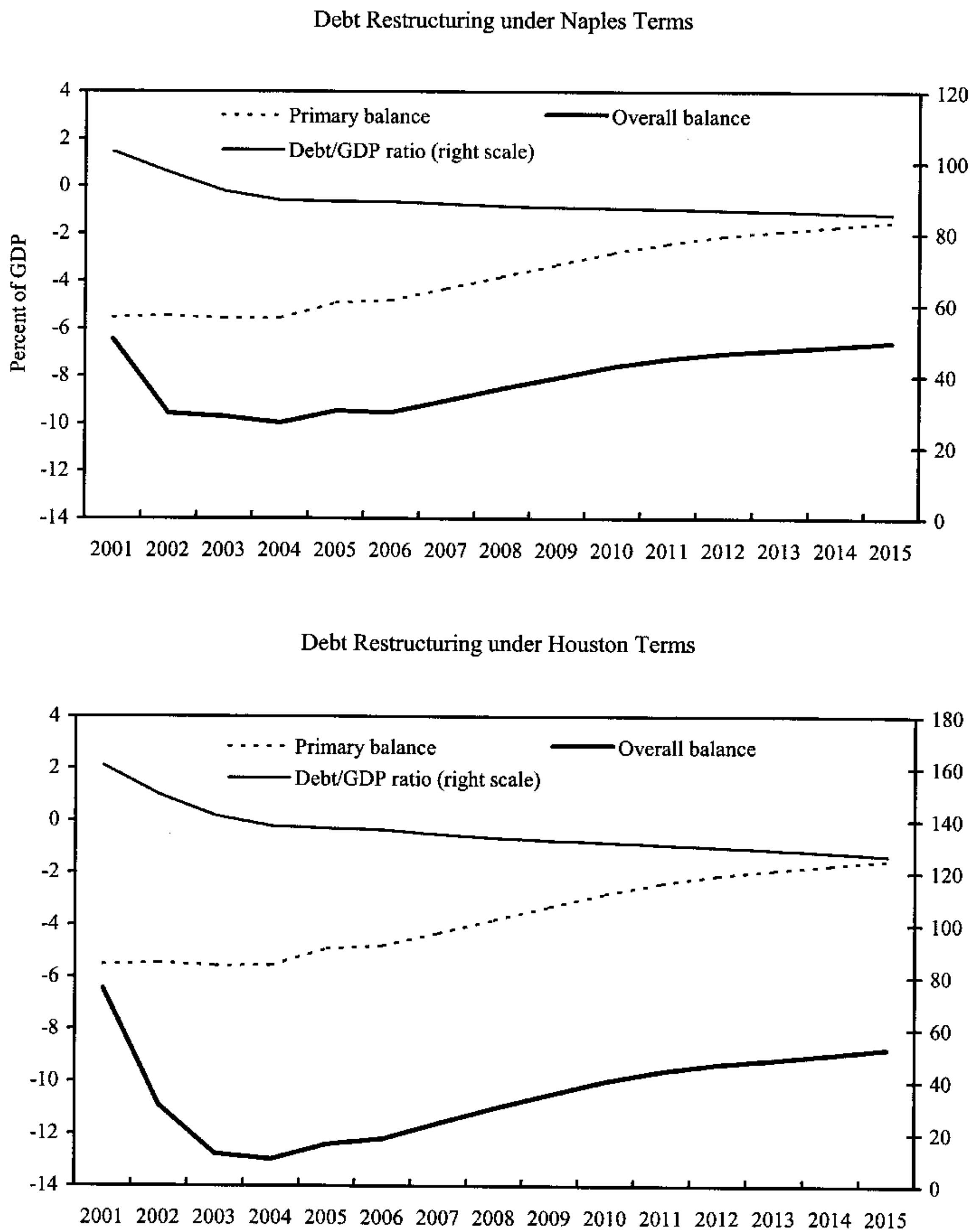
1/ Data after February 1999 excludes Kosovo and Metohia.

2/ In January 1994, monthly inflation peaked at 300 billion percent; figures for February 1994-January 1995 represent accumulated inflation relative to end-January 1994.

3/ The official exchange rate includes a premium which was applied in most but not all official transactions between May-November 2000. The exchange rate was unified on December 5, 2000.

4/ Real index obtained by applying the FRY retail price index and the German CPI to the average parallel market rate. Increase denotes depreciation.

Figure 3. Federal Republic of Yugoslavia: Public Debt, 2001-2015



Sources: Ministries of Finance of the FRY, Serbia, and Montenegro; and Fund staff estimates and projections.

Table 1. Federal Republic of Yugoslavia (Serbia/Montenegro): Selected Economic and Financial Indicators, 1996-2001 1/

	1996	1997	1998	1999	2000 Prel.	2001 Prel. Proj.
Real economy						
GDP, in millions of US dollars	14,455	16,556	13,889	10,155	8,071	10,231
Average net real wage, 1994 =100	120	146	150	129	150	150
Average net wage in DM, at gray market exchange rates	155	206	169	109	99	149
			(Percent change)			
Real GDP	7.8	10.1	1.9	-15.7	5.0	5.0
Industrial production	7.6	9.5	3.6	-22.5	10.9	0.0
Retail prices (annual average)	92.7	18.5	29.8	42.4	71.8	86-89
Retail prices (end of period)	...	...	...	49.9	113.5	30-35
Unemployment rate (in percent) 2/	25.8	25.8	25.1	26.5	27.3	...
			(Percent of GDP)			
General government finances 3/						
Revenue 4/	...	...	...	...	38.8	39.9
Expenditure	...	...	...	...	39.7	45.9
Of which: Budget for reconstruction and recovery	...	...	...	...	0.0	2.3
Cash balance	...	...	...	...	-0.9	-6.1
Domestic financing	...	...	...	...	0.1	0.6
Foreign financing	...	...	...	...	0.0	2.9
Foreign grants	...	...	...	...	0.8	1.2
Privatization receipts	...	...	...	...	0.0	1.4
Commitment balance 5/	...	...	...	...	-3.0	-6.1
			(Percent change)			
Money supply (end-of-period)						
M1 6/	...	...	...	47.3	85.1	36.0
M2 6/ 7/	...	...	...	67.6	61.4	20.4
Balance of payments			(In billions of U.S. dollars)			
Merchandise exports 8/	2.0	2.4	3.0	1.7	1.9	2.1
Merchandise imports	-4.1	-4.8	-4.8	-3.3	-3.8	-4.5
Trade balance	-2.1	-2.4	-1.9	-1.6	-1.8	-2.4
Current account balance, after grants 9/	-0.6	-1.6	-0.7	-0.8	-0.4	-1.2
(In percent of GDP)	-4.1	-9.4	-5.0	-7.5	-5.0	-11.4
Current account balance, before grants 9/	-0.6	-1.6	-0.7	-0.8	-0.7	-1.8
(In percent of GDP)	-4.1	-9.4	-5.0	-7.5	-8.3	-17.7
Foreign debt (year-end) 10/	...	...	...	...	11.7	12.5
Gross official reserves	...	...	...	0.3	0.5	0.7
(In months of imports of goods and services)	...	...	...	1.1	1.5	1.7

Sources: Federal Statistical Office; National Bank of Yugoslavia; Ministry of Finance of the Federal Republic; Ministry of Finance of the Republic of Serbia; and Fund staff estimates.

1/ With the exception of money supply and foreign debt, data for 1999-2001 exclude Kosovo. GDP excludes Kosovo throughout.
2/ Excludes workers on "forced holiday" (about 20-25 percent of the labor force in recent years).
3/ Fiscal operations of all levels of government, except for Montenegro where it excludes local governments.
4/ Excludes foreign grants.
5/ Excludes arrears of local governments and most interest payments on foreign debt due but not paid.
6/ From 1999 onwards excludes Montenegro.
7/ Frozen foreign-currency deposits are excluded and other foreign-currency deposits are valued at parallel market rates until September 2000 and at YUD 30 per DM thereafter.
8/ From 1996, includes previously unrecorded exports of about US$0.2 billion.
9/ In 2000-01, includes previously unrecorded transfers of US$0.6 billion.
10/ Includes arrears on unpaid imports of fuel and gas.

Table 2. Federal Republic of Yugoslavia: Balance of Payments, 1997-2002

(in millions of U.S. dollars)

	1997	1998	1999	2000	2001	2002
				Prel.	Projections	
Trade balance	-2,352	-1,816	-1,619	-1,849	-2,441	-2,566
Exports f.o.b.	2,447	3,033	1,677	1,923	2,064	2,403
(percent growth)		24	-45	14.7	7.3	16.4
Recorded	2,368	2,858	1,498	1,723	1,964	2,403
Unrecorded	79	175	179	200	100	0
Imports f.o.b.	-4,799	-4,849	-3,296	-3,772	-4,506	-4,969
(percent growth)		1.0	-32.0	14.4	19.4	10.3
Services, net	456	493	228	331	210	239
Receipts	818	914	471	624	775	884
Expenditure	-362	-421	-243	-293	-565	-644
Net factor income 1/	25	8	-41	-1	-470	-855
Of which: Net interest	25	8	-41	11	-470	-855
Earnings	59	57	43	53	52	59
Payments	-34	-49	-84	-42	-522	-915
Private remittances	310	655	668	848	890	914
Inflows	662	1,033	948	1,132	1,190	1,250
Recorded	465	688	501	632	980	1,070
Unrecorded	197	345	447	500	210	180
Outflows	-352	-378	-280	-284	-300	-336
Current account balance, before grants	-1,562	-660	-764	-671	-1,812	-2,268
(In percent of GDP)	-9.4	-4.8	-7.5	-8.3	-17.7	-19.7
Official grants	0	0	0	271	550	290
Foreign direct investment	740	113	112	25	160	300
Foreign loans	283	-10	-25	181	-98	-79
Medium and long term	54	25	12	214	-98	-120
Disbursements	128	50	29	227	70	82
Amortization 2/	-74	-25	-17	-14	-168	-202
Short term, net	229	-35	-37	-33	0	41
Other capital inflows	139	78	30	49	50	50
Capital account balance	1,162	181	117	255	112	271
Errors and omissions	180	278	410	290	290	290
Overall balance	-220	-201	-237	145	-860	-1,417
Financing	220	201	237	-145	-9,806	-250
Net foreign assets (increase, -)	18	115	111	-207	-217	-250
Central Bank						
Gross foreign reserves	18	115	111	-227	-217	-250
Gross foreign liabilities	0	0	0	20	0	0
IMF	0	0	0	20	0	0
Other	0	0	0	0	0	0
Arrears (reduction, -) 3/	202	86	126	62	-9,589	0
Financing gap, *to be filled by:*	0	0	0	0	10,666	1,667
Program and project assistance	0	0	0	0	821	1,190
World Bank	0	0	0	0	85	205
IMF	0	0	0	0	192	64
EBRD	0	0	0	0	10	100
Other, including June Donor Conference	0	0	0	0	534	...
Of which : EU/G-24 balance of payments support	0	0	0	0	300	...
Other project assistance	0	0	0	0	234	...
Of which : Grants	0	0	0	0	100	310
Residual gap, *to be possibly filled by debt relief 4/*	0	0	0	0	9,845	477
Arrears	0	0	0	0	9,369	...
Current maturities	0	0	0	0	476	...
Memorandum items:						
Current account balance, after committed and expected grants	-1,562	-660	-764	-400	-1,162	-1,668
(In percent of GDP)	-9.4	-4.8	-7.5	-5.0	-11.4	-14.5
Debt service, cash 5/	108	74	101	56	215	925
(In percent of GDP)	0.7	0.5	1.0	0.7	2.1	8.0
Principal	74	25	17	14	11	165
Interest	34	49	84	42	204	760

Sources: National Bank of Yugoslavia and Fund staff estimates.

1/ Up to 2000, only interest paid is included.

2/ Up to 2000, only amortization paid is included.

3/ Reflects the accumulation of arrears on unpaid imports of oil and gas. In 1999-2000 also includes arrears on unpaid interest.

4/ The assumed rescheduling on Houston terms (consolidation period through end-March 2002) would cover the residual gap in 2001 and about US$190 million in 2002.

5/ Includes interest on short term debt but not principal repayments.

Table 3. Federal Republic of Yugoslavia: Stock of External Debt at end-December 2000
(In millions of U.S. dollars)

	Creditor	Total Debt	*Of which:* Arrears Principal	Interest	Late Interest	Total Arrears
I.	Total stock of outstanding debt	11,725	5,535	1,558	2,496	9,589
	Of which : Medium and long-term debt	11,062	5,535	1,558	2,496	9,589
II.	Multilateral creditors	2,526	1,167	360	588	2,115
	IMF	152	0	0	0	0
	IBRD	1,781	1,004 1/	263	436	1,703
	Eurofima	126	0	0	0	0
	IFC	137	76	9	52	137
	EIB	275	59	82	79	220
	Other	55	28	6	21	55
III.	Official bilateral creditors	4,918	2,559	404	1,570	4,533
	Paris Club	4,582	2,523	404	1,570	4,497
	Pre-cutoff (1982) debt	3,520	1,975	304	1,209	3,488
	Previously rescheduled	2,450	1,363	269	818	2,450
	Previously not rescheduled	1,070	612	35	391	1,038
	Post-cutoff (1982) debt	1,062	548	100	361	1,009
	Other bilateral creditors (largely post-1992)	336	36	0	0	36
IV.	London Club 2/	2,309	836	717	120	1,673
V.	Other commercial creditors	599	323	17	218	558
VI.	Debt incurred in non-convertible currencies	209	209	0	0	209
VII.	Debt related to unpaid imports of oil and gas	501	441	60	0	501
VIII.	Short-term debt (largely non-guaranteed)	663	0	0	0	0

Source: Data provided by the FRY authorities; not yet reconciled with creditor data.

1/ Including exchange rate adjustments.

2/ Debt held by the NBY amounting to US$500 million has been excluded; but other debt held by Yugoslav-connected parties may be included.

Table 4. Federal Republic of Yugoslavia: Net Foreign Assets--Actual and Program Floors, December 2000 - December 2001
(In millions of US dollars at end-2000 exchange rates)

	2000	2001					
	Dec.	Jan.	Feb.	Mar. Prel.	June Prog.	Sep. Prog.	Dec. Prog.
Net foreign assets of the NBY 1/	364	376	399	457	389	369	389
Net foreign assets of the NBY for program purposes	-308	-305	-283	-231	-283 2/	-303 2/	-283 2/
Gross foreign assets	516	528	551	608	605	649	733
Gold	125	125	126	126	...	...	...
Foreign currencies	240	197	187	178	...	...	...
Foreign exchange accounts abroad	152	206	239	305	...	...	...
Reserve-related liabilities (-)	152	152	152	152	216	280	344
Gross reserve liabilities for program purposes (-)	825	833	834	840	888	952	1,016
IMF	152	152	152	152	216	280	344
Other	0	0	0	0	0	0	0
Adjustments for program purposes	672	681	682	688	672	672	672
Foreign currency liabilities to domestic banks	672	681	682	688	...	...	...
Loan from China deposited by Yugoslav bank	100	100	100	100	...	...	...
Forex deposits from commercial banks	61	65	61	66	...	...	...
Unpaid interest	70	70	70	70	...	...	...
Short-term loan from commercial banks	11	12	12	12	...	...	...
Minimum reserve and other deposits	105	109	115	115	...	...	...
Old obligations commercial banks	325	325	325	325	...	...	...
Foreign currency liabilities to nonbank private residents	0	0	0	0	...	...	...
Net foreign assets of commercial banks of Serbia	366	387	365	364	366	366	366

Sources: National Bank of Yugoslavia; and Fund staff estimates and calculations.

1/ Excluding frozen assets and liabilities of the FRY and undivided assets of the SFRY.
2/ Program floor.

Table 5. Federal Republic of Yugoslavia: Balance Sheet of the National Bank of Yugoslavia, December 1999-December 2001 1/

(In millions of dinars; end of period)

	1999	2000				2001					
	Dec.	Mar.	June	Sep.	Dec.	Jan.	Feb.	Mar. Prel.	June Prog.	Sep. Prog.	Dec. Prog.
Net foreign assets	-22,549	-26,135	-21,231	-27,167	-19,470	-19,272	-17,876	-14,618	-17,879 2/	-19142 2/	-17,879 2/
Net foreign assets in DM million	-1,074	-1,162	-923	-906	-649	-642	-596	-487	-596	-638	-596
Gross foreign assets 3/	11,975	11,751	17,375	24,628	32,619	33,326	34,817	38,430	38,197	40,977	46,282
Gross reserve liabilities (-) 4/	-34,524	-37,886	-38,606	-51,795	-52,088	-52,598	-52,693	-53,048	-56,076	-60119	-64,161
Net domestic assets	32,016	36,085	32,085	41,388	39,315	37,797	36,256	34,526	39,064 5/	41766 5/	42909 5/
Domestic credit	107,968	120,412	124,285	167,691	153,432	151,839	149,674	145,329	...	...	...
Net claims on government	5,096	6,415	6,344	8,781	5,480	5,490	3,944	1,849	...	...	...
Claims	6,713	8,083	8,675	11,162	11,424	11,352	11,427	11,433	...	...	...
Dinar credits	1,652	2,364	2,685	2,691	3,071	3,107	3,182	3,187	...	...	...
Foreign currency credits	5,060	5,720	5,990	8,472	8,353	8,245	8,245	8,246	...	...	...
Liabilities (-)	-1,617	-1,668	-2,331	-2,381	-5,944	-5,862	-7,483	-9,584	...	...	...
Dinar liabilities	-547	-498	-1,145	-702	-1,462	-1,365	-2,980	-3,608	...	...	...
Foreign currency liabilities	-1,070	-1,170	-1,186	-1,680	-4,482	-4,497	-4,503	-5,976	...	...	...
Net claims on banks	100,214	111,013	115,110	154,894	144,753	143,244	142,926	140,340	...	...	...
Claims	100,677	111,488	115,404	155,964	145,431	144,469	144,200	141,592	...	...	...
Recourse to required reserves	866	859	1,023	1,521	1,002	1,029	1,105	882	...	...	...
Other dinar credits	4,120	3,357	3,224	3,322	3,364	3,423	3,409	3,401	...	...	...
Foreign currency credits	95,690	107,271	111,157	151,121	141,065	140,017	139,686	137,309	...	...	...
Foreign currency credits in DM million	4,557	4,768	4,833	5,037	4,702	4,667	4,656	4,577	...	...	...
Liabilities (-)	-463	-475	-294	-1,070	-677	-1,225	-1,275	-1,252	...	...	...
Net claims on the rest of the economy	2,658	2,984	2,832	4,016	3,199	3,106	2,805	3,140	...	...	...
Claims	2,785	3,095	3,106	4,178	3,660	3,683	3,567	3,559	...	...	...
Dinar credits	2,663	2,957	2,963	3,981	3,457	3,481	3,365	3,358	...	...	...
Foreign currency credits	123	137	143	197	203	202	202	201	...	...	...
Liabilities (-)	-127	-111	-274	-161	-461	-578	-762	-419	...	...	...
Dinar deposits	-127	-111	-274	-161	-461	-578	-762	-419	...	...	...
Other assets, net	-75,951	-84,327	-92,200	-126,303	-114,117	-114,042	-113,419	-110,802	...	...	...
Reserve money	9,467	9,950	10,854	14,222	19,845	18,524	18,379	19,907	21186	22624	25,030
Currency in circulation	6,688	6,203	7,159	9,026	10,933	9,907	10,419	11,258	12100	13100	14,869
Reserve deposits	2,779	3,747	3,695	5,196	8,912	8,617	7,960	8,649	9086	9524	10,160
Required reserves held 6/	1,217	1,656	1,723	2,569	3,822	4,169	4,172	4,730	5886	6124	6,560
Shortfall in required reserves 6/	866	859	1,023	1,521	1,002	1,029	1,105	882	0	0	0
Excess reserves 7/	696	1,231	948	1,106	4,088	3,420	2,684	3,037	3200	3400	3600
Memorandum items: (quarterly average, 12-months growth rates, unless otherwise indicated) 6/											
Reserve money, nominal	26.0	28.0	27.9	66.9	109.6	96.2	88.9	100.1	95.2	59.1	26.1
Reserve money, real	-15.9	-14.6	-20.1	5.2	-1.8	-10.1	-14.8	-9.5	-11.6	-17.5	-4.8
Currency in circulation, nominal	32.3	23.8	30.6	57.5	63.5	63.3	73.2	81.5	69.0	45.1	36.0
Currency in circulation, real	-11.8	-17.4	-18.4	-0.7	-23.4	-25.2	-21.9	-17.9	-23.5	-24.7	2.6
Required reserves, including shortfall, nominal	2.7	12.7	33.1	130.4	131.6	133.5	122.8	123.1	114.3	49.7	36.0
Required reserves, including shortfall, real	-31.5	-24.8	-16.8	45.3	8.5	7.0	0.4	0.9	-3.0	-22.3	2.6
Excess reserves, nominal	62.4	131.4	1.1	8.8	487.4	197.9	99.8	146.6	237.5	207.5	-11.9
Excess reserves, real	8.4	54.5	-36.8	-31.4	175.1	36.5	-9.9	11.6	52.8	59.5	33.5
Excess reserves as a share of quarterly GDP (percent)	1.18	1.89	1.28	1.29	3.07	2.50	1.90	2.08	1.86	1.91	1.88
Cash in circulation as share of quarterly GDP (percent)	11.37	9.51	9.69	10.50	8.22	7.23	7.36	7.70	7.04	7.38	7.75

Sources: National Bank of Yugoslavia; and Fund staff estimates and calculations.

1/ Foreign exchange denominated items convered at parallel market exchange rates up to June 2000, at YUD 30 = DM for September and at end-2000 (program) exchange rates thereafter.
2/ Program floor.
3/ Excluding frozen assets of the FRY and undivided assets of the SFRY.
4/ Excludes long-term liabilities and undivided liabilities of the SFRY. Including foreign-currency denominated liabilities to domestic banks and residents.
5/ Program ceiling.
6/ Reserves banks are required to hold in NBY account 201 to satisfy the standard 24.5 percent reserve requirement.
7/ Comprises balances in Giro accounts and cash in commercial bank vaults.

Table 6. Monetary survey of Serbia, December 1999 - December 2001

(In millions of dinars; end of period)

	1999	2000				2001					
	Dec.	Mar.	June	Sept.	December	January	February	March Preliminary	June Program	September Program	December Program
Net Foreign Assets 1/	21,596	21,093	28,765	41,663	46,090	48,196	48,266	51,818	47,675	46,411	47,675
(NFA in DM m.)	1,028	937	1,251	1,389	1,536	1,607	1,609	1,727	1,589	1,547	1,589
Assets	26,921	27,068	34,916	50,300	55,712	57,782	57,852	61,404	61,303	64,083	69,389
NBY	11,975	11,751	17,375	24,628	32,619	33,326	34,817	38,430	38,197	40,977	46,282
Commercial banks	14,947	15,317	17,540	25,672	23,093	24,456	23,035	22,974	23,106	23,106	23,106
Liabilities (-) 2/	-5,325	-5,975	-6,151	-8,636	-9,623	-9,586	-9,586	-9,586	-13,628	-17,671	-21,714
NBY	-5,325	-5,975	-6,151	-8,636	-9,623	-9,586	-9,586	-9,586	-13,628	-17,671	-21,714
Net Domestic Assets	18,991	21,675	17,765	18,306	19,433	17,007	16,748	15,720	24,604 3/	28,226 3/	31,226 3/
Domestic credit	133,017	152,501	159,805	210,846	218,642	219,804	218,515	215,825		...	...
Net credit to government	6,869	7,627	6,962	10,066	5,917	5,829	4,519	1,788	7,917 3/	9,917 3/	9,917 3/
Credit	10,521	11,645	12,363	15,347	15,367	14,999	14,889	14,710	...	...	...
Dinar credit	4,573	4,926	5,339	5,446	5,521	5,279	5,171	5,052	...	...	...
NBY	1,652	2,364	2,685	2,691	3,071	3,107	3,182	3,187	...	...	...
Commercial banks	2,921	2,562	2,654	2,756	2,450	2,173	1,989	1,865	...	...	...
Foreign currency credits	5,948	6,719	7,024	9,901	9,846	9,720	9,718	9,658	...	...	...
NBY	5,060	5,720	5,990	8,472	8,353	8,245	8,246	8,246	...	...	...
Commercial banks	887	999	1,034	1,429	1,493	1,475	1,472	1,412	...	...	...
Deposits	-3,652	-4,018	-5,402	-5,281	-9,450	-9,171	-10,369	-12,922	...	...	...
Dinar credit	-2,448	-2,625	-3,854	-3,324	-4,745	-4,492	-5,686	-6,771	...	...	...
NBY	-547	-498	-1,145	-702	-1,462	-1,365	-2,980	-3,608	...	...	...
Commercial banks	-1,901	-2,127	-2,709	-2,622	-3,282	-3,127	-2,706	-3,163	...	...	...
Foreign currency deposits	-1,204	-1,393	-1,548	-1,958	-4,705	-4,679	-4,683	-6,151	...	...	...
NBY	-1,070	-1,170	-1,186	-1,680	-4,482	-4,497	-4,503	-5,976	...	...	...
Commercial banks	-134	-223	-361	-278	-223	-182	-180	-175	...	...	...
Credit to the non-government sector	126,148	144,874	152,844	200,780	212,725	213,976	213,996	214,037	...	...	...
Households	1,663	2,063	2,687	3,178	2,684	2,714	2,242	2,344	...	...	...
Non-profit and other sectors	3,662	7,130	7,037	8,184	24,409	25,132	24,861	24,828	...	...	...
Enterprises in dinar	20,719	23,118	25,334	28,674	31,189	31,786	33,424	34,468	...	...	...
Enterprises in foreign currency	100,104	112,563	117,786	160,744	154,444	154,344	153,469	152,397	...	...	...
Enterprises in foreign currency (DM million)	4,767	5,003	5,121	5,358	5,148	5,145	5,116	5,080	...	...	...
Other items, net.	-114,026	-130,826	-142,041	-192,539	-199,209	-202,797	-201,767	-200,105	...	...	...
Broad Money (M2)	40,587	42,768	46,530	59,970	65,522	65,203	65,015	67,538	72,279	74,637	78,901
Dinar-denominated M2	18,229	19,277	21,054	25,752	32,588	32,089	32,496	35,244	38,521	40,591	44,319
M1	14,552	15,476	17,208	21,078	26,954	26,262	26,580	28,875	31,648	33,440	36,658
Currency outside banks	6,688	6,203	7,159	9,026	10,932	9,907	10,419	11,257	12,100	13,100	14,869
Demand deposit	7,864	9,273	10,049	12,051	16,022	16,355	16,161	17,618	19,548	20,340	21,789
Time and savings deposits	3,677	3,801	3,846	4,675	5,633	5,827	5,916	6,369	6,873	7,151	7,661
Foreign currency deposit (non-frozen)	22,358	23,491	25,476	34,218	32,935	33,114	32,519	32,294	33,758	34,046	34,581
Foreign currency deposit (not-frozen), DM million	1,065	1,044	1,108	1,141	1,098	1,104	1,084	1,076	1,125	1,135	1,153
Memorandum items:											
Frozen foreign currency deposit (dinar million)	143,956	156,258	159,790	210,102	211,431	212,019	212,023	...		...	...
Frozen foreign currency deposit (DM million))	6,855	6,945	6,947	7,003	7,048	7,067	7,067	...		...	...

Sources: National Bank of Yugoslavia; and Fund staff estimates and calculations.

1/ Foreign-exchange denominated items convered at parallel market exchange rates up to September 2000, at YUD 30 = DM for September and at end-2000 (program) exchange rates thereafter.

2/ Excluding frozen liabilities and liabilities that are likely to be rescheduled as part of Yugoslavia's negotiations with official creditors.

3/ Program ceiling.

Table 7A. Federal Republic of Yugoslavia: Consolidated General Government Fiscal Operations in 2000-2001 1/

	Consolidated General Government excluding Montenegro						Consolidated General Government including Montenegro					
	2000 Jan.-Dec. Actual	2001 Jan.-Dec. Proj.	2000 Jan.-Dec. Actual	2001 Jan.-Dec. Proj.	2000 Jan.-Dec. Actual	2001 Jan.-Dec. Proj.	2000 Jan.-Dec. Estimated	2001 Jan.-Dec. Proj.	2000 Jan.-Dec. Estimated	2001 Jan.-Dec. Proj.	2000 Jan.-Dec. Estimated	2001 Jan.-Dec. Proj.
	(Billion dinars)		(Percent of GDP) 2/		(Euro million)		(Billion dinars)		(Percent of GDP) 2/		(Euro million)	
Total revenue	129.0	250.8	35.7	36.5	3,436	3,976	140.4	274.3	38.8	39.9	3,740	4,349
Current revenue	129.0	250.3	35.7	36.4	3,436	3,968	140.4	273.2	38.8	39.7	3,740	4,331
Tax revenue	115.9	229.9	32.0	33.4	3,087	3,645	126.6	251.6	35.0	36.6	3,373	3,988
Personal income tax	12.6	26.0	3.5	3.8	336	412	12.9	26.7	3.6	3.9	343	424
Social security contributions	39.7	73.2	11.0	10.6	1,058	1,160	44.8	83.9	12.4	12.2	1,193	1,330
Corporate income tax	1.1	2.1	0.3	0.3	29	33	1.1	2.1	0.3	0.3	29	33
Retail sales tax	29.4	57.5	8.1	8.4	784	912	32.9	63.8	9.1	9.3	877	1,012
Excises	9.9	25.1	2.7	3.7	263	398	9.9	25.1	2.7	3.7	263	398
Taxes on international trade and operations	8.5	14.1	2.4	2.1	227	224	10.3	17.8	2.9	2.6	276	282
Other taxes	14.6	31.9	4.0	4.6	389	506	14.7	32.1	4.1	4.7	392	509
Extrabudgetary taxes	0.0	0.0	0.0	0.0	0	0	0.0	0.0	0.0	0.0	0	0
Nontax revenue	13.1	20.4	3.6	3.0	349	323	13.8	21.6	3.8	3.1	367	342
Capital revenue	0.0	0.5	0.0	0.1	0	8	0.0	1.1	0.0	0.2	0	18
Total expenditure and net lending	129.6	289.5	35.8	42.1	3,451	4,589	143.6	315.9	39.7	45.9	3,824	5,008
Current expenditure	118.6	256.2	32.8	37.3	3,159	4,062	131.2	279.6	36.3	40.7	3,493	4,434
Expenditure on goods and services	61.6	123.2	17.0	17.9	1,642	1,953	66.4	132.7	18.4	19.3	1,768	2,104
Wages and salaries	33.4	64.5	9.2	9.4	890	1,023	36.0	71.1	10.0	10.3	959	1,127
Other purchases of goods and services	28.2	58.7	7.8	8.5	751	930	30.4	61.6	8.4	9.0	809	977
Interest payment	2.2	6.7	0.6	1.0	58	106	2.2	6.7	0.6	1.0	59	107
Subsidies and other current transfers	54.8	126.3	15.1	18.4	1,459	2,002	62.5	140.2	17.3	20.4	1,666	2,223
Subsidies	7.1	21.8	2.0	3.2	189	345	8.1	22.5	2.2	3.3	215	356
Transfers to households	47.7	104.5	13.2	15.2	1,270	1,657	54.5	117.7	15.1	17.1	1,451	1,866
Capital expenditure	11.0	23.6	3.0	3.4	292	375	11.8	24.8	3.3	3.6	314	394
General reserves	0.0	2.8	0.0	0.4	0	44	0.3	4.1	0.1	0.6	8	65
Lending minus repayment	0.0	6.8	0.0	1.0	0	108	0.3	7.3	0.1	1.1	8	116
Overall balance	-0.6	-38.7	-0.2	-5.6	-15	-614	-3.2	-41.8	-0.9	-6.1	-85	-662
Foreign grants	0.1	5.2	0.0	0.8	3	82	2.8	8.1	0.8	1.2	74	128
Overall balance including grants	-0.5	-33.5	-0.1	-4.9	-13	-531	-0.4	-33.7	-0.1	-4.9	-11	-534
Statistical discrepancy	0.0	0.0	0.0	0.0	1	0	0.0	0.0	0.0	0.0	1	0
Financing	0.5	33.5	0.1	4.9	14	531	0.5	33.7	0.1	4.9	12	534
Domestic financing	0.5	4.0	0.1	0.6	14	63	0.5	4.1	0.1	0.6	12	65
Bank financing	0.1	4.0	0.0	0.6	4	63	0.1	4.1	0.0	0.6	2	65
NBY	0.1	4.0	0.0	0.6	4	63	0.1	4.0	0.0	0.6	4	63
Commercial banks	0.0	0.0	0.0	0.0	0	0	-0.1	0.2	0.0	0.0	-2	3
Non-bank financing	0.4	0.0	0.1	0.0	10	0	0.4	0.0	0.1	0.0	10	0
Foreign Financing	0.0	19.9	0.0	2.9	0	315	0.0	19.9	0.0	2.9	0	315
Privatization receipts	0.0	9.7	0.0	1.4	0	153	0.0	9.7	0.0	1.4	0	153
Unidentified financing	0.0	0.0	0.0	0.0	0	0	0.0	0.0	0.0	0.0	0	0
Accumulation of expenditure arrears	7.5	0.0	2.1	0.0	201	0	7.5	0.0	2.1	0.0	201	0
Overall commitment balance excluding foreign grants	-8.1	-38.7	-2.2	-5.6	-216	-614	-10.7	-41.8	-3.0	-6.1	-285	-662

Sources: Ministries of Finance of the FRY, Republic of Serbia and Republic of Montenegro; and Fund staff estimates.

1/ Consolidated general government includes the federal, the republican and local governments, the social security funds and the extrabudgetary programs.

2/ Expressed in terms of GDP of the FRY excluding Kosovo.

Table 7B. Federal Republic of Yugoslavia: Federal Government Fiscal Operations, 1997-2001

(In percent of GDP) 1/

	1997 Jan.-Dec. Actual	1998 Jan.-Dec. Actual	1999 Jan.-Dec. Actual	2000 Budget	2000 Jan.-Dec. Estimates	2001 Budget	2001 Jan.-Dec. Projections
A Total revenue and grants (1+2)	6.6	6.1	7.0	8.1	7.5	7.6	6.7
1 Total revenue (1.1+1.2)	6.6	6.1	7.0	8.1	7.5	7.6	6.7
1.1 Current revenue (1.1.1+1.1.2)	6.6	6.1	7.0	8.1	7.5	7.6	6.7
1.1.1 Tax revenue (1.1.1.1+1.1.1.2+1.1.1.3)	5.3	5.2	5.7	7.1	6.7	6.3	5.8
1.1.1.1 Turnover (retail sales) tax	2.1	2.4	2.5	3.3	4.2	3.7	3.5
1.1.1.2 Taxes on international trade and operations	2.7	2.3	2.3	3.2	2.4	2.4	2.1
1.1.1.3 Other taxes	0.5	0.4	0.3	0.6	0.2	0.3	0.2
1.1.1.4 Extrabudgetary taxes	0.0	0.0	0.6	0.0	0.0	0.0	0.0
1.1.2 Nontax revenue	1.4	0.9	1.2	1.0	0.8	1.3	0.9
1.2 Capital revenue	0.0	0.0	0.0	0.0	0.0	0.0	0.0
2 Grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0
B Total expenditure and net lending (1+2)	6.6	6.1	7.0	8.1	7.5	7.6	6.7
1 Total expenditure (1.1+1.2)	6.6	6.1	7.0	8.1	7.4	7.4	6.4
1.1 Current expenditure (1.1.1+1.1.2)	6.6	6.1	7.0	8.1	7.4	7.3	6.3
1.1.1 Interest	0.0	0.0	0.0	0.2	0.1	0.1	0.1
1.1.2 Non-interest (1.1.2.1+1.1.2.2+1.1.2.3+1.1.2.4)	6.6	6.1	7.0	7.9	7.3	7.2	6.3
1.1.2.1 General Government Services	0.8	0.9	0.9	0.9	0.8	1.2	1.0
1.1.2.2 Defense	4.8	4.2	5.2	5.9	5.0	4.7	4.0
1.1.2.3 Social Insurance and Social Security Transfers	0.6	0.5	0.5	0.6	1.2	1.1	1.4
1.1.2.5 Other non-interest expenditure	0.4	0.4	0.4	0.5	0.3	0.1	0.0
1.2 Capital expenditure	0.0	0.0	0.0	0.0	0.0	0.1	0.1
2 Net lending	0.0	0.0	0.0	0.0	0.1	0.2	0.3
Overall budget balance (cash) (A-B)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Statistical discrepancy	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financing (1+2+3)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
1 Domestic financing (net) (1.1+1.2)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
1.1 Banking system (1.1.1+1.1.2)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
1.1.1 National Bank of Yugoslavia	0.0	0.0	0.0	0.0	0.0	0.0	0.0
1.1.2 Commercial banks	0.0	0.0	0.0	0.0	0.0	0.0	0.0
1.2 N onbank	0.0	0.0	0.0	0.0	0.0	0.0	0.0
2 Foreign financing (net) (2.1-2.2)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
2.1 Disbursements	0.0	0.0	0.0	0.0	0.0	0.0	0.0
2.2 Amortization	0.0	0.0	0.0	0.0	0.0	0.0	0.0
3 Privatization receipts	0.0	0.0	0.0	0.0	0.0	0.0	0.0
4 Unidentified financing	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:							
Nominal GDP (billion Dinars)	112.3	154.6	188.0	279.4	361.6	604.0	687.5
Modified overall balance including newly accumulated arrears	...	...	...	...	-1.1	...	0.0

Sources: Ministry of Finance of the FRY; and Fund staff estimates.

1/ Expressed in terms of GDP of the FRY excluding Kosovo.

Table 7C. Serbia: Republican Government Fiscal Operations, 1997-2001

(In percent of GDP) 1/

	1997	1998	1999	2000		2001		
	Jan.-Dec Actua	Jan.-Dec Actua	Jan.-Dec Preliminar	Budget	Jan.-Dec Estimate	Jan.-Mar. Temporary Budget 2/	Jan.-Dec Budge	Jan.-Dec Projection
A Total revenue and grants (1+2)	**12.3**	**10.9**	**9.4**	**10.4**	**13.7**	**14.2**	**16.3**	**15.8**
1 Total revenue (1.1+1.2)	12.3	10.9	9.4	10.4	13.6	14.2	15.7	15.3
1.1 Current revenue (1.1.1+1.1.2)	12.3	10.9	9.4	10.4	13.6	14.2	15.7	15.3
1.1.1 Tax revenue (1.1.1.1+...+1.1.1.6)	12.3	10.9	9.4	10.4	12.2	13.5	14.8	14.5
1.1.1.1 Personal income tax	6.4	4.8	3.7	4.2	3.4	3.7	3.7	3.6
1.1.1.2 Corporate income tax	0.3	0.3	0.5	0.6	0.3	0.2	0.3	0.3
1.1.1.3 Turnover (retail sales) tax	3.6	3.1	3.1	3.4	3.4	3.7	4.3	4.0
1.1.1.4 Excises	1.0	0.8	0.5	1.2	2.2	3.3	3.7	3.7
1.1.1.5 Property taxes	0.3	0.4	0.4	0.4	0.2	0.3	0.0	0.0
1.1.1.6 Other taxes	0.7	1.5	1.1	0.7	2.7	2.3	2.8	2.9
1.1.2 Nontax revenue	0.0	0.0	0.0	0.0	1.4	0.7	0.9	0.8
1.2 Capital revenue	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
2 Grants	0.0	0.0	0.0	0.0	0.0	0.0	0.6	0.6
Of which : Grants for the budget for recovery and restructuring	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
B. Total expenditure and net lending (1+5)	**12.3**	**10.9**	**9.4**	**10.4**	**14.0**	**14.2**	**18.9**	**20.7**
1. Total expenditure (2+3+4)	12.3	10.9	9.4	10.4	14.0	14.2	18.1	20.0
2 Current expenditure (2.1+2.2+2.3)	12.0	10.8	8.9	10.1	12.2	14.0	16.2	16.6
2.1. Expenditure on goods and services (2.1.1+...+2.1.4)	9.8	9.1	8.0	8.3	6.7	11.7	7.6	7.8
2.1.1 Wages and salaries	4.5	3.6	3.8	3.9	3.7	3.6	4.0	4.0
2.1.2 Employer contribution	1.4	1.1	1.2	1.0	0.9	1.2	0.9	0.9
2.1.3 Severance payments	0.0	0.0	0.0	0.0	0.0	0.0	0.2	0.2
2.1.4 Other purchases of goods and services	3.9	4.4	3.0	3.3	2.1	6.9	2.6	2.7
2.2. Interest payment	0.1	0.3	0.2	0.1	0.1	0.1	0.8	0.7
2.3. Subsidies and other current transfers	2.1	1.4	0.8	1.7	5.3	2.2	7.8	8.2
2.3.1 Subsidies	0.0	0.0	0.0	0.0	2.0	0.0	2.4	2.3
2.3.2 Transfers to households	2.0	1.3	0.8	1.3	1.4	1.9	2.5	2.4
Of which : Budget for recovery and reconstruction	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
2.3.3 Current transfers to other levels of government	0.1	0.1	0.0	0.3	1.9	0.3	3.0	3.4
Federal budget	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Republican budget	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Local Budgets	0.1	0.1	0.0	0.3	0.5	0.3	0.1	0.1
Pension Funds	0.0	0.0	0.0	0.0	1.4	0.0	2.4	2.6
Health Fund	0.0	0.0	0.0	0.0	0.0	0.0	0.3	0.3
Labor Market Fund	0.0	0.0	0.0	0.0	0.0	0.0	0.2	0.4
3. Capital expenditure	0.3	0.1	0.4	0.3	1.8	0.3	0.7	2.9
Capital transfer to other levels of government	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
4. General reserves	0.0	0.0	0.0	0.0	0.0	0.0	1.2	0.4
5. Lending minus repayment	0.0	0.0	0.0	0.0	0.0	0.0	0.8	0.7
Overall budget balance (cash) (A-B)	**0.0**	**0.0**	**0.0**	**0.0**	**-0.3**	**-0.1**	**-2.6**	**-4.9**
Core balance 3/	0.0	0.0	0.0	0.0	-0.3	-0.1	-2.6	-4.9
Balance of the budget for recovery and reconstruction 4/	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Statistical discrepancy	0.0	0.5	0.2	0.0	0.0	-0.1	0.0	0.0
Financing (1+2+3+4)	**0.0**	**0.5**	**0.2**	**0.0**	**0.3**	**0.0**	**2.6**	**4.9**
1 Domestic financing (net) (1.1+1.2)	0.0	0.5	0.2	0.0	0.3	0.0	0.6	0.6
1.1 Banking system (1.1.1+1.1.2)	0.0	0.5	0.2	0.0	0.2	0.0	0.6	0.6
1.1.1 National Bank of Yugoslavia	0.0	0.1	0.2	0.0	0.2	0.0	0.6	0.6
1.1.2 Commercial banks	0.0	0.3	0.0	0.0	0.0	0.0	0.0	0.0
1.2 Nonbank	0.0	0.0	0.0	0.0	0.1	0.0	0.0	0.0
2 Foreign financing (net) (2.1-2.2)	0.0	0.0	0.0	0.0	0.0	0.0	0.6	2.9
2.1 Disbursements	0.0	0.0	0.0	0.0	0.0	0.0	0.6	2.9
2.2 Amortization	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
3 Privatization receipts	0.0	0.0	0.0	0.0	0.0	0.0	1.4	1.4
4 Unidentified financing	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:								
Nominal GDP (billion Dinars)	112.3	154.6	188.0	279.4	361.6	131.2	685.0	687.5
Arrears (end of period)	0.2	0.8	2.7	0.0	0.9	0.0	2.8	0.5
Modified overall balance including newly accumulated arrears	0.0	-0.6	-2.0	0.0	0.2	0.0	-4.9	-4.9
Reform related expenditure							1.1	1.3
Of which : Social Solidarity Fund							0.4	0.4
Bank restructuring							0.1	0.1
Enterprise restructuring							0.2	0.2
Severance payment							0.2	0.2
Transfer to the Labor Market Fund							0.2	0.4
Overall core balance excluding reform related expenditure							-1.5	-1.3

Sources: Ministry of Finance of Serbia; and Fund staff estimates.

1/ Expressed in terms of GDP of the FRY excluding Kosovo.

2/ Expressed in terms of quarterly GDP of the FRY excluding Kosovo.

3/ Core balance excludes grants for and expenditure in the budget for recovery and reconstruction.

4/ Includes grants for and expenditure in the budget for recovery and reconstruction.

Table 7D. Montenegro: Republican Government Fiscal Operations, 2000-2001
(In percent of Montenegrin GDP)

	2000		2001		
	Budget	Jan.-Dec. Projections	Jan.-Dec. Budget	Jan.-Mar. Preliminary	Jan.-April Preliminary
A Total revenue and grants (1+2)	**31.5**	**37.2**	**30.9**	**6.5**	**9.6**
1 Total revenue (1.1+1.2)	29.0	28.8	26.7	6.1	8.4
1.1 Current revenue (1.1.1+1.1.2)	29.0	28.8	26.7	6.1	8.4
1.1.1 Tax revenue (1.1.1.1+1.1.1.2+1.1.1.3+1.1.1.4)	28.2	23.4	23.0	4.9	6.9
1.1.1.1 Personal income	11.9	6.8	7.4	1.6	2.2
1.1.1.2 Turnover (retail sales) tax	4.5	4.8	7.5	1.3	1.8
1.1.1.3 Excises	9.1	7.4	4.6	0.8	1.1
1.1.1.4 Other taxes	2.6	4.4	3.5	1.1	1.7
1.1.2 Nontax revenue	0.8	5.4	3.8	1.2	1.5
1.2 Capital revenue	0.0	0.0	0.0	0.0	0.0
2 Grants	2.5	8.3	4.1	0.5	1.2
B Total expenditure and net lending (1+2)	**31.3**	**37.0**	**30.8**	**8.2**	**12.0**
1 Total expenditure (1.1+1.2)	31.3	37.0	30.5	8.3	11.9
1.1 Current expenditure (1.1.1+1.1.2)	27.8	32.4	28.0	7.5	10.9
1.1.1 Interest	0.1	0.2	0.1	0.0	0.0
1.1.2 Non-interest (1.1.2.1+1.1.2.2+1.1.2.3+1.1.2.4)	27.7	32.2	28.0	7.5	10.9
1.1.2.1 wages and salaries	16.3	15.6	15.8	2.8	4.1
1.1.2.2 goods and services	0.0	0.0	5.3	1.9	2.4
1.1.2.3 Social Insurance and Social Security Transfers	2.9	3.9	4.2	1.9	3.0
1.1.2.4 Other non-interest expenditure	8.4	12.8	2.7	0.9	1.3
1.2 Capital expenditure	3.6	4.6	2.5	0.8	1.1
2 Net lending	0.0	0.0	0.4	-0.1	0.0
C Net transfer to other levels of government (1+3-2-4)	**0.1**	**0.1**	**0.0**	**0.0**	**0.0**
1 Transfers to lower levels of government	0.1	0.1	0.0	0.0	0.0
2 Transfers from lower levels of government	0.0	0.0	0.0	0.0	0.0
3 Transfers to extra-budgetary social security funds	0.0	0.0	0.0	0.0	0.0
4 Transfers from extra-budgetary funds	0.0	0.0	0.0	0.0	0.0
Overall budget balance excluding grants (cash) (A-B-C-2)	**-2.5**	**-8.3**	**-4.1**	**-2.1**	**-4.9**
Overall budget balance (cash) (A-B-C)	**0.0**	**0.0**	**0.0**	**-1.7**	**-2.4**
Statistical discrepancy	0.0	0.0	0.0	-0.1	0.0
Financing (1+2+3)	**0.0**	**0.0**	**0.0**	**1.5**	**2.4**
1 Domestic financing (net) (1.1+1.2)	0.0	0.0	0.0	1.5	2.4
1.1 Banking system (1.1.1+1.1.2)	0.0	0.0	0.0	1.5	2.4
1.1.1 National Bank of Yugoslavia	0.0	0.0	0.0	0.0	0.0
1.1.2 Commercial banks	0.0	0.0	0.0	1.5	2.4
1.2 Nonbank	0.0	0.0	0.0	0.0	0.0
2 Foreign financing (net) (2.1-2.2)	0.0	0.0	0.0	0.0	0.0
2.1 Disbursements	0.0	0.0	0.0	0.0	0.0
2.2 Amortization	0.0	0.0	0.0	0.0	0.0
3 Privatization receipts	0.0	0.0	0.0	0.0	0.0
Memorandum items:					
Nominal GDP (million DM)	1252.3	1300.0	1455.0	1455.0	1455.0

Sources: Ministry of Finance of Montenegro; and Fund staff estimates.

Table 8. Federal Republic of Yugoslavia (Serbia/Montenegro): Macroframework Indicators, 2000-2005 1/

	2000	2001	2002	2003	2004	2005
	Prel.	Projection				
			(Percent change)			
Real GDP	5.0	5.0	5.0	5.0	5.0	4.0
End-period inflation (RPI)	113.5	30-35	13.5	9.3	7.8	7.0
Real exchange rate (-, appreciation)	30.0	-34.9	-5.0	-4.0	-3.0	-2.0
Real consumption per capita	5.1	6.9	3.4	3.3	3.1	2.2
Private	19.2	5.5	0.0	2.7	2.0	0.6
Public	...	12.5	15.8	5.0	6.6	7.3
			(In percent of GDP)			
Debt rescheduling under Houston terms 2/						
Gross domestic savings	-3.5	-3.5	-0.9	1.4	3.7	5.7
Net factor receipts and transfers from abroad 2/	13.9	10.5	5.7	4.1	3.6	2.9
Gross national savings	10.4	7.0	4.8	5.5	7.3	8.6
Private sector	8.1	8.7	10.9	11.2	13.2	14.6
Public sector	2.3	-1.7	-6.1	-5.7	-6.0	-6.0
Gross investment	15.3	18.3	19.2	19.6	19.8	19.8
Private sector	13.1	14.4	14.9	14.8	15.0	15.6
Public sector	3.3	3.6	4.0	4.5	4.5	4.0
Savings - investment balance	-5.0	-11.4	-14.5	-14.1	-12.5	-11.2
Private sector	-5.0	-5.7	-4.0	-3.6	-1.8	-1.0
Public sector	-1.0	-5.4	-10.1	-10.2	-10.5	-10.0
Foreign savings 3/	5.0	11.4	14.5	14.1	12.5	11.2
Net exports of goods & services	-18.8	-21.8	-20.2	-18.2	-16.0	-14.1
Debt Rescheduling under Naples terms 4/						
Gross domestic savings	-3.5	-3.5	-1.0	1.4	3.8	5.7
Net factor receipts and transfers from abroad 4/	13.9	12.3	9.1	7.3	6.7	5.8
Gross national savings	10.4	8.8	8.1	8.8	10.4	11.6
Private sector	8.1	10.6	14.2	14.5	16.4	17.5
Public sector	2.3	-1.7	-6.1	-5.7	-6.0	-6.0
Gross investment	15.3	18.3	19.2	19.6	19.8	19.8
Private sector	13.1	14.4	14.8	14.8	15.0	15.6
Public sector	3.3	3.6	4.0	4.5	4.5	4.0
Savings - investment balance	-5.0	-9.5	-11.1	-10.8	-9.4	-8.2
Private sector	-5.0	-3.8	-0.6	-0.3	1.3	1.9
Public sector	-1.0	-5.4	-10.1	-10.2	-10.5	-10.0
Foreign savings 3/	5.0	9.5	11.1	10.8	9.4	8.2
Net exports of goods & services	-18.8	-21.8	-20.2	-18.2	-16.0	-14.1

Sources: Federal Bureau of Statistics, Ministries of Finance of the FRY, Republic of Serbia, and Republic of Montenegro, and Fund staff estimates.

1/ Projections of key variables (inflation, real GDP growth, the exchange rate, and investment) are consistent with achievement of medium term external and fiscal sustainability. For comparison purposes, they are identical in both scenarios even though sustainability is not achievable under Houston terms.

2/ The servicing of foreign debt is shown on a cash basis in 2000 and on an accrual basis thereafter, assuming refinancing of most multilateral debt, and restructuring of eligible bilateral debt on Houston terms in mid-2001 with capitalization of moratorium interest during the consolidation period.

3/ Current account deficit.

4/ The servicing of foreign debt is shown on a cash basis in 2000 and on an accrual basis thereafter, assuming refinancing of most multilateral debt, and restructuring of eligible bilateral debt on Naples terms in mid-2001 with capitalization of moratorium interest during the consolidation period.

Table 9. Federal Republic of Yugoslavia: Medium-Term External Sustainability, 2000-2020

	2000	2001	2002	2003	2004	2005	2006	2009	2010	2015	2020
					(In millions of U.S. dollars)						
Debt rescheduling on Houston terms 1/											
					Baseline Scenario						
Export growth (in percent)	15.0	7.3	16.4	16.4	16.4	15.0	13.0	10.3	9.5	7.3	6.3
Import growth (in percent)	14.4	19.4	10.3	9.2	7.8	6.9	6.7	6.3	6.3	6.3	6.3
Current account balance	-400	-1,262	-1,978	-2,329	-2,277	-2,156	-2,053	-1,971	-1,952	-2,104	-3,133
(percent of GDP)	-4.8	-12.3	-17.2	-17.9	-16.0	-14.1	-12.5	-9.9	-9.2	-7.3	-8.0
Before grants, percent of GDP	-8.3	-17.7	-19.7	-17.9	-16.0	-14.1	-12.5	-9.9	-9.2	-7.3	-8.0
Excluding net factor income, percent of GDP	-4.7	-6.9	-8.6	-10.0	-8.6	-7.1	-5.8	-3.7	-3.4	-1.7	-2.3
Gross borrowing requirements	227	1,267	1,480	1,486	1,588	1,784	1,998	2,738	2,887	5,285	6,498
(percent of GDP)	2.7	11.0	11.4	10.4	10.4	10.9	11.3	12.9	12.8	22.1	25.6
Gross official reserves 2/	516	733	983	1,233	1,508	1,783	2,078	2,738	2,913	3,973	5,415
(in months of imports of GS)	1.5	1.7	2.1	2.4	2.7	3.0	3.2	3.5	3.5	3.5	3.5
External public debt 2/	11,726	12,532	13,808	15,029	16,125	17,255	18,006	20,952	21,876	26,608	33,544
(percent of GDP)	145.3	122.5	119.7	115.7	113.3	112.9	109.7	105.2	103.3	92.6	86.0
External debt service	56	215	925	1,206	1,491	1,809	2,090	3,049	3,315	6,065	7,163
(percent of exports of GS)	2.2	7.6	28.1	31.7	33.9	35.8	36.5	40.5	40.5	50.6	43.6
					Faster export growth 3/						
External public debt 2/	11,726	12,532	13,788	14,959	15,966	16,956	17,541	19,823	20,461	23,043	26,074
(percent of GDP)	145.3	122.5	119.6	115.2	112.2	111.0	106.9	99.5	96.7	80.2	66.9
External debt service	56	215	925	1,204	1,487	1,800	2,072	2,981	3,220	5,456	5,682
(percent of exports of GS)	2.2	7.6	28.0	31.3	33.1	34.7	35.3	38.6	38.3	44.3	33.6
					Slower export growth 4/						
External public debt 2/	11,726	12,532	13,829	15,099	16,282	17,549	18,462	22,056	23,259	30,085	40,830
(percent of GDP)	145.3	122.5	119.9	116.3	114.4	114.9	112.5	110.8	109.9	104.7	104.7
External debt service	56	215	925	1,207	1,496	1,819	2,108	3,114	3,408	6,659	8,609
(percent of exports of GS)	2.2	7.6	28.3	32.1	34.6	36.9	37.8	42.5	42.8	57.1	53.8
Debt rescheduling on Naples terms 5/											
					Baseline Scenario						
Export growth (in percent)	15.0	7.3	16.4	16.4	16.4	15.0	13.0	10.3	9.5	7.3	6.3
Import growth (in percent)	14.4	19.4	10.3	9.2	7.8	6.9	6.7	6.3	6.3	6.3	6.3
Current account balance	-400	-1,087	-1,580	-1,932	-1,858	-1,721	-1,593	-1,424	-1,375	-1,209	-1,619
(percent of GDP)	-4.8	-10.6	-13.7	-14.9	-13.1	-11.3	-9.7	-7.2	-6.5	-4.2	-4.2
Before grants, percent of GDP	-8.3	-16.0	-16.2	-14.9	-13.1	-11.3	-9.7	-7.2	-6.5	-4.2	-4.2
Excluding net factor income, percent of GDP	-4.7	-6.9	-8.6	-10.0	-8.6	-7.1	-5.8	-3.7	-3.4	-1.7	-2.3
Gross borrowing requirements	227	1,092	1,120	1,088	1,071	1,124	1,260	1,627	1,617	1,798	2,141
(percent of GDP)	2.7	9.5	8.6	7.6	7.0	6.9	7.2	7.7	7.2	7.5	8.4
Gross official reserves 2/	505	722	972	1,222	1,497	1,772	2,067	2,727	2,913	3,973	5,415
(in months of imports of GS)	1.5	1.7	2.1	2.4	2.7	3.0	3.2	3.5	3.5	3.5	3.5
External public debt 2/	11,726	7,502	8,409	9,233	9,910	10,605	11,163	12,557	12,905	13,926	14,556
(percent of GDP)	*145.3*	*73.3*	*72.9*	*71.1*	*69.7*	*69.4*	*68.0*	*63.1*	*61.0*	*48.5*	*37.3*
External debt service	56	215	640	808	974	1,150	1,385	1,990	2,103	2,667	2,939
(percent of exports of GS)	2.2	7.6	19.5	21.2	22.1	22.8	24.2	26.4	25.7	22.3	17.9
					Faster export growth 3/						
External public debt 2/	11726	7,502	8,389	9,163	9,751	10,306	10,698	11,427	11,489	10,362	7,085
(percent of GDP)	145.3	73.3	72.7	70.5	68.5	67.4	65.2	57.4	54.3	36.1	18.2
External debt service	56	215	640	807	970	1,140	1,367	1,922	2,008	2,058	1,457
(percent of exports of GS)	2.2	7.6	19.3	20.9	21.6	22.0	23.3	24.9	23.9	16.7	8.6
					Slower export growth 4/						
External public debt 2/	11,726	7,502	8,430	9,303	10,067	10,899	11,619	13,660	14,288	17,404	21,842
(percent of GDP)	145.3	73.3	73.1	71.6	70.8	71.3	70.8	68.6	67.5	60.6	56.0
External debt service	56	215	640	809	978	1,159	1,402	2,055	2,196	3,261	4,384
(percent of exports of GS)	2.2	7.6	19.6	21.5	22.6	23.5	25.1	28.0	27.6	28.0	27.4

Sources: National Bank of Yugoslavia; and Fund staff estimates.

1/ Assumes refinancing of most multilateral debt and rescheduling of eligible bilateral debt on Houston terms with capitalization of moratorium interest, in mid-2001.

2/ End-of-period.

3/ Assumes that merchandise exports grow 1 percentage point faster each year in 2002-2005, holding GDP and import growth constant compared to baseline.

4/ Assumes that merchandise exports grow 1 percentage point slower each year in 2002-2005, holding GDP and import growth constant compared to baseline.

5/ Assumes refinancing of most multilateral debt and rescheduling of eligible bilateral debt on Naples terms with capitalization of moratorium interest, in mid-2001.

Table 10 Federal Republic of Yugoslavia: Indicators of External Vulnerability 1998-2001 1/

(In percent of GDP, unless otherwise indicated)

	1998	1999	2000 Est.	2001 Proj.
Financial indicators				
Public sector debt	...	...	183.4	161.1
Broad money (percent change, 12-month basis)	69.4	67.6	61.4	20.4
Private sector credit (percent change, 12 month basis)	...	128.4	68.6	...
Weighted interest rates (percent per month, December) 2/	7.0	3.9	6.8	...
Retail prices (percent per annum, e.o.p.)	...	49.9	113.5	30-35
External Indicators				
Exports (percent change, 12-month basis in US$)	24.0	-44.7	14.7	7.3
Imports (percent change, 12-month basis in US$)	1.0	-32.0	14.4	19.4
Terms of Trade (percent change, 12 month basis)	-2.6	-4.4	0.0	1.0
Current account balance, before grants	-4.8	-7.5	-8.3	-17.7
Current account balance after grants and FDI	-3.9	-6.4	-4.6	-9.8
Errors and omissions	2.0	4.0	3.6	2.8
Gross official reserves (in US$ millions)	326	293	516	733
(in months of imports GS of the following year)	1.1	0.9	1.2	1.6
Central Bank short-term foreign liabilities (in US$ millions) 3/	0	0	0	0
Gross reserves of the banking system (in US$ millions)	774	659	882	1,099
(in months of imports GS of the following year)	2.6	1.9	2.1	2.3
Short term foreign liabilities of the commercial banks (in US$)	...	...	663	663
Foreign currency liabilities of the commercial banks (in US $)	...	...	4,345	4,371
Official reserves/Broad money (M2) (percent)	18	30	50	59
Official reserves/Narrow money (M0) (percent)	59	126	164	185
Total short term external debt by original maturity (in US$ millions)	...	...	663	663
Total short term external debt by remaining maturity (in US$ millions)	...	...	864	916
Total short term external debt to reserves by original maturity (in percent)	...	...	128.5	90.5
Total short term external debt to total debt by original maturity (in percent)	...	...	5.7	5.3
Total short term external debt to total debts by remaining maturity (in percent)	...	...	7.4	7.3
Total short term external debt to reserves by remaining maturity (in percent)	...	...	75.2	60.3
Total external debt (in US$ millions)	...	...	11,725	12,532
Of which: Public and Publicly guaranteed debt 4/	...	...	11,063	11,869
Total external debt (in percent of exports of G&S)	...	...	460.3	441.4
External interest payments (in percent of exports of G&S)	...	...	1.6	18.4
External amortization payments (in percent of exports of G&S)	...	...	0.0	5.9
Exchange rate, official (per DM, end of period)	6	6	30	...
Exchange rate, parallel (per DM, end of period)	8	21	30	...
REER (annual average, February-December 1994 = 100)	109.1	149.5	194.4	126.5

Sources: Yugoslav authorities; and Fund staff estimates.

1/ All stocks are measured end-of-period.

2/ Weighted interest rates on commercial paper, bank bills, and certificates of deposit.

3/ Excluding IMF.

4/ Assuming all long- and medium-term external bank debt to official creditors is government guaranteed.

Table 11. Federal Republic of Yugoslavia: Fiscal Sustainability, 2001-2015 1/

(In percent of GDP)

	Debt Restructuring under Naples Terms							Debt Restructuring under Houston Terms						
	2001	2002	2003	2004	2005	2010	2015	2001	2001	2003	2004	2005	2010	2015
Primary revenue	39.9	39.6	39.3	39.0	38.7	38.4	38.4	39.9	39.6	39.3	39.0	38.7	38.4	38.4
Primary expenditure 2/	45.4	45.1	44.9	44.6	43.6	41.2	39.9	45.4	45.1	44.9	44.6	43.6	41.2	39.9
Of which:														
Repayment of frozen foreign currency deposits	1.5	1.3	1.4	1.5	0.9	0.9	0.9	1.5	1.3	1.4	1.5	0.9	0.9	0.9
Other primary expenditure	43.9	43.7	43.5	43.1	42.7	40.3	39.0	43.9	43.7	43.5	43.1	42.7	40.3	39.0
Primary balance	-5.5	-5.5	-5.6	-5.6	-4.9	-2.8	-1.5	-5.5	-5.5	-5.6	-5.6	-4.9	-2.8	-1.5
Interest costs 3/	0.9	4.1	4.1	4.4	4.6	4.8	5.1	0.9	5.5	7.2	7.4	7.5	7.2	7.2
Overall balance	-6.4	-9.6	-9.7	-10.0	-9.5	-7.6	-6.6	-6.4	-10.9	-12.8	-13.0	-12.4	-10.0	-8.7
Financing	6.4	9.6	9.7	10.0	9.5	7.6	6.6	6.4	10.9	12.8	13.0	12.4	10.0	8.7
Foreign grants	1.5	1.7	1.9	1.8	1.7	1.1	0.2	1.5	1.7	1.9	1.8	1.7	1.1	0.2
Foreign borrowing	3.0	5.5	4.9	4.8	4.8	4.9	4.7	3.0	6.5	7.2	7.0	6.6	6.1	5.5
Domestic borrowing	0.5	1.1	1.0	1.7	1.7	1.6	1.6	0.5	1.4	1.8	2.5	2.8	2.8	3.0
Privatization receipts	1.5	1.3	1.9	1.8	1.3	0.0	0.0	1.5	1.3	1.9	1.8	1.3	0.0	0.0
Public debt (end of year stock) 4/	103.1	97.2	91.8	89.2	88.9	87.1	85.4	161.1	149.9	141.7	137.8	137.0	131.6	126.6
Public sector gross borrowing requirement	2.8	8.1	9.4	11.8	13.3	12.8	14.1	2.8	9.4	12.7	16.4	19.2	20.2	23.8
Gross borrowing requirement as percent of primary own revenue	7.1	20.4	23.9	30.3	34.2	33.4	36.6	7.1	23.8	32.3	42.0	49.5	52.6	61.9
Interest expenditure as percent of primary own revenue	2.3	10.4	10.5	11.3	11.8	12.5	13.2	2.3	13.8	18.3	19.0	19.4	18.7	18.8
Assumptions														
Real growth (percent per annum)	5.0	5.0	5.0	5.0	4.0	4.5	4.5	5.0	5.0	5.0	5.0	4.0	4.5	4.5
Average effective nominal interest rate (US$, percent per annum)	1.1	4.3	4.8	5.2	5.4	5.7	6.2	0.7	3.7	5.4	5.7	5.8	5.7	6.0
Rate of real appreciation (RPI based, percent per annum)	15.1	5.0	4.0	3.0	2.0	1.0	1.0	15.1	5.0	4.0	3.0	2.0	1.0	1.0

Sources: Data provided by the Yugoslav authorities; and Fund staff estimates and projections.

1/ Public sector, defined as the consolidated general government (excluding the social security funds and local governments in Montenegro) and the National Bank of Yugoslavia.

2/ Excludes payments on called guarantees.

3/ Includes payments on called guarantees.

4/ Includes foreign debt held by the National Bank and the liabilities of commercial banks related to frozen foreign currency deposits.

Table 12. Federal Republic of Yugoslavia: External Financing Requirements and Sources, 1998-2001
(In millions of U.S. dollars)

	1998	1999	2000 Prel.	2001 Proj.
1. Gross financing requirements	-720	-818	-1,074	-11,786
External current account deficit (excluding official transfers)	-660	-764	-671	-1,812
Debt amortization	-60	-54	-47	-168
Medium- and long-term debt	-25	-17	-14	-168
Public sector	...	...	...	-58
Multilateral 1/	...	...	...	-31
Bonds and notes	...	...	...	0
Other	...	...	...	-27
Commercial banks and corporate private sector	...	...	...	-110
Short-term debt 2/	-35	-37	-33	0
Repayment of arrears	0	0	0	-9,589
Gross reserve accumulation	0	0	-227	-217
IMF repurchases and repayments	0	0	-129	0
2. Available financing	720	818	1,074	1,120
Official grants	0	0	271	550
Foreign direct investment (net)	113	112	25	160
Debt financing from private creditors	78	30	49	50
Medium and long-term financing	78	30	49	0
To public sector	0	0	0	0
Of which: Balance of payments financing 3/	0	0	0	0
To commercial banks	26	19	8	0
To corporate private sector	52	11	41	0
Short-term financing	0	0	0	50
Official creditors	50	29	227	70
Multilateral 1/	...	...	...	...
Of which: Balance of payments financing	...	...	...	...
Bilateral	...	...	...	...
To public sector	...	...	...	...
Of which: Balance of payments financing	...	...	...	...
To private sector	...	...	...	...
IMF	0	0	150	0
Accumulation of arrears (exceptional)	86	126	62	0
Other flows 4/	393	521	290	290
3. Financing gap	0	0	0	10,666
Program and project assistance	0	0	0	821
World Bank	0	0	0	85
IMF	0	0	0	192
EBRD	0	0	0	10
Other, including June Donor Conference 5/	0	0	0	534
Of which: Balance of payment support	0	0	0	300
Debt relief	0	0	0	9,845
Memorandum item				
Total balance of payments financing	0	0	0	577

Sources: National Bank of Yugoslavia; and Fund staff estimates.

1/ Excluding IMF.

2/ Original maturity of less than 1 year. Stock at end of the previous period.

3/ Includes those transactions that are undertaken for the purpose of financing a balance of payments deficit or an increase in reserves.

4/ Includes all other net financial flows and errors and ommissions.

Table 13. Federal Republic of Yugoslavia: Schedule of Purchases
Under the Stand-By Arrangement

	Amount of Purchase		Conditions
	In millions of SDRs	In percent of quota 1/	
June 2001	50.0	10.7	Board approval of stand-by arrangement.
August 15, 2001	50.0	10.7	Observance of end-June 2001 performance criteria and completion of quarterly review.
November 15, 2001	50.0	10.7	Observance of end-September 2001 performance criteria and completion of quarterly review.
February 15, 2002	50.0	10.7	Observance of end-December 2001 performance criteria and completion of quarterly review.
Total	200.0	42.8	

1/ The quota is SDR 467.7.

Table 14. Federal Republic of Yugoslavia: Indicators of Capacity to Repay the Fund, 2000-2007

	2000	2001	2002	2003	2004	2005	2006	2007
	Prel.	Projections 1/						
Fund repurchases and charges 2/								
In millions of SDRs	...	7.3	15.4	16.3	92.7	163.2	85.9	8.1
In millions of U.S. dollars	...	9.4	19.9	21.1	120.3	212.2	111.8	10.5
In percent of exports of goods and NFS	...	0.3	0.6	0.6	2.7	4.2	2.0	0.2
In percent of debt service	...	1.4	1.8	1.7	8.0	11.7	5.3	0.5
In percent of quota	...	1.6	3.3	3.5	19.8	34.9	18.4	1.7
In percent of gross official reserves	...	1.3	2.0	1.7	8.0	11.9	5.4	0.5
Fund credit outstanding								
In millions of SDRs	116.9	266.9	316.9	316.9	239.7	87.5	6.3	0.0
In millions of U.S. dollars	154.2	344.8	410.1	410.7	311.1	113.8	8.1	0.0
In percent of quota	25.0	57.1	67.8	67.8	51.3	18.7	1.3	0.0
In percent of GDP	1.9	3.4	3.6	3.2	2.2	0.7	0.0	0.0
In percent of gross official reserves	29.9	47.0	41.7	33.3	20.6	6.4	0.4	0.0
Memorandum items:								
Exports of goods and NFS (millions of US$)	2,547	2,839	3,286	3,804	4,404	5,053	5,723	6,298
Debt service (millions of US$)	56	691	1,117	1,224	1,507	1,816	2,090	2,339
Quota (millions of SDRs)	468	468	468	468	468	468	468	468
Quota (millions of US$)	617	604	605	606	607	608	608	608
Gross official reserves (millions of US$)	516	733	983	1,233	1,508	1,783	2,078	2,280
GDP (millions of US$)	8,071	10,231	11,532	12,988	14,228	15,280	16,410	17,624
U.S. dollar per SDR	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3

Sources: Yugoslav authorities and Fund staff estimates.

1/ As of May 23, 2001.
2/ Arrears to the Fund of SDR 101 million were cleared on December 20, 2000.

Federal Republic of Yugoslavia: Fund Relations
As of April 30, 2001

I. **Membership Status:** Joined: 12/14/1992; Article XIV

	SDR Million	%Quota
II. **General Resources Account:**	SDR Million	%Quota
Quota	467.70	100.0
Fund Holdings of Currency	584.64	125.0
III. **SDR Department:**	SDR Million	%Allocation
Net cumulative allocation	56.66	100.0
Holdings	13.34	23.5
IV. **Outstanding Purchases and Loans:**	SDR Million	%Quota
Stand-by arrangements	116.93	25.0
First Credit Tranche		
V. **Financial Arrangements:**	None	

VI. **Projected Obligations to Fund:**[1] (SDR Million; based on existing use of resources and present holdings of SDRs):

	Overdue 03/31/2001	2001	2002	2003	2004	2005
			Forthcoming			
Principal					58.5	58.5
Charges/Interest		5.5	7.2	7.2	6.4	3.8
Total		5.5	7.2	7.2	64.9	62.3

VII. **Exchange Arrangement**

The currency of FRY is the Yugoslav Dinar (YUD). On January 1, 2001, FRY adopted a managed float system.

VIII. **Last Article IV Consultation**

No consultation discussions have yet been held with FRY.

IX. **Technical Assistance**

Department	**Timing**	**Purpose**
FAD	February 2001	Tax policy and administration

[1] The projection of charges and interest assumes that overdue principal at the report date (if any) will remain outstanding, but forthcoming obligations will be settled on time.

FAD	March 2001	Public expenditure management
FAD	April 2001	Tax administration
MAE	November 2000	Diagnostic mission
MAE	December 2000	Diagnostic mission:
		Monetary policy instruments
		Bank supervision
		Payments system
		Foreign exchange operations and reserves management
		Development of money and securities markets
MAE	February 2001	Banking supervision and restructuring
MAE	April 2001	Diagnostic mission:
		Bank restructuring
		Monetary and foreign exchange dev.
STA	February 2001	Money and banking statistics

Federal Republic of Yugoslavia: Relations with the World Bank Group

1. Based on a decision by the World Bank's Board of Directors, the Former Socialist Federal Republic of Yugoslavia (SFRY) ceased to be a member of the World Bank Group in February 1993. On May 8, 2001, the World Bank's Board approved the succession of the Federal Republic of Yugoslavia (FRY) to SFRY's membership in the IBRD. FRY membership in IDA is expected to follow very shortly.

2. The conditions for FRY's membership were that it would: (i) become a member of the IMF; (ii) accept the Bank's Articles of Agreement and the terms and conditions of subscription to the shares of Bank capital to which it succeeds; (iii) make local currency payments as necessary with respect to shares to which it succeeds; (iv) enter into final agreement with the Bank on the loans of the SFRY it assumes; and (v) eliminate or agree with the Bank on a plan to eliminate the arrears in the servicing of the Bank loans it has assumed.[1]

3. As of December 31, 2000, the stock of arrears of the FRY to the IBRD amounted to US$1.7 billion. The plan for arrears resolution agreed to as a condition of membership provides for the exceptional consolidation of FRY's arrears into a new package of IBRD loans. As part of the membership package the Bank's Board of Directors approved temporary exceptional IDA eligibility for FRY, allowing up to US$540 million in new IDA loans over the next three years, once arrears have actually been cleared. The consolidation package resolving arrears is expected to be finalized in the second half of 2001.

4. The Bank has in place a two-phase strategy that has enabled it to be active even prior to arrears clearance. On March 13, 2001, the Board of Directors approved the establishment of a Trust Fund for FRY (TFFRY) and the transfer of US$30 million of IBRD surplus to be used to provide grant financing of selected priority activities. The Bank has also been active in providing analytical and advisory support to FRY, in partnership with the European Commission, the IMF and others. This support is focused on preparing an Economic Recovery and Transition Program, and mobilizing assistance for FRY. These activities involve working closely with the FRY Government on their reform program, as well as close dialogue with the international donor community on issues of direction, speed and sequencing of reforms. The program will be submitted to a donor pledging conference to take place in June 2001.

5. In the context of the membership package the Bank's Board of Directors also endorsed a Transitional Support Strategy (TSS) that provides the framework for World Bank assistance to FRY in FY02. A total of up to US$200 million in IDA resources could be

[1] These same conditions were also met by the other successor states of the SFRY (Bosnia and Herzegovina, Croatia, the former Yugoslav Republic of Macedonia and Slovenia) prior to membership in the World Bank.

provided as credits to FRY, with up to US$160 million as quick-disbursing assistance in support of priority reforms in the areas of fiscal management, private sector development and banking reform. Up to US$40 million would also be provided in support of investment operations in FY02. In addition, the strategy provides for advisory activities including a Public Expenditure Review, household survey work preparatory to a Poverty Assessment, (and to the government's planned Interim Poverty Reduction Strategy Paper), and a Private Sector Development Strategy (in conjunction with the IFC and EBRD)..

Federal Republic of Yugoslavia: Statistical Issues

1. Yugoslavia has a well developed statistical database. However, coverage slipped during the 1990s as transactions were increasingly conducted outside the formal economy. Kosovo does not report data to the Federal authorities since March 1999. In 2000, Montenegro ceased to report monetary data, while real sector data are reported only for inclusion in Federal aggregates, but not for separate publication. Further, definitions are not in line with international standards, as they were developed to accommodate national characteristics and because they were not updated during the recent decade when Yugoslavia was isolated from international developments.

A. Real Sector

2. Real sector statistics are compiled and published by the Federal Statistics Bureau (FBS), the Statistics Institute of the Republic of Serbia and the Statistics Institute of the Republic of Montenegro. A key basic source of economic information is the Accounts and Payments Bureau (ZOP), which compiles semi-annual and annual balance sheets and income statements from all economic agents. The compilation methods and statistical measurements are still largely those appropriate to a socially/state owned economy and material definition of production. Information on production and labor is principally collected from compulsory enterprise reports although quarterly surveys are conducted on household expenditures and employment in small establishments. As small, private, enterprises whose compliance with statistics requirements tends to be low have accounted for an increasing share of economic activity, the reliability and coverage of official statistics has deteriorated over the past years.

3. National accounts on a material basis are compiled annually with approximately a half-year delay. National accounts in accordance with the SNA methodology are being compiled with increasing elaboration regularly since 1994, but with a substantial delay; the latest available NA refer to 1998. The SNA methodology appears to be adequately implemented at present, but the source data—enterprise income statements—suffer from serious deficiencies due to non-standard accounting rules and misreporting. The three major sources of distortion in the estimates of production are incomplete coverage, use of official exchange rates for the recording of all transactions when in the past most transactions were carried out at gray market rates, and over-statement of stock accumulation due to valuation inaccuracies. Price statistics are compiled on a number of price baskets, notably the retail price index, cost of living index, industrial producers' price index and others. While frequency and methodology of observation appear adequate, weighting, data storage and dissemination could be improved. Considerable resources are being expended on real sector statistics in FRY. The advice of a multi-topic statistics mission would be very welcome by the authorities and likely to yield substantial improvements.

B. Balance of Payments

4. The balance of payments is being compiled by the National Bank of Yugoslavia (NBY). Principal data sources are customs data on merchandise trade as processed by the FBS, information of foreign exchange transactions provided by banks and exchange bureaus.

The NBY keeps appropriately detailed records of external debt held by commercial banks, the government and itself. While the data compilation procedures appear appropriate, balance of payments statistics suffer from substantial under-recording owing to the large proportion of foreign exchange transactions carried outside official channels and under-reporting of external trade. Since the implementation of the emergency post-conflict assistance program, the NBY has expended commendable efforts to improve its estimation of actual flows based on existing data. The advice and assistance of a multi-topic mission would be very welcome by the authorities and could yield further substantial improvements in the external sector data.

C. Government Finance

5. Fiscal statistics for the federal government are compiled by the Federal Ministry of Finance, for the rest of Serbia by the Serbian Ministry of Finance. Principal data source are the budget execution reports of the spending Ministries and first level budget units and ZOP reports. Revenue data are timely and reliable as they are reported by ZOP. Expenditure data are compiled with longer delays. Since the implementation of the emergency post-conflict assistance program, the government in Serbia made serious effort to bring in line the existing budget reporting system with GFS, but full compliance will require a complete overhaul of the system of fiscal accounts which will be done this year with technical assistance from the Fund and other TA providers. Data on expenditure arrears are less reliable due to the lack of basic treasury functions in the existing system of expenditure management. Fiscal data for the central government of Montenegro is prepared by the Ministry of Finance, based on the new GFS classification and is available on a timely basis. Data for the social security funds are reported directly by the funds and are available only with major delays and are not based on GFS classification. No data is available for local governments.

D. Monetary Accounts

6. Monetary statistics are prepared by the NBY based on the Yugoslav chart of accounts that deviates substantially from international standards. Considerable effort has been devoted by the Fund, during four EU1 mission in 2000–01 and one STA mission in 2001, in preparing monetary statistics that approximate Fund standards. The STA mission reviewed procedures for collecting and compiling monetary statistics. The mission concluded that, while good institutional base existed for monetary data collection and compilation, major enhancements were needed to ensure closer conformity with internationally accepted practices. The mission initiated preparatory work to facilitate implementation of the framework for monetary statistics recommended in the *Money and Financial Statistics Manual (MFSM)* and made specific recommendations in a number of areas, including as regards the sectorization and classification of existing accounts. Further technical assistance in this area is required. Future improvements in the quality of monetary statistics will be largely contingent upon the implementation of a new chart of accounts for financial institutions reflecting modern accounting standards. As Montenegro no longer reports monetary data to the NBY, and because it has adopted the DM as legal tender, it is in the process of establishing its own monetary statistical database with technical assistance from USAID.

Federal Republic of Yugoslavia: Core Statistical Indicators
(As of May 15, 2001)

	Exchange rates 1/	International Reserves	Central Bank Balance Sheet	Reserve Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance 2/	Government Balance	Gross Social Product	External Debt/ Debt Service
Date of Latest Observation	May 14, 2001	May 10, 2001	Mar. 31, 2001	April 25, 2001	May 9, 2001	May 9, 2001	April 30, 2001	Mar. 31, 2001	March 31, 2001	March 31, 2001	Dec. 31, 1999	March 31, 2001
Date Received	May 14, 2001	May 14. 2001	May 5, 2001	May 15. 2001	May 10, 2001	May 10, 2001	May 10, 2001	May, 2001	May, 2001	May 11, 2001		May, 2001
Frequency of Data	Daily	Daily	Monthly	Daily	Monthly	Daily	Monthly	Monthly	Monthly	Monthly	Annually	Monthly
Frequency of Reporting	Weekly	Weekly	Monthly	Weekly	Monthly	Weekly	Monthly	Monthly	Monthly	Monthly	Annually	Monthly
Source of Update	NBY	NBY	NBY	NBY	NBY	NBY	FBS	FBS	FBS	Ministries of Finance of the FRY, Serbia, and Montenegro	FBS	NBY
Mode of Reporting	Report to the Fund	Report to the Fund	Report to the Fund	Report to the Fund	Report to the Fund	Report to the Fund	Website	Website	Website	Report to the Fund	Website	NBY
Confidentiality	Public	Confi-Dential	Confi-dential	Confi-dential	Confi-dential	Public	Public	Public	Public	Public	Public	Confiden-tial
Frequency of Publication	Daily	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Annually	Annually	Monthly

May 25, 2001

Mr. Horst Köhler
Managing Director
International Monetary Fund
700 19th Street
Washington DC 20431

Dear Mr. Köhler:

Over the past several months, we have formulated and started implementing, in cooperation with the Fund and the World Bank, a comprehensive stabilization and reform program for 2001 aimed at setting the basis for sustainable economic recovery and improvement in living standards. Our program is described in detail in the attached Memorandum on Economic and Financial Policies. In support of this program, we hereby request on behalf of the FRY authorities a stand-by arrangement in the amount of SDR 200 million, with an expiration date of March 31, 2002.

We believe that the policies and measures described in the attached memorandum are sufficient to achieve its objectives, but we stand ready to take additional measures and seek new understandings with the Fund, if necessary, to keep the program on track. We will remain in close consultation with the Fund in accordance with the Fund's policies on such consultations, and will provide the Fund with all information that it requests to assess the implementation of the program. The program will be reviewed by the Fund by August 15, November 15, 2001, and February 15, 2002. The first review will focus on developments in the budget and the pension fund, monetary and exchange rate policy, and bank restructuring, while the second review will be the occasion for reaching understandings on fiscal policy for 2002.

Yours sincerely,

Miroljub Labus
Deputy Prime Minister and Minister
of Foreign Economic Relations
Federal Republic of Yugoslavia

Mladjan Dinkic
Governor
National Bank of Yugoslavia

Bozidar Djelic
Minister of Finance
Republic of Serbia

Miroslav Ivanisevic
Minister of Finance
Republic of Montenegro

FEDERAL REPUBLIC OF YUGOSLAVIA

MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

I. Introduction

1. This memorandum sets forth the economic objectives and policies of the federal and republican governments of the Federal Republic of Yugoslavia (FRY) for 2001, which have been formulated within a medium-term framework geared to achieving sustainable growth and external viability. As described below, the economic program is comprehensive in scope, encompassing policies to address severe macroeconomic imbalances, reform the public finances, and restructure the banking and enterprise sectors. Annex A to this memorandum describes the quantitative performance criteria and indicative limits under the program; Annex B lists the prior actions and preconditions for consideration of the program by the IMF Executive Board, and the structural performance criteria and benchmarks under the program; and Annex C defines the performance criteria and indicative targets and describes the reporting arrangements.

2. **The strengthening of democracy in FRY since last October has set the basis for FRY's reintegration with the world economy and the initiation of economic reform.** The events of last October ushered in important changes in federal policies and institutions, including at the National Bank of Yugoslavia (NBY). On December 20, 2000, FRY became a member of the Fund and adopted—and has since firmly implemented—a post-conflict program supported by the Fund. Following elections in Serbia on December 23, 2000, a new government was formed in late January 2001, giving new impetus to the reform effort. The federal and both republican governments are fully committed to the implementation of the macroeconomic and structural policies described in this memorandum.

II. Background

3. **The economic legacy of ten years of regional conflicts, isolation, and economic mismanagement is dismal.** Output stands at about 50 percent of its 1989 level; infrastructure is in disrepair; recorded unemployment is about 30 percent of the work force; 12-month inflation runs at about 120 percent; average wages are at about DM 140 per month; and the external position is nonviable, owing in part to a crushing debt burden. Economic performance in 2000 featured a modest output recovery, with real GDP growing by about 5 percent, recovering partially from a 16 percent decline in 1999 as a result of the Kosovo war. A severe drought resulted in a 19 percent decline in agricultural output, while industrial output rose by 11 percent. Since last September, industrial output has trended downwards apparently due to energy shortages and capacity constraints after a decade of disinvestment. Meanwhile, benefits from the lifting of the sanctions have yet to materialize. Following price liberalization in October and a price jump in the late months of 2000, inflation is now running at an annualized rate of 46 percent, reflecting in part continued administered price adjustments. The economy of Montenegro has also suffered massively as a result of the

economic disruptions in the region over the past decade, although the standard of living has declined less than in Serbia. The adoption by Montenegro of the DM (euro) as its sole currency last November has helped stabilize prices and strengthen financial discipline, but has also revealed underlying weaknesses in the economy.

III. Economic Objectives and Policies for 2001

4. **The envisaged policies of the federal and republican governments will set the basis for a viable external position and sustainable output recovery by: reducing macroeconomic imbalances, advancing economic restructuring, and catalyzing external assistance, including debt relief.** In light of difficult initial conditions, achieving these aims will require generous support from creditors and donors, as well as difficult policy choices at home.

5. **Macroeconomic policies in Serbia will be geared to lowering inflation while protecting the most vulnerable groups of the population and supporting a sustainable output recovery.** In this regard, credit and fiscal policies will be constrained by the severe demonetization of the economy and the prospect of a gradual recovery of confidence in the dinar. Accordingly, the target for the general government deficit in 2001 is consistent with limited borrowing from the banking system (0.6 percent of GDP in 2001), while the monetary program is based on the assumption of unchanged velocity. Wage policy in the state sector will aim to keep the annual wage bill constant in real terms on the basis of the targeted rate of inflation, which should help limit inflation, including through its demonstration effect.

6. **Structural policies in Serbia will seek to reduce price distortions and impediments to growth, although with significant economic and social costs.** The program for Serbia includes a major liberalization of the foreign exchange, trade, and price regimes; a radical reform of the public finances; restructuring of the banking system; and important steps in enterprise restructuring and privatization. Policy implementation will impose economic dislocation, which needs to be addressed through targeted social support. Foreign assistance, some of which remains to be secured, should facilitate reform by helping to alleviate social hardship.

7. **Consistent with the above policies, the program for Serbia aims at rapid disinflation and a moderate recovery in output.** Specifically, the program will aim at lowering 12-month (retail price) inflation to 30–35 percent by end-2001. This is consistent with underlying inflation of 15–20 percent, broadly in line with recent trends, and large adjustments in utility prices. Real GDP is expected to rise by around 5 percent in 2001, owing mainly to a rebound in agricultural output after last year's drought. The rest of the economy will probably grow by 2–3 percent, with the positive effects from the removal of the sanctions being moderated by capacity constraints and the adverse short-term impact of economic restructuring.

8. **In Montenegro, macroeconomic policies reflect the republic's own monetary and exchange regimes.** As the centerpiece of its economic program, the government in November 2000 successfully adopted the DM (euro) as the legal tender of the Republic,

replacing the dual system that had existed for the previous year. This radical currency reform, has revealed underlying weaknesses in the fiscal and banking spheres, and precluded the possibility of superficial correction by recourse to money creation and inflation. For this reason, the burden of fiscal adjustment on Montenegro will be particularly difficult. The advent of price stability has also introduced more realism to the expectations of the population, facilitating a government policy to refrain from any further increases in the minimum wage during 2001. Consistent with these policies, 12-month inflation in Montenegro is expected to decelerate to about 6½ percent by end-2001, compared with about 25 percent at end-2000, while output is expected to rise by 5 percent in 2001.

9. **In both republics, external consolidation is a key objective of the program.** The program aims at containing FRY's current account deficit (*after* grants) to US$1.2 billion (11½ percent of GDP) in 2001 and strengthening gross official reserves by the equivalent of about US$200 million, roughly corresponding to purchases from the Fund. Exports are expected to rise by 7½ percent in U.S. dollar terms, reflecting a rebound in the second half of the year in response to the removal of international sanctions. Imports are projected to rise by19 percent in U.S. dollar terms, largely as a result of increased foreign assistance. These projections, as well as assumptions about the capital account, reserve accumulation, and arrears clearance, imply a financing gap of about US$10.7 billion in 2001, of which about US$0.8 billion could be covered by balance of payments and project assistance and the remainder by rescheduling of arrears and current maturities and capitalization of moratorium interest. Financing for a significant part of the remaining gap is expected to be identified in the context of the Donor Conference scheduled for June 29, 2001.

A. External Outlook and Debt Management

10. **The outlook for FRY's external position is overshadowed by the crushing burden of its external debt, the bulk of which is in arrears.** At around 145 percent of GDP at end-2000, external debt cannot be serviced without unacceptable sacrifice of economic activity. Accordingly, the FRY authorities are requesting from Paris Club creditors a rescheduling on Naples terms, including treatment of arrears; and comparable treatment from other official bilateral and commercial creditors. However, even with concessional debt relief and rescheduling, a substantial financing gap would persist over the next few years, owing to the rising debt service burden and reconstruction needs. Accordingly, in the context of the June Donor Conference and in discussions with official donors and creditors, the FRY authorities will be seeking support of the order of at least US$1.2 billion per year (on a commitment basis) through 2005.

11. **In light of the difficult external debt position and the prospects for substantial external support on highly concessional terms, the federal and republican governments and the NBY will refrain from borrowing or guaranteeing foreign loans on nonconcessional terms.** The only exception to this policy will be loans provided directly by the EBRD, EIB, IBRD, or IFC.

12. **The FRY authorities will intensify efforts to reach agreement with the other successor states on the division of the assets of the former Yugoslavia.** Frozen gold and

foreign exchange deposits of the NBY with banks abroad amount to about US$0.9 billion. The division of these and other disputed assets among the successors to the former Yugoslavia is likely to be a complex process.

B. Fiscal Policy

13. **Fiscal policy in 2001 will be geared to disinflation, supporting a sustainable economic recovery, addressing the costs of the transition, and enhancing transparency in government operations.** Specifically, the fiscal program for 2001 provides for: (i) strict limits on general government borrowing from the banking system; (ii) increased social transfers targeted toward the most vulnerable groups of the population; and (iii) a bold fiscal reform in Serbia to eliminate major tax distortions and enhance transparency in spending. A large portion of investment and economic restructuring programs in Serbia has been explicitly identified as contingent on external financing. This segment of expenditures will be presented at the Donor Pledging Conference in June 2001 as Serbia's supplementary "budget for recovery and reconstruction," with a view to attracting foreign financial assistance. Excluding Serbia's supplementary budget, total public expenditure on a consolidated basis will reach some 43.6 percent of GDP in FRY, with the federal government, Serbia and Montenegro accounting for 6.7, 33.1, and 3.8 percentage points, respectively. On this basis, the overall cash deficit (before grants and privatization receipts) of the general government in FRY is projected to reach 3.8 percent of GDP in 2001. This will be financed by recourse to the banking system in an amount equivalent to 0.6 percent of GDP, privatization receipts of 1.4 percent of GDP, and foreign grants and loans of US$180 million or 1.8 percent of GDP. Excluding foreign assistance in support of Serbia's budget for recovery and reconstruction, an additional US$550 million (5½ percent of GDP) of humanitarian and reconstruction foreign assistance is estimated to be delivered outside budget channels. The supplementary budget—whose scope and size will depend on commitments at the June Donor Conference—is preliminarily estimated at about 2.3 percent of GDP in 2001. Such spending is likely to have limited, if any, inflationary effects—since it will be fully foreign-financed, have a large import component, and tend to involve idle resources in the construction sector—while it would help remove bottlenecks in infrastructure and enhance productive capacity.

14. **Budget execution will be subject to a high degree of uncertainty owing to major structural fiscal reforms and bank and enterprise restructuring.** To facilitate orderly budget execution, the federal and the republican governments shall (i) in close collaboration with Fund staff, monitor revenue performance to allow for timely corrective actions; (ii) backload discretionary expenditure to create additional cushioning; (iii) refrain from allocating any part of general reserves to existing budget programs until the last quarter of the year, and consult with Fund staff prior to any major allocation of general reserves; (iv) identify expenditures of 0.5 percent of GDP in the Serbian budget that will only be undertaken after consultation with the Fund staff and taking into account overall fiscal trends; and (v) if budget execution data point to a higher consolidated general government deficit than envisaged under the program, immediately impose fiscal measures to maintain the budget deficit within the agreed target on a sustainable basis.

15. **Achieving fiscal sustainability over the medium term will be a challenging task.** The fiscal position of the general government in FRY will remain under heavy pressure over the medium term, owing in part to the resumption of external debt servicing, the gradual repayment of frozen foreign currency deposits, enterprise and bank restructuring costs, and open unemployment, putting pressure on the unemployment fund and the budget. With a view to alleviating these pressures, the federal and Serbian governments have decided to modify the original schedule of repaying frozen foreign currency deposits (FFCDs), by rephasing repayments as needed to ensure that they will be limited to no more than 0.9 percent of projected GDP in 2005 and subsequent years, compared to over 2 percent of projected GDP in 2005–11 on average under the original repayment schedule. In light of uncertainty about the overall size of the obligation—as indicated by the limited withdrawals in 2000 and so far in 2001 under the repayment scheme—the government will issue bonds only up to amounts corresponding to repayments of DM 10,000 per account during the period through end-2001, and will discuss the revised repayment schedule for 2005 and subsequent years in the context of the second review under the stand-by arrangement.

Federal government

16. The federal government has adopted new fiscal measures to ensure that the targeted decline in federal spending—by 0.8 percent of GDP—is effected in an orderly fashion. In particular, salaries in the federal administration and the federal army have been frozen at their January level, and wage payments will be limited to the equivalent of 12 months salary. Military pension entitlements will be reviewed with a view to bringing them more in line with civilian pension entitlements. Investment expenditure will be reduced by some YUD 1.4 billion (or 0.2 percent of GDP). Finally, in order to ensure that spending on material costs is kept in line with budgetary resources, military spending will be brought under civilian control and its transparency will be enhanced. To this end, accounting and other financial functions of the military have been moved from the General Staff headquarters to the Ministry of Defense and will, therefore, be subject to the standard accounting procedures of the federal government.

Serbian government

17. **Tax reform in Serbia will eliminate the most distortionary elements of the tax system.** With regard to consumption taxes, all surtaxes have been abolished and a single rate final-stage tax of 17 percent has been introduced with a narrow set of exemptions. The effective tax rate has been thereby raised by 1.8 percentage points. A federal surtax of 3 percent will be applied to the same taxable base. Multiple excise taxes have been replaced with a system of simplified specific excises, while a variety of taxes on financial transaction has been replaced with a single financial transaction tax. New draft legislation will regulate all forms of property taxes, which will be assigned to local governments. Finally, the existing local taxes on wages paid by employers have been unified into a single local tax. The new tax laws and amendments were approved by parliament, in conjunction with the 2001 Budget. As of June 1, 2001, the tax base for personal income tax and social security contributions will be broadened to include all forms of cash benefits paid to employees; tax and contribution rates will be lowered by 10 percent compared to revenue neutral rates.

18. **To improve transparency, all previous extra-budgetary programs financed by earmarked special surtaxes have been integrated into the budget and all earmarking of revenues in the Serbian budget has been abolished.** While the social security funds (pension, health care, and unemployment) remain separate budget entities with their own revenues from social security contributions, all surtaxes previously earmarked to these funds have been abolished and revenues from these taxes have been replaced by transfers from the republican budget. These transfers will be adequately sized to ensure that social security funds do not accumulate new arrears.

19. **The Serbian budget submitted to Parliament is consistent with an overall deficit (before privatization receipts and grants) of YUD 21.8 billion or 3.2 percent of GDP.** This includes a total transfer of YUD 23.4 billion (3.4 percent of GDP) to the social security funds. As a result of the tax reform discussed above and the tax administration measures described below, total revenue is expected to increase by 1.7 percentage points of GDP. Concerning expenditures, the total net wage bill is budgeted to remain unchanged in real terms on the basis of the targeted rate of inflation, with teachers benefiting from a real increase of 14 percent to reduce inequities. In order to create room for more competitive salaries in the public sector, employment in central government in Serbia will be reduced by 4,000 people or some 6 percent by the end of the year. Severance payments to laid off civil servants will amount to YUD 1.2 billion, or some 0.2 percent of GDP. The budget provides for substantially increased funds for social assistance to the most vulnerable families (2.4 percent of GDP, compared to 1.4 percent last year). Subsidies to producers will amount to 2.4 percent of GDP, up from 2 percent last year, concomitant with a reduction in quasi-fiscal deficits. Funds in the amount of 0.3 percent of GDP have been allocated to provide training for workers laid-off as a result of fiscal reforms and to cover the operational costs of the Bank Rehabilitation Agency (BRA). The share of the Serbian budget for interest payments on restructured foreign debt is estimated to amount to 0.5 percent of GDP, while its share for the cost of repayment of frozen household foreign-exchange deposits will be 0.8 percent of GDP.

20. **The budget execution system will be strengthened.** Serbia's budget execution system has been highly inefficient, contributing to a waste of public funds. To address the most immediate problems, the Serbian authorities are committed to carry out a set of short-term measures to improve cash management and budget reporting and introduce commitment control. These measures have been formulated with the assistance of a recent IMF Fiscal Affairs Department technical assistance mission. The Serbian government is committed to an ambitious medium-term agenda for improving expenditure management, which will include the creation of a Treasury Department. Concerning arrears, the government's efforts in 2001 will focus on avoiding the accumulation of new arrears, while allowing for a modest reduction of accumulated arrears, mainly in child care benefits and agricultural pensions.

21. **The envisaged reform of old-age and disability pension insurance is key to the attainment of fiscal sustainability over the medium to long run.** Presently, the pay-as-you-go system is burdened by an unusually high dependency ratio (in the Serbian fund, the ratio of contributors to beneficiaries fell from 2.6 in 1990 to 1.4 in 2000) and one of the highest replacement rates in Central and Eastern Europe (83 percent for old-age pensions in

Serbia). A government-appointed expert group is analyzing the pension system and is expected to present recommendations by end-June. The government plans to restructure the present system by, among other things, raising the statutory retirement age, changing the benefit formulas, and giving more equal treatment to men and women. More immediately, the government plans to sever the link between pensions and wages, and replace it by indexation to either the cost of living or a combination of the cost of living and wages. Also, with a view to more immediate results, the government plans to raise the indexation trigger—which is presently a 5 percentage point cumulative increase in wages—for the upper one third of the pensioners. These two latter measures will be introduced before end-June 2001. The Serbian budget includes a total transfer of YUD 16.3 billion (2.4 percent of GDP) to the pension funds. However, since the amount of this transfer was determined on the assumption that the short-term measures mentioned above would be introduced together with the approval of the 2001 Budget, the delayed changes will require an additional transfer of YUD 1.3 billion (0.2 percent of GDP) to be charged against the general reserves of the republican budget.

22. **A set of structural measures will be introduced to improve the operation of the Health Care Fund.** In particular, the government will extend and redesign the existing system of co-payments to promote a more rational use of the services offered by health care providers under the state-financed health insurance scheme. The most vulnerable parts of the society will be exempted from co-payments. The new system will be in place by end-May 2001 and will generate YUD 0.8–1 billion (0.1 percent of GDP) additional revenue for the Health Care Fund on an annual basis. In accordance with WHO recommendations, the government will revise the list of drugs offered to the insured population in state pharmacies, to bring expenditure on drugs in line with the financial resources available to the health care system. A decree stipulating the new list of pharmaceuticals will be issued by end-June 2001. These measures should ensure that the Health Care Fund does not require a transfer from the republican budget in excess of the budgeted amount of YUD 2 billion (0.3 percent of GDP) in 2001, while meeting its current obligations in full. Regarding medium-term reforms, the government plans to appoint a special committee to produce a concept paper on reform of the health care system in cooperation with experts from the World Bank.

23. **The Labor Market Fund will be allocated increased resources.** Reflecting the fiscal implications of enterprise restructuring, this fund will require a total transfer of YUD 3 billion (0.5 percent of GDP) from the republican budget, some YUD 1.5 billion higher than originally budgeted. The increase in allocation to the fund will be charged against the general reserves of the government. As noted in ¶46 below, new labor legislation will seek to improve the effectiveness of the Labor Market Fund.

24. **A preliminary government review of the social safety net suggests that there is room for improvement in its administration and targeting.** In both republics, social protection is dominated by child protection programs (with budgeted child allowances in 2001 amounting to 1.7 percent of GDP), followed by programs of welfare assistance to families in greatest need (about 30,000 households in Serbia and 8,000 in Montenegro, with a total budgeted cost of 0.3 percent of GDP). The allocation for child allowances in the Serbian budget in 2001 was increased by nearly 1 percent of GDP to 1.6 percent of GDP in 2001 to

fully fund statutory entitlements and settle arrears. Its targeting will be improved through greater reliance on regional social protection centers, while regional inequities will be alleviated through the temporary programs of social assistance related to economic reform. In particular, a fund amounting to 0.4 percent of GDP will be used to assist vulnerable families' adjustment to administered price increases and the tax reform. A social protection strategy for the medium term will be elaborated further in close collaboration with the World Bank, by September 2001.

Montenegrin government

25. **Partly as a result of a failure to capture a substantial share of economic activity in the tax net, and also partly because of the need to provide social support to vulnerable sections of the community, the fiscal situation remains very difficult.** In 2000, the overall fiscal deficit on a cash basis (wholly financed by foreign grants) reached approximately DM 136 million (10.5 percent of Montenegro's GDP), while arrears rose by some DM 64 million (4.9 percent of GDP). A series of minimum wage adjustments during 2000 (by 60 percent to DM 80 per month) were partly warranted to correct distortions caused by a period of high inflation, but they also severely aggravated the fiscal burden by increasing public sector pay and benefit levels. This was also largely responsible for the rise in planned expenditure on wages and salaries in the budget sphere and extra-budgetary funds of almost 50 percent in DM terms and a projected increase in pensions of 20 percent in 2001. In addition, health expenditures are expected to rise by some 15 percent during 2001. These increases cannot be met by an expected 19 percent (DM 115 million) increase in current revenue collection relative to 2000, and the shortfall will be further aggravated by a possible 35 percent decline in foreign grants.

26. **Faced with such a difficult situation, the government intends to cut expenditures with a view to limiting the fiscal deficit (before grants) to DM 95 million (6.5 percent of Montenegro's GDP) in 2001, in line with expected foreign grants.** Enterprise and quasi-government subsidies will be reduced by 56 percent and material expenses by 19 percent. The achievement of such planned reductions in expenditures should be facilitated by the adoption of a new Public Procurement Law in mid-2001. In addition, the government intends to complete the liberalization of prices of basic foodstuffs in August 2001, which will generate savings of DM 24 million (1.7 percent of Montenegro's GDP) in annual budgetary subsidies. The impact of this measure on socially vulnerable households will be compensated by additional direct payments costing some DM 7.5 million. At the same time, an augmentation of the system of family material support, which is means-tested, will cost DM 24 million on an annual basis, but will be partially offset by a scaling back of the inadequately targeted system of child benefits, saving DM 15 million. These expenditure plans are rather ambitious on the aggregate and—despite some DM 9.6 million (0.7 percent of Montenegro's GDP) that has been set aside in unallocated expenditures—the fiscal position remains precarious. In an effort to minimize deviations from the budgetary plans and to improve the flexibility of budgetary policies, the government will de-link the statutory minimum wage from public sector pay and social benefit levels by end-September 2001. Moreover, should revenue projections (including grants) not meet expectations, the

government is prepared to take other measures, as necessary, to balance the budget and avoid the accumulation of new arrears.

27. **The preparations for introduction of a Treasury system from mid-2002 are already well advanced.** This system will substantially improve budgetary control. The government has adopted an organic budget law, to be enacted (in amended form) in mid-2001, which mandates adoption of a standard budget classification system and a centralized treasury system operating within the Ministry of Finance. It also includes a provision empowering the Minister of Finance to close the accounts of line ministries. In addition, a reorganization of the Ministry of Finance should improve operational capacity during 2001. The introduction of a GFS classification system for the central government budget will be extended to cover the extra-budgetary funds during the course of this year, leading to the development of reliable consolidated central government accounts for 2002.

28. **The extra-budgetary funds remain a critical source of concern and will require radical overhaul.** The government has already prepared a general review of the pension system (with the help of USAID experts) and intend to consider a number of reforms during the remainder of this year, for possible introduction during 2002. An overhaul of the health system will, however, have to await much-needed technical assistance.

29. **Plans for a systematic overhaul of Montenegro's tax policy regime have already been set in place.** By mid-year, the government will approve a Tax Action Plan delineating adequate measures for the planning and implementation of a comprehensive tax code and with a view to improving tax collection, broadening the effective tax base, and lowering tax rates. Tax administration will be bolstered by a reorganization that could involve the merger of all tax functions into a unified revenue authority.

C. Quasi-Fiscal Deficits and Enterprise Financial Discipline

30. **Mindful of the enormous costs to the economy caused by the supply difficulties of Serbia's electricity utility (EPS), electricity tariffs were raised by 60 percent on average on April 15, 2001 and will be increased further by 40 percent on June 1 and another 40 percent on October 1, 2001.** The April and June price adjustments will bring the price to a level estimated by World Bank staff as sufficient to cover most operational costs this year, thereby substantially limiting the need for budgetary subsidies, while at least US$80 million in donor assistance will be needed to cover capital repair and maintenance costs. The October price adjustment will be the next step toward bringing the electricity price closer to medium-term economic cost. The government has agreed with EPS on cost-cutting measures to ensure rational utilization of the increased revenue stream.

31. **The Serbian government is adopting measures to strengthen financial discipline in the state-owned enterprise sector.** The eight largest state-owned companies account for 6 percent of registered employment and provide key inputs to the rest of the economy. The Serbian government is presently establishing the necessary mechanisms to monitor and control revenue and expenditure developments, in particular wage costs and bank borrowing in these companies. Work on preparing restructuring programs, in cooperation with the new managements, has commenced for the largest among them. In the meantime, to encourage

rationalization in employment and cost control, the wage bills for 2001 of all state-owned companies in which average wages exceed those for the economy as a whole by more than 20 percent have been frozen at their January level, thereby ensuring that the state-owned company wage bill will remain roughly unchanged in real terms in 2001 on the basis of the targeted rate of inflation.

D. Monetary and Exchange Rate Policy

32. **The NBY will maintain tight credit conditions with a view to lowering inflation.** Quarterly credit and money targets for end-June and for the remainder of 2001 are consistent with projected nominal GDP growth, unchanged velocity of seasonally adjusted broad money, and end-2001 NFA at US$25 million above its end-2000 level. The assumption of unchanged velocity reflects conservative assumptions regarding the rebuilding of confidence in the dinar. In the event of higher-than-projected NFA, the NBY will seek to ascertain the reasons behind this development and its implications for credit policy, in consultation with Fund staff. If higher-than-projected NFA reflects temporary and reversible factors, the NBY will seek to sterilize the foreign exchange inflows by maintaining NDA below the program ceiling. If, instead, it reflects improved confidence in the currency, this would allow a correspondingly higher level of reserve money. In any event, owing to the uncertainties about the monetary transmission mechanism and the economic outlook, the NBY intends to review the credit targets on a quarterly basis.

33. **Exchange rate policy will be consistent with safeguarding external competitiveness and the foreign reserve target.** Despite a substantial real appreciation in recent months, the exchange rate of the dinar appears to be adequate, judging from its historical real levels and the absence of downward pressures on the NFA of the NBY. Nevertheless, the NBY will monitor developments in the foreign exchange market closely and will allow the exchange rate to depreciate as needed to ensure an adequate level of external cost competitiveness and to achieve the objective for external reserves. Exchange rate policy will be the subject of reviews under the program.

34. **Monetary policy will be increasingly conducted on the basis of market-oriented policy instruments.** The NBY has doubled the interest rate charged on shortfalls in required reserves to 4 percent and, for reasons of transparency, has started recording such shortfalls as credits to banks. Moreover, the NBY will raise the discount rate to a level that better reflects conditions in the money market and will conduct auctions of its securities in quantities sufficient to absorb the excess liquidity in the market and accept the resulting interest rates. Such policies would permit a relaxation of exchange and trade restrictions without undue pressure on the exchange rate.

35. **Further progress toward relying on market-based monetary policy instruments should be made once the proper institutional framework is in place.** Following the restructuring of the banking system in the coming months and in line with recommendations of the Fund's Monetary and Exchange Affairs Department, the NBY intends to replace the current reserve requirement system with one based on average reserve deposits, gradually reduce the required reserve ratio from its current level of 24.5 percent as monetary conditions

permit, widen reserve requirements coverage to include foreign exchange deposits, and increasingly rely on open market operations in dinars and foreign exchange for the conduct of monetary policy

E. Foreign Exchange and Trade Regimes

36. **The NBY will further liberalize the foreign exchange market, with the aim of accepting the obligations under Article VIII of the Fund's Articles of Agreement following a review of the exchange system by the Fund's Legal Department.** The foreign exchange regime has undergone major improvements since last October, as evidenced by the unification of the exchange rate and abolition of onerous exchange restrictions last December (in the form of mandatory sales of foreign exchange by importers and exporters), and the adoption of a managed float at the beginning of this year. In addition, administrative procedures regarding payments for imports have been simplified, and responsibility for verification of the nature of the relevant transactions has been shifted to commercial banks. Moreover, the ceilings for pre-payment of imports were abolished for raw materials and equipment imports, while a 30 percent ceiling has been maintained for specific categories of consumer goods. While the aim of this restriction has been to prevent capital flight, it could act to also prevent legitimate current transactions, and the NBY abolished it in April. The NBY also abolished the exceptional penalty on commercial banks regarding payments for imports that do not eventually take place. In addition, the recently amended foreign exchange law will be revised further, with a view to explicitly allowing foreign exchange transactions to take place at *any* exchange rate, i.e., even at rates other than those set at the interbank foreign exchange market under the supervision of the NBY; in the meantime, a NBY decision has allowed the conduct of foreign exchange transactions at exchange rates that fall within a 5 percent range around the exchange rate determined at the interbank foreign exchange market.

37. **The program provides for a major liberalization of foreign trade and a tariff reform in Serbia.** Some initial steps in liberalizing trade were taken last December when the federal parliament adopted a number of amendments to the Law on Foreign Trade with a view to reducing barriers to entry into the trading industry. Nevertheless, the foreign trade regime continues to suffer from numerous quantitative restrictions and pervasive licensing requirements, while the tariff schedule is characterized by high rates with substantial variation and escalation. In cooperation with Fund and World Bank staff, the federal authorities adopted, in mid-May 2001, legislation to: (a) abolish most of the quantitative restrictions; (b) adopt a new tariff schedule; and (c) make progress toward eliminating export quotas. Non-tariff barriers were removed with the exception of about 40 (out of 8,500) tariff lines covering steel products, and measures to enforce environmental, health and safety standards, as well as those related to national security. Quantitative restrictions limiting the imports of steel products will be phased out according to a yet-to-be-established timetable, which will be formulated in the context of a restructuring of the steel industry. In any case, these measures will be removed in the context of FRY's WTO accession negotiations. The new import tariff schedule consists of 6 tariff bands with rates of 1, 5, 10, 15, 20, and 30 percent; the simple average import duty was reduced from about 14 percent to under 10 percent. For the time being, export quotas remain in force on some 30 tariff lines,

including wheat, corn, live animals, edible oil and sugar. However, as the domestic food supplies increase, the government intends to remove these export restrictions on a case-by-case basis.

38. **In Montenegro, the authorities intend to continue to foster an open international trading system, building on the significant liberalization already implemented over the past two years.** This will be enshrined in a new Foreign Trade and Customs Law—to be adopted by end-June 2001—that will also seek to contain traffic in illegal substances and maintain appropriate national health and safety standards.

F. Bank Reform

39. **The NBY is making good progress in diagnosing the problems of the banking sector in preparation for intervening the insolvent banks.** Reflecting the dire conditions of the enterprise sector, inadequate banking supervision, and poor corporate governance over many years, the banking system is largely insolvent and unable to perform its intermediation function. Against this background, in late 2000 the new NBY management sought to ascertain the financial condition of banks by undertaking a bank survey that covered most banks in Serbia on a voluntary basis, with the assistance of a reputable international accounting firm. Based on this survey, banks in Serbia were divided into four categories: (A) healthy; (B) solvent but undercapitalized; (C) insolvent with some systemic importance or potential economic value; and (D) insolvent of no systemic importance. Category A banks will be monitored in the future with normal supervision tools. Category B banks will be subject to enhanced supervision and asked to develop specific recapitalization plans, under which they will be given a limited amount of time to restore their capital to satisfactory levels. Since February, the NBY has been preparing diagnostic reports, based in part on on-site examinations, on category C and D banks (28 banks, including six major banks, jointly accounting for about 80 percent of the assets of the banking system). The diagnostic reports for the six major banks as well as a considerable number of smaller banks are expected to be completed by end-April, and all diagnostic reports for the problem banks have been completed as of May 20, 2001. As described in the following paragraph, these diagnostic reports will form the base for the intervention of all banks confirmed to be insolvent.

40. **The banking resolution strategy will seek rehabilitation or liquidation of banks on an expeditious basis, taking into account the prospects for privatization and the resource constraints.** Following the conclusion of the on-site inspections of the problem banks, the authorities have prepared a detailed strategy for intervention of the insolvent banks and their resolution, in consultation with the Fund and the World Bank. The strategy specifies the modalities of the workout of the assets carved out of banks. The NBY envisages that the intervention of at least the largest banks will take place at or around mid-June 2001. Banks that are presumed to have some systemic importance and value (category C, likely to include at least the six largest banks) will be placed under the control of the BRA for rehabilitation or liquidation. The rest will have their licenses revoked and be liquidated under court supervision. Bank rehabilitation will be undertaken only if it is expected to produce a viable bank with good prospects for privatization through a sale to a private strategic investor at a reasonable price; and can be implemented with identifiable fiscal resources. Banks for

rehabilitation will be restructured financially—through a carving out of bad debt and partial creditor haircuts—as well as operationally, with a view to their achieving core profitability (i.e., after taking into account the effect of the negative net worth on income) within a period of 12 months. If this appears to be unachievable based on performance during the first six months—owing, say, to failure to reach agreement on a haircut that respects the fiscal constraints and/or unduly slow progress in operational restructuring—the banks will be closed and liquidated. During the rehabilitation period, the banks' activities will be tightly restricted, with a view to limiting contingent government liabilities. In general, the principle of no new net lending will apply and all non-retail credit activity will be subject to BRA approval. The NBY will deal with the temporary liquidity needs of the problem banks strictly within the limits of the monetary program. In the case of liquidation, creditors' claims will be satisfied in accordance with existing legislation on the seniority of claims and the government will not assume any liabilities (including through the granting of new guarantees) in excess of existing guarantees on deposits. Given the need for the BRA to focus exclusively on the management and supervision of bank restructuring, the authorities will explore the possibility of transferring operational control of BRA's assets to the Privatization Ministry or another specialized government agency.

41. **The costs of bank restructuring will be significant—albeit difficult to estimate at this stage—pointing to the need for external assistance**. According to preliminary estimates, the uncovered potential losses of the insolvent banks—excluding liabilities related to the Paris Club, London Club, and households' frozen foreign currency deposits—amount to about US$1.1 billion (11 percent of GDP in 2001). This amount could be reduced significantly were bank creditors to share in the losses. This will depend on whether the BRA will be able to negotiate partial creditor haircuts. The Serbian budget for 2001 provides YUD 600 million for bank restructuring costs incurred by the BRA. In addition, funds are expected to be available from multilateral institutions (including a portion of the World Bank's US$30 million trust fund to support TA for bank resolution), the EU, and bilateral donors.

42. **The NBY has embarked upon an ambitious program to strengthen bank supervision.** The program includes a review of prudential regulations, strengthening of off-site reporting and analysis, introduction of on-site risk-based supervision, development of enhanced supervision and enforcement measures, and strengthening loan classification and provisioning regulations. Specifically, a review of prudential regulations, carried out with technical assistance from the Bundesbank, will be completed by end-May. The review has identified the need to strengthen legislation and regulations regarding (i) capital adequacy, (ii) large exposures, (iii) lending to connected parties, and (iv) risk management. The new standards will come into effect from January 1, 2002, based on legislation presented to Parliament by end-June, and supported by new regulations, staff training, dissemination of internal manuals, and bank awareness measures to be carried out during the remainder of 2001. Under the new regulations, banks will be expected to produce monthly reports to bank supervisors on the basis of new reporting requirements. Supervision and enforcement will also be strengthened through the publication of an enforcement manual by end-June 2001, including asset classification and provisioning guidelines. Banks will be given a grace period

to improve compliance with the new regulations before their rigorous application from January 1, 2002.

43. **In Montenegro, the restructuring of the banking system will be a major plank of reform policies for 2001.** The Council of the Central Bank has been recently appointed, thereby empowering the bank to implement the Central Bank Law approved in November 2000 and to complete the establishment of core central bank operations and functions. With donor assistance, good progress has been made in enhancing the Central Bank's supervisory capacity. Legislation and accompanying regulations have been adopted, establishing rigorous licensing provisions and financial reporting and performance requirements for commercial banks, and containing strong, prompt, corrective action and bank exit provisions. The Central Bank has also initiated an independent external financial audit of the Clearing and Settlements Bureau (ZOP), and intends to move ahead with reform of the payments system as soon as practicable. Meanwhile, Montenegro's largest domestic bank is suffering from a severe liquidity shortage. The Council of the Central Bank has appointed a temporary administrator to assume responsibility for running this bank, which is now precluded from making any new loans. The future of the bank will be determined after two months of a possible 12-month term of the administrator and a thorough analysis of the financial and operational conditions of the bank has been carried out. A foreign strategic partner may be sought for the bank but, in any event, no public money will be expended on the bank's rescue or recapitalization. However, the social costs from the reform of the payments system and the restructuring of the banking system will be significant. Given the severity of the budget situation, the authorities intend to request financial assistance in support of the reform efforts.

G. Private Sector Development

44. **In Serbia, a new approach to privatization has been adopted, with support from the World Bank.** In line with the new approach, at least 70 percent of enterprise equity will be offered to strategic investors with a view to establishing clearly defined ownership and dominant owners. Employees and management will not be given preferential treatment in the sale of these enterprises, and the entire process will be conducted under strict rules to ensure transparency. The first draft of the new privatization law has already been completed in cooperation with the World Bank, and the full legal framework for privatization will be in place by end-June 2001. Steps to design the organizational structure and legal underpinnings of the Privatization Agency and decisions regarding its staffing are being taken in parallel, so that full operation of the Agency can be expected by mid-July 2001. In the meantime, privatizations under the 1997 Privatization Law were stopped shortly after the new Serbian government assumed power. Those enterprises that have begun or completed self-privatization under this law (about one seventh of medium and large enterprises) will be allowed to retain the new ownership structure. However, the authorities plan to use the unallocated share of ownership presently held by the government, and encourage employee-owners to offer a share of the ownership in their hands, to offer controlling stakes for sale to strategic investors in these companies as well. To facilitate the further transformation of ownership in previously privatized enterprises, the new privatization law will remove restrictions on the trading of employee shares.

45. **Serbia's new privatization program will move along two tracks.** First, through the Privatization Agency, the government will take charge of initiating and executing the privatization of the eight largest state-owned companies, mainly utilities, as well as of some 120–150 socially owned enterprises of strategic importance. In the case of the utilities, their sale will be preceded by the establishment of adequate regulatory frameworks. Strategically important socially owned enterprises will be sold through tenders offering at least 70 percent of ownership to strategic investors. Some 15 percent of capital of the state-owned and strategic socially owned enterprises will be distributed free of charge to enterprise employees, while another 15 percent will be placed in a privatization register for eventual distribution free of charge to citizens at large. The government is in the process of privatizing three cement factories under the authority granted to it by the 1997 law and, in cooperation with the World Bank, selecting another 31 strategic enterprises—to be divided into seven pools—for early privatization under the new law. The authorities envisage to have at least 4 (of the seven) contracts with investor advisors signed by end-October 2001, and to be in the position to offer at least one pool of enterprises for sale by end-December 2001. Second, with regard to the remaining 4,000 enterprises (7,000, including subsidiaries) privatization may be initiated either by the enterprises themselves or by the Privatization Agency, which can propose either a tender or an auction to attract potential strategic investors. In any case, the preparation and execution of the privatization of all enterprises will be closely supervised by the Privatization Agency and subject to well-defined tender and auction rules to ensure full transparency and accountability in the process. To provide incentives to workers and managers for rapid privatization under this scheme, the costless allocation of ownership shares to employees would decline steadily from a maximum of 30 percent to zero after four years from the coming into effect of the new law. If after four years there are still enterprises that have not been sold, their privatization will be taken over by the Agency.

46. **Envisaged labor market reform should improve the business environment and facilitate economic restructuring.** In this regard, draft laws on labor relations will be submitted to the federal and Serbian parliaments by end-June. Similarly, new laws on Employment and the Rights of the Unemployed will be submitted to parliament by end-August. The new legislation will: (a) guarantee core labor standards, including the freedom of association and participation in collective bargaining for employees and employers; (b) streamline and reduce minimum statutory benefits for employment termination and unemployment; (c) liberalize hiring procedures and allow for flexibility in the modality of employment (fixed-term contracts, part-time employment, seasonal, and casual labor); (d) liberalize wage determination, except for the minimum wage; and (e) bring statutory minimum leave and maternity benefits to levels affordable to the majority of the economy.

47. **The federal and Serbian authorities are establishing task forces to review existing commercial and bankruptcy legislation, as well as to identify the obstacles to its effective enforcement.** The legal system currently favors debtors over creditors regarding rights arising in foreclosures, bankruptcies and enterprise liquidations, while the processes themselves are lengthy and uncertain. The goal is to identify the institutional changes necessary to harden the budget-constraint and increase the security of property. Pending implementation of these institutional changes, new regulations to be adopted by end-June

will allow for greater reliance on out-of-court procedures that will run in parallel or in lieu of bankruptcy and liquidation.

48. **In Montenegro, private sector development will be predicated on an acceleration of the privatization program and the creation of a market-friendly climate for investors.** Privatization of the majority of shares in all enterprises will be conducted by international tender to attract strategic investors and improve corporate governance, while minority shares will be preserved for a mass voucher privatization program that is set to begin this year. Also, during the course of 2001, the government intends to approve a new Company Law consistent with international best practices, as well as a new Bankruptcy Law to promote the rapid and efficient transformation of the enterprise sector. A new Foreign Investment Law aimed at protecting investments and guaranteeing the right to profit repatriation was already approved in 2000.

Yugoslavia: Quantitative Performance Criteria and Indicative Limits Under the 2001-2002 Stand-By Arrangement 1/

(In millions of dinars, unless otherwise noted)

	2000	2001			
	end-December Actual	end-March Estimate	end-June Target	end-September Target	end-December Target
A. Quantitative performance criteria					
Floor on the net foreign assets of the NBY 2/	-308	-231	-283	-303	-283
Ceiling on net domestic assets of the NBY	39,315	34,526	39,064	41,766	42,909
Ceiling on net credit of the banking system to the consolidated general government 3/ 4/	3,373	294	5,373	7,373	7,373
Ceiling on contracting or guaranteeing of new nonconcessional external debt with original maturity of more than one year by the public sector 2/ 5/	...	0	0	0	0
Ceiling on new external debt owed by the consolidated general government or guaranteed by the public sector with an original maturity of up to and including one year 2/ 6/	...	0	0	0	0
Ceiling on new guarantees and the assumption of enterprise debt to banks by the public sector 7/	...	0	0	0	0
Ceiling on outstanding external debt service arrears 8/	...	0	0	0	0
B. Indicative targets					
Ceiling on net domestic assets of the banking system 9/	19,433	15,720	24,604	28,226	31,226
Ceiling on change in the arrears of					
the federal government	...	0	0	0	0
the consolidated general government in Serbia	...	0	0	0	0
the consolidated general government in Montenegro	...	0	0	0	0
Ceiling on the wage bill of the 8 largest public enterprises, cumulative from beginning of year 10/	9,992	4,328	8,756	13,207	17,658

1/ Quantitative performance criteria and indicative targets are defined in Annex C.

2/ In millions of U.S. dollars; definitions have been revised to take foreign-exchange denominated liabilities into account.

3/ For program purposes, the ceilings on net credit of the banking system to the consolidated general government will be adjusted downward by the cumulative increase in the stock of government debt held by the nonbank public, starting from January 1, 2001, and upward for any decrease.

4/ The consolidated general government comprises the federal, the Serbian republican and local governments, the Montenegrin republican government, the Serbian and Montenegrin social security funds, and the Serbian special extrabudgetary programs.

5/ Excluding loans from the EBRD, EIB, IBRD, or IFC. The public sector comprises the consolidated general government and the National Bank of Yugoslavia.

6/ Excluding normal import-related credits.

7/ Excluded is indebtedness arising from the fulfillment of existing guarantees.

8/ Excludes debts subject to rescheduling/negotiations. The nonaccumulation of new external arrears is also a continuous performance criterion.

9/ Foreign currency denominated loans and deposits at program exchange rates.

10/ JP Elektroprivreda Srbije, JP Nafna Industrija Srbije, JP PTT Srbije, JP Jugoslovenski Aerotransport, JP Zelenicko Transportno Preduzece Srbije, JP Radio Televizija Srbije, JP Srbija Sume, and JP Srbija Vode. Wage bill ceilings are consistent with nominal wages being maintained throughout the year at their January 2001 level, in accordance with the *Decree on the Level of Wages and Other Earnings in Public Enterprises*, Official Gazette, 19/01.

Federal Republic of Yugoslavia: Stand-By Arrangement, April 2001-March 2002
Prior Actions, Structural Performance Criteria, and Structural Benchmarks

	Implementation Date
I. Prior Actions and Preconditions for Board Consideration	
1. (Serbia) Increase in average electricity tariff (weighted by consumption) by 60 percent effective April 15, and by 40 percent on June 1, 2001.	
2. (Serbia) Parliamentary approval of (a) a budget for 2001 and (b) tax reform measures consistent with program objectives.	
3. (Federation) Freezing of all salaries paid out of the federal budget at the January 2001 level through a government decree.	
4. (Federation) Liberalization of the foreign trade regime, involving: elimination of all import licensing requirements, except those on 40 tariff lines covering steel products and those necessary to enforce environmental, health, safety and national security objectives; elimination of all export licensing requirements, except those on some 30 tariff lines, covering inter alia wheat, corn, live animals, edible oil, and sugar; and reducing the maximum tariff rate to 30 percent, while lowering the simple average tariff to below 10 percent.	
5. (Montenegro) Appointment of a special administrator for the largest bank, which is highly illiquid.	
6. (Federation) Agreement with World Bank on an arrears clearance plan.	
7. (Federation) Agreement with the EU on an arrears clearance plan (regarding obligations to the EIB).	
8. (Federation) Financing assurances from the Paris Club.	
II. Structural Performance Criteria	
1. (Serbia) Increase in average electricity tariff (weighted by consumption) by 40 percent.	October 1, 2001
III. Structural Benchmarks	
A. Fiscal Sector	
1. (Serbia) Redesign of the co-payment system in the health care sector, with a view to generating additional revenue of YUD 0.8-1.0 billion on an annual basis.	end-May 2001
2. (Montenegro) Adoption of an organic budget system law to standardize budget classification and implementation of a centralized treasury system.	end-June 2001

Federal Republic of Yugoslavia: Stand-By Arrangement, April 2001-March 2002
Prior Actions, Structural Performance Criteria, and Structural Benchmarks

	Implementation Date
3. (Serbia) Issuance of decree revising the list of drugs offered to the general public population in state pharmacies, to bring expenditure on drugs in line with financial resources available to the health care system.	end-June 2001
4. (Serbia) Improvement of cash management and fiscal reporting by eliminating primary budget managers' expenditure accounts and own accounts of direct spending units (637 accounts and their 850 subaccounts) and by creating ledger accounts within account 630.	end-September 2001
5. (Montenegro) De-linking of the statutory minimum wage from public sector pay and social benefits levels.	end-September 2001
6. (Serbia) Establishment of a Central Accounting Division in the Treasury Department of the Ministry of Finance and Economy.	end-December 2001
7. (Serbia) Establishment of a new system of commitment control based in the Treasury's Central Accounting Division.	end-December 2001
8. (Serbia) Set up of a Large Taxpayer Office in Belgrade.	end-December 2001
B. Financial Sector	
1. (Federation and NBY) Adoption of a strategy for bank restructuring, in consultation with the Fund and the World Bank.	May 15, 2001
2. (Federation and NBY) Intervention of the six largest, illiquid, banks in Serbia.	end-June 2001
C. Private Sector Development	
1. (Serbia) Parliamentary approval of privatization legislation in Serbia, designed in cooperation with the World Bank, to :	end-June 2001
(a) attract investment capital by offering at least 70 percent of enterprise shares to investors and no privilege to company management, management, workers, or any other agents regarding purchase of these shares;	
(b) create, through dominant ownership, a clear ownership structure conducive to efficient resource allocation and good enterprise management;	
(c) facilitate failed enterprise liquidation/work-outs prior to privatization, among other things by authorizing the Privatization Agency to require an enterprise to enter workout/liquidation;	
(d) establish transparent and efficient privatization procedures.	

Federal Republic of Yugoslavia: Stand-By Arrangement, April 2001-March 2002
Prior Actions, Structural Performance Criteria, and Structural Benchmarks

	Implementation Date
Legislation to include Law on Privatization, Law on Shares, Law on Agency for Privatization, Ordinance on Privatization Program, Ordinance on Public Tender, Ordinance on Auctions, Ordinance on Business Valuation, and Ordinance on Appraisers.	
2. (Serbia) Conclusion of at least six contracts for the privatization of either large companies or pools of six companies each with investment banks hired through competitive international tenders (out of a total of four large companies and five pools).	end-October 2001
3. (Serbia) Offer of at least one company or pool of six companies for sale observing well defined, internationally accepted tender rules.	end-December 2001

Federal Republic of Yugoslavia: Technical Memorandum of Understanding

May 25, 2001

I. Introduction

1. This memorandum sets out the understandings between the Yugoslav authorities and staff of the International Monetary Fund (IMF) regarding the definitions of quantitative and structural performance criteria and benchmarks, as well as indicative targets, for the 10-month stand-by arrangement (SBA), as well as the mechanisms to monitor the program and related reporting requirements. To monitor the evolution of the economy during the program period, the Yugoslav authorities will provide the data listed in each section below to the European 1 Department of the Fund, in accordance with the indicated timing. The quantitative performance criteria and indicative targets will be monitored on the basis of the methodological classification of monetary and financial data that was in place on December 31, 2000, except as noted below. For program purposes, the public sector consists of the consolidated general government (comprising the federal, Serbian Republican and local governments, the Montenegrin Republican government, the Serbian and Montenegrin social security funds, and the Serbian special budgetary programs) and the National Bank of Yugoslavia (NBY). The authorities will inform the Fund staff of any new funds or special extrabudgetary programs that may be created during the program period to carry out operations of a fiscal nature as defined in the IMF's *Manual on Government Financial Statistics,* and will ensure that these will be incorporated within the definition of consolidated general government. Quantitative performance criteria and indicative targets for end-June, end-September and end-December 2001 are specified in Annex A of the Memorandum of Economic and Financial Policies (MEFP).

II. Quantitative Criteria: Definitions and Reporting Standards

A. Floor for Net Foreign Assets of the NBY

2. **Definition.** Net foreign assets (NFA) of the NBY consists of foreign reserve assets minus foreign reserve liabilities.

- For purposes of the program, **foreign reserve assets** shall be defined as monetary gold, holdings of SDRs, the reserve position in the IMF, and NBY holdings of foreign exchange in convertible currencies. The assets should be under the effective control of, and readily available to, the NBY. Excluded from foreign reserve assets are frozen assets of the Federal Republic of Yugoslavia (FRY), undivided assets of the Socialist Federal Republic of Yugoslavia (SFRY), long-term assets, NBY claims on bank and nonbank residents, as well as Yugoslav commercial banks located abroad, any assets in nonconvertible currencies, encumbered reserve assets pledged as collateral for foreign loans, reserve assets pledged through forward contracts, and precious metals other than gold. Monetary gold shall be valued at an accounting price of US$272.60 per ounce, and SDRs at SDR1 = US$1.3029. On December 31, 2000 the NBY's foreign reserve assets as defined above amounted to US$516 million, including gold valued at US$125 million.

- For purposes of the program, **foreign reserve liabilities** shall be defined as any short-term loan or deposit (with a maturity of up to and including one year), swaps (including any portion of the NBY gold that is collateralized), and forward liabilities of the NBY—in convertible currencies to residents and nonresidents; IMF purchases; and loans contracted by the NBY after December 31, 2000 from international capital markets, foreign banks or other financial institutions, foreign governments, and bridging loans from the BIS, irrespective of their maturity. On December 31, 2000, the NBY's foreign reserve liabilities, as defined above, to nonresidents were US$152 million and to residents were US$672 million.

- All assets and liabilities denominated in convertible currencies other than the U.S. dollar shall be converted at their respective exchange rates against the U.S. dollar prevailing on December 31, 2000. All changes of definition or valuation of assets or liabilities, as well as details of operations concerning sales, purchases or swap operations with respect to gold shall be communicated to the Fund staff within one week of the operation.

3. **Reporting.** Data on foreign reserve assets and foreign reserve liabilities of the NBY shall be transmitted to the European 1 Department of the Fund on a weekly basis within four business days of the end of each business week. To facilitate program monitoring, the NBY will provide the data at the indicated constant prices and exchange rates, as well as at current exchange rates (Annex A). The NBY will report if any of the reported foreign reserve assets are illiquid or pledged, swapped, or encumbered.

4. **Adjusters**. For program purposes the floor on net foreign assets will be adjusted upward pari pasu to the extent that: (i) the NBY recovers frozen assets of the FRY, undivided assets of the SFRY, long-term assets, and foreign-exchange-denominated claims on resident banks and nonbanks, as well as Yugoslav commercial banks abroad; (ii) the restructuring of the banking sector by the Bank Restructuring Agency (BRA) involves a decline in NBY foreign-exchange-denominated liabilities to resident banks; and (iii) cumulative World Bank disbursements of program loans during 2001 exceed interest payments on the World Bank consolidation loan by more than US$20 million. The floor will be adjusted downwards to the extent that cumulative disbursements of EU macro-financial assistance during 2001 fall short of debt service and arrears payments to the EIB, subject to a maximum adjustment of US$50 million.

B. Ceiling on Net Domestic Assets of the NBY

5. **Definition.** For purposes of the program, net domestic assets (NDA) of the NBY are defined as the difference between reserve money (as defined in section E) and net foreign assets (as defined in section A), with the latter being converted from U.S. dollars into dinars at the program accounting exchange rate of US$1 = YUD 63.1659, which was the rate prevailing on December 31, 2000 and the exchange rates of the US$ *vis-a-vis* other

currencies prevailing on that day. As of December 31, 2000, the domestic assets of the NBY so defined were valued at YUD 39,315 (Annex A).

6. **Reporting.** The ceilings will be monitored on the basis of daily data on the accounts of the NBY, reporting foreign reserves assets and liabilities as defined under section A and reserve money as defined under section E supplied to the European 1 Department of the Fund by the NBY, within four business days of the end of each business week.

C. Ceiling on the Net Credit of the Banking System to the Consolidated General Government

7. **Definition.** The banking system comprises the NBY and the commercial banks, including all banks in Montenegro. The consolidated general government is defined above.

- For program purposes, **net credit of the banking system to the consolidated general government** is defined as all claims (i.e., credits, securities, and other claims in both dinar and foreign currencies) of the banking system on the consolidated general government less all deposits of the consolidated general government with the banking system, including foreign currency deposits. Foreign currency deposits and foreign-currency denominated credits to the general government will be reported at the end-December 2000 exchange rates. Any holdings of government securities by commercial banks mandated by the NBY against reserve requirements above the actual amounts held at end-December 2000 (YUD 174 million) will be included in the credit of the banking system to the consolidated general government. Before undertaking any changes to reserve requirements, the NBY will consult with the Fund staff. (Net bank credit to the consolidated general government in Montenegro will be monitored on the basis of data supplied by the Montenegrin authorities; at end-December 2000, net credit of the banking system in Montenegro to the consolidated general government in Montenegro amounted to minus DM 84.8 million.)

8. **Reporting.** The ceilings will be monitored from end-weekly data on the accounts of the banking system supplied to the European 1 Department of the Fund with a lag not to exceed two weeks.

9. **Adjusters.** For program purposes, the ceilings on net credit of the banking system to the consolidated general government will be adjusted downward by the cumulative increase in the stock of government debt held by the nonbank public (other than that related to the frozen foreign currency deposits), starting from January 1, 2001, and upward for any decrease.

D. Ceiling on Change in Arrears

10. For program purposes, indicative targets will be set on the change in domestic arrears. Separate indicative targets will be set for the federal government, the consolidated general government in Serbia, and the consolidated general government in Montenegro.

11. **Definition**

- For the purpose of establishing compliance with this indicative target, the federal government is defined to comprise all budgetary institutions financed from the federal budget, including the federal army and the federal pension fund for retired military personal. The consolidated general government in Serbia is defined to comprise all budgetary institutions financed from the Serbian republican budget, the Republican Pension and Invalidity Insurance Fund for Employees, the Republican Pension and Invalidity Insurance Fund for Self-employed, the Republican Pension and Invalidity Insurance Fund for Agricultural Workers, the Republican Health Insurance Fund, the Republican Labor Market Agency, all republican special directorates, the Serbian Development Fund, and all other budgetary and extrabudgetary funds created by the government of Serbia existing before or created during the period of the program. The consolidated general government in Montenegro is defined to comprise all budgetary institutions financed from the republican budget, the Republican Pension and Invalidity Insurance Fund, the Republican Health Insurance Fund, the Republican Labor Market Fund, and all other budgetary and extrabudgetary funds created by the government of Montenegro existing before or created during the period of the program.

- The outstanding stock of domestic arrears comprises wage and pension arrears; arrears with respect to accrued tax and social security contribution obligations, including personal income tax and social security contributions of employees withheld at source; arrears on social entitlement benefits (apart from pensions) to households; arrears incurred with respect to the purchases of goods and services from suppliers; and arrears related to the servicing of domestic debt.

- The outstanding stock of wage arrears at a particular date are defined as total accumulated unpaid wages of all employees on the regular payroll of all units belonging to the parts of the general government as defined above, up to the latest preceding regular pay date, which have not been settled by the test date. The total stocks of wage arrears, thus defined, are on a gross basis and are calculated by summing the wage arrears of all units of government with regard to their own employees; transfers between different levels of government for making wage or other payments are excluded from the estimates of these wage arrears.

- Pension arrears are defined as total accumulated pensions due but not disbursed by the pension funds concerned to all pensioners in the pension rolls up to the latest preceding pension disbursement date.

- The outstanding stocks of tax and social contribution arrears at a particular date comprise total accumulated accrued tax obligations of the parts of the general government as defined above that have not been paid by the test date. The total stocks of such arrears are on a gross basis and are calculated as the sum of such arrears.

- Social entitlement payments, apart from pensions, are defined as all cash payments due directly to, or on behalf of, the population in accordance with stipulations in the law and which are not contingent upon the provision of any services or sale of any goods or assets to the general government by such members of the population in return for these payments. The stock of such entitlement arrears are defined as total accumulated payments due but not disbursed by all units of government up to the test date. Thus defined, these arrears are also on a gross basis and do not include the netting out of any transfers made between different units of the general government for the payment of such entitlements.

- Arrears to suppliers comprise payments delayed beyond what was explicitly specified in relevant contracts, or in the absence of such specification, for two months from the date of submission of bills, for already-effected purchases of goods or services by the government concerned. These include, *inter alia*, arrears to utility companies, arrears incurred with respect to service and maintenance contracts, and payments not made for the purchase of goods and supplies such as equipment and furniture. These arrears are also defined on a gross basis and overdue tax and other obligations to the government of the relevant enterprises are not included in the calculation of the arrears of the government unless there is mutual agreement on the cancellation of debts. Netting out of any transfers made between different units of the general government for the payment of such arrears and obligations are also not taken into consideration.

- Arrears to domestic banks and nonbank lenders comprise all overdue payments related to financial contracts between the government and domestic banks, nonbank financial institutions, nonfinancial institutions, and private lenders.

- At end-December 2000, the stock of arrears of the Federal government was estimated at YUD 7.063 billion; and the stock of arrears of the consolidated general government in Serbia was estimated at YUD 32.522 billion.

- DM denominated claims on government will be converted at the exchange rate of DM 1 = YUD 30; claims denominated in currencies other than the DM will first be converted at their respective exchange rates against the DM prevailing on December 31, 2000. The change in arrears is defined as the change in the end-period stock of arrears. Changes in wage and pension arrears will be adjusted for the changes in the average wage and average pension in the economy relative to their respective values in December 2000.

12. **Reporting**. Before the last business day of each month, data on end-period stocks of arrears for the previous month will be supplied to the European 1 Department of the Fund by the Federal Ministry of Finance, the Ministry of Finance of Serbia, and the Ministry of Finance of Montenegro.

E. Definition of Reserve Money

13. **Definition.** Reserve money is defined as the sum of currency in circulation (NBY Bulletin, September 2000, Table 3A, column 8) and reserves banks are required to hold under the standard reserve requirement, plus excess reserves of the commercial banks at the NBY. Shortfalls in reserves that banks are required to hold, will be included in required reserves (and therefore in reserve money), as well as in bank borrowing from the NBY. Reserves that banks are required to hold under the standard reserve requirement are currently set at 24.5 percent of the base as defined in the NBY Decision of September 24, 1999. Reserves that banks hold at the NBY to satisfy other additional or special reserve requirements will not be included as part of the amounts necessary to satisfy the standard reserve requirement. The amounts that banks are permitted to hold in securities to satisfy the statutory reserve requirement will be limited to the amount that banks were holding as of December 31, 2000 banks YUD 174.1 million. Excess reserves include commercial bank balances in Giro accounts 620 and 625 with the NBY and cash in commercial bank vaults.

14. Data on reserve money will be monitored from the daily indicators data of the NBY, which shall be supplied to the European 1 Department of the Fund weekly by the NBY with a three-day lag. On December 31, 2000, currency in circulation amounted to YUD 10,933 million while required reserves amounted to YUD 4,824.0 million, and excess reserves to YUD 4,088 million. Data on effective reserve requirements and the deposit base used in reserve requirement calculations will be supplied to the European 1 Department within two days of the 11th, 18th, and 28th day of each month.

15. **Adjusters.** For program monitoring purposes, reserve money will be adjusted as follows: Should the standard reserve requirement increase (decrease) from the level prevailing on [December 31, 2000], the ceiling on net domestic assets would be increased (decreased) by an amount equivalent to the change in the standard reserve requirement ratio multiplied by the programmed deposit base used in the calculation of required reserves. Before making any such changes, the NBY will consult with Fund staff. Required reserves of banks placed under BRA administration or liquidation will remain part of reserve money for program purposes.

F. 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 public sector, except on debt subject to rescheduling or restructuring. The program requires that no new external arrears be accumulated at any time under the arrangement.

17. **Reporting.** The accounting of nonreschedulable 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. This accounting will include, separately, arrears owed by the Federal, Serbian and Montenegrin governments, and other public sector entities; arrears owed by Yugoslav Airlines; and arrears owed to Paris Club creditors, non-Paris club creditors, and other creditors. Data on other arrears, which are reschedulable, will be provided separately.

G. Ceilings on External Debt

18. **Definitions.** First, with regard to the ceiling on contracting or guaranteeing of new nonconcessional external debt by the public sector with original maturity of more than one year: This performance criterion applies not only to debt as defined in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt adopted on August 24, 2000 (Decision No. 12274-(00/85), see attachment to this Annex) but also to commitments contracted or guaranteed for which value has not been received. Excluded from this performance criterion are loans from, or other indebtedness to, the EBRD, the EIB, the IBRD, the IMF, and the IFC. Concessionality will be based on a currency-specific discount rate based on the ten-year average of the OECD's commercial interest reference rate (CIRR) for loans or leases with maturities greater than 15 years and on the six-month average CIRR for loans and leases maturing in less than 15 years. Under this definition of concessionality, only debt with a grant element equivalent to 35 percent or more will be excluded from the debt limit. Second, with regard to the ceiling on new external debt with original maturity of up to and including one year owed by the consolidated general government or guaranteed by the public sector : The term "debt" has the meaning set forth in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt adopted on August 24, 2000 (Decision No. 12274-(00/85). Excluded from this performance criterion are short-term import credits.

19. **Reporting.** A debt -by-debt accounting of all new concessional and nonconcessional debt contracted or guaranteed by he public sector, including the original debt documentation, as well as all relevant supporting materials, will be transmitted on a quarterly basis within four weeks of the end of each quarter.

III. OTHER REPORTING REQUIREMENT FOR PROGRAM MONITORING

A. Macroeconomic Monitoring Committee

20. A macroeconomic monitoring committee, composed of senior officials from the Federal Government, Serbian and Montenegrin Ministries of Finance, the NBY, and other relevant agencies, shall be responsible for monitoring the performance of the program, informing the Fund regularly about the progress of the program, and transmitting the supporting materials necessary for the evaluation of performance criteria and benchmarks.

B. Developments on Structural Performance Criteria and Benchmarks

21. The authorities will notify the European 1 Department of the Fund of **developments on structural performance criteria and benchmarks** as soon as they occur. The authorities will provide the documentation, according to the dates in Annex B, elaborating on policy implementation. **The authorities will also notify the European 1 Department of the Fund of any economic developments or policy measures that could have a significant impact on the implementation of this program.**

C. Data Reporting

Production and prices

22. The following information will be transmitted at the time of their publication:

- The retail price index, the industrial price index, the industrial production index, wages and employment, and exports and imports.

23. Any revision to the national accounts data will be transmitted within three weeks of the date of the revision.

Public finance

24. Monthly data on public finance will require a consolidated budget report of the Federal and Republican governments comprising:

- The revenue data by each major item, including that collected by the federal and the republican governments;
- Details of the recurrent and capital expenditure of the federal and republican governments; and
- Details of budget financing, domestic, and external data will be transmitted within four weeks of the end of each month.

Monetary sector data

25. The following data will be transmitted on a daily/weekly/biweekly basis within one/five working days of the end of each day/week.

- Daily movements in gross foreign exchange reserves of the NBY at current exchange rates, indicating amounts sold/bought at the auction, purchases through ZOP, purchases on the interbank market, inflows of foreign grants, inflows of foreign loans, and repayments of frozen currency deposits.
- Daily movements in foreign exchange denominated liabilities of the NBY to (i) non-residents; (ii) Yugoslav banks; and (iii) Yugoslav residents.
- Daily movements in liquid foreign exchange assets of Yugoslav banks as reported by these banks to the NBY.
- Daily movements in reserve money, indicating currency in circulation, the basis upon which required reserves are calculated, required reserves, reserves held, and excess reserves.

- Treasury bill auction details (rates, amounts per maturity and number of banks participating in the auction per maturity); and

- Interbank foreign exchange rates and volume of transactions.

- Public sector borrowing and lending from commercial banks and the NBY

26. The balance sheet of the NBY and the consolidated balance sheets of the commercial banks, including all banks in Montenegro, will be transmitted on a monthly basis within three weeks of the end of each month. The stocks of government and mandatory and voluntary NBY securities held by banks and by non-banks, as available to the NBY, detailed information on interbank money market transactions (terms, duration, and participating institutions), and interest rate developments will be transmitted on a monthly basis within two weeks of the end of each month.

External data

27. The following data will be transmitted as follows:

- The interbank market exchange rate, as the simple average of the daily-weighted average buying and selling rates, will be transmitted on a weekly basis within five business days of the end of the week;

- Balance of payments data on services, private transfers, and capital account transactions will be transmitted on a quarterly basis within four weeks of the end of each quarter; and

- Detailed monthly data on the volume and prices exports and imports, including a separate report on imported petroleum products.

Executive Board Decision No. 6230-(79/140) (Guidelines on Performance Criteria with Respect to Foreign Debt) adopted August 3, 1979, as amended by Executive Board Decision No. 11096-(95/100) adopted October 25, 1995, and as amended on August 24, 2000

Point No. 9

(a) For the purpose of this guideline, the term "debt" will be understood to mean a current, i.e., not contingent, liability, created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which requires the obligor to make one or more payments in the form of assets (including currency) or services, at some future point(s) in time; these payments will discharge the principal and/or interest liabilities incurred under the contract. Debts can take a number of forms, the primary ones being as follows:

(i) loans, i.e., advances of money to the obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future (including deposits, bonds, debentures, commercial loans and buyers' credits) and temporary exchanges of assets that are equivalent to fully collateralized loans under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements);

(ii) suppliers' credits, i.e., contracts where the supplier permits the obligor to defer payments until some time after the date on which the goods are delivered or services are provided; and

(iii) leases, i.e., arrangements under which property is provided which the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the lessor retains the title to the property. For the purpose of the guideline, the debt is the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement excluding those payments that cover the operation, repair or maintenance of the property.

(b) Under the definition of debt set out in point 9(a) above, arrears, penalties, and judicially awarded damages arising from the failure to make payment under a contractual obligation that constitutes debt are debt. However, arrears arising from the failure to make payment at the time of delivery of assets or services are not debt.

Statement by the IMF Staff Representative
June 11, 2001

1. This statement updates the information presented in EBS/01/81 (5/25/01) as regards (a) the fulfillment of preconditions for Board consideration of the Federal Republic of Yugoslavia's (FRY) request for a stand-by arrangement, including the implications for the program of recently adopted trade measures, and (b) a recently reached agreement among former republics of the Socialist Federal Republic of Yugoslavia (SFRY) on succession issues.

Preconditions for Board Consideration

2. FRY has met the remaining two preconditions for Board consideration of the proposed stand-by arrangement. Specifically, the Serbian authorities raised the price of electricity by 40 percent on June 1, 2001, as envisaged under the program. As a result of this measure and a 60 percent increase implemented on April 15, the average price of electricity in Serbia is now estimated at slightly over 2 U.S. cents per Kwh; this is broadly sufficient to cover most operational costs (¶29 of EBS/01/81). In addition, on June 5, 2001, the EU Council of Ministers (ECOFIN) approved in principle a plan for the clearance of FRY's arrears to the European Investment Bank (EIB) amounting to about US$220 million, as well as balance of payments assistance to FRY of up to €300 million. The balance of payments assistance would have a 40 percent grant component and be disbursed in three tranches. The first two tranches would become available during 2001 and, jointly, slightly exceed the amount of debt service payments (including arrears clearance) to the EIB during the year, in line with the external financing assumptions of the program (¶20 of EBS/01/81).

3. As envisaged under the program, the authorities adopted in May, as a prior action, a far-reaching trade system reform, including a revised tariff schedule (¶33 of EBS/01/81). The maximum import duty recorded in the tariff schedule was reduced to 30 percent and the simple average of import duties to under 10 percent. Since then, a provision in the law that allows for seasonal duties has been invoked, temporarily raising tariffs on 4 tariff lines to 30 percent, on 31 tariff lines covering agricultural goods to 40 percent, and on one tariff line (tomatoes) to 50 percent (there are about 8,500 tariff lines in total). After these duties, the simple average import duty remains below 10 percent. The authorities consider this measure to be in line with their commitments under the program, as seasonal duties have been traditionally applied during the crop season. They have reiterated their commitment to promoting liberal trading environment and they committed not to introduce further increases in tariff duties. Since the increases in tariff duties were limited to a small number of tariff lines on a seasonal basis and the authorities have committed to not raise tariff duties further, staff is satisfied with the measures taken by the authorities to introduce a revised tariff schedule.

Agreement on Succession Issues

4. At a meeting in Vienna on May 25, 2001, representatives of the five successor states to the former SFRY initialed a framework agreement on succession issues. The agreement is expected to be approved by the governments of the successor states by June 15, 2001; to be

ratified subsequently by the respective parliaments; and to come into effect 30 days after ratification by all parties. According to information provided by the FRY authorities, the agreement has seven annexes covering, in particular, movable and immovable property (including diplomatic and consular property), financial assets and liabilities, archives, and pensions. The agreement is generally guided by the principles of dividing (a) property abroad and remaining financial assets, on a proportional basis, and (b) property in the territory of the former SFRY, on the basis of its location. Special negotiations, possibly under the auspices of the BIS, will be conducted to resolve outstanding differences relating to citizens' frozen foreign exchange accounts. The agreement confirms the effective division of liabilities on the basis of earlier agreements by four of the five successor states with Paris Club and London Club creditors and excludes any financial claims against each other related to Paris Club and London Club obligations.

5. Under the agreement, FRY will be entitled to 38 percent of available SFRY financial assets. About US$1,024 million of financial assets are reported to be in the form of gold, foreign exchange deposits and securities.[1] However, according to the FRY authorities, the bulk of claims on SFRY joint venture banks abroad (which are largely insolvent or have been liquidated) is not available, implying that FRY's share in these financial assets will be about US$144 million (equivalent to 38 percent of the monetary gold and foreign exchange held in foreign banks, totaling US$378 million, see footnote 1), plus 38 percent of whatever assets are eventually recovered from the joint venture banks. (This would be in addition to the equivalent of about US$144 million of gold held with the BIS, which is to be allocated to FRY in the coming weeks on the basis of an agreement reached in Brussels on April 10, 2001.) Data on assets and liabilities under outstanding clearing arrangements still need to be reconciled before being divided among the successor states; the most important item within this category is an unreconciled claim on Russia of approximately US$1.4–1.5 billion. Under the proposed stand-by arrangement, distribution of foreign financial assets to FRY, as a result of the succession process or unfreezing, leads to a corresponding upward adjustment of the NFA floor (monitored as a performance criterion under the program) with a view to preventing a relaxation of the financial policy targets.

[1] The financial assets of the SFRY and its National Bank of Yugoslavia (NBY) to be allocated under the agreement include: (a) monetary gold and foreign exchange held in foreign banks, totaling US$378 million, and (b) foreign exchange accounts held with SFRY joint-venture banks abroad, with a nominal value of some US$646 million.

INTERNATIONAL MONETARY FUND
EXTERNAL RELATIONS DEPARTMENT

EDITORIAL DIVISION
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FOR IMMEDIATE RELEASE
June 11, 2001

International Monetary Fund
Washington, D.C. 20431 USA

IMF Approves US$249 Million Stand-By Credit for the Federal Republic of Yugoslavia

The Executive Board of the International Monetary Fund (IMF) today approved a stand-by credit of SDR 200 million (about US$249 million) for the Federal Republic of Yugoslavia (FRY) through March 31, 2002 in support of the government's economic program. This decision will enable the Federal Republic of Yugoslavia to draw SDR 50 million (about US$62 million) immediately. Three installments of SDR 50 million could follow after the conclusion of quarterly reviews of the program.

Following the Executive Board discussion, Stanley Fischer, First Deputy Managing Director and Acting Chairman, said:

"The FRY authorities have embarked with impressive speed and commitment on the extremely difficult task of reconstructing their devastated economy. Maintaining this momentum will be key to building broad political support for the reform and securing its sustainability.

"The Fund-supported program provides for strong macroeconomic policies coupled with bold structural reforms. Adherence to the program's credit and fiscal targets will be important to reduce inflation and create an environment that is supportive of reform. Significantly, important structural reforms—including the liberalization of the foreign exchange and trade systems, and a radical reform of the fiscal system—have been implemented upfront. Moreover, the authorities have formulated and started to implement a bank resolution strategy in collaboration with the IMF and the World Bank, while a new transparent privatization framework is about to be adopted in the coming weeks.

"In Montenegro, significant institutional reforms have been introduced over the past several years, and the recent adoption of the DM (euro) as its sole legal tender has contributed to financial stability. However, the fiscal situation has worsened this year, which points to the need for strong corrective measures. There is also a need to make progress in bank restructuring and enterprise privatization.

"While the authorities' policy achievements so far have been impressive, their sustainability will critically require that the underlying causes of the macroeconomic imbalances are addressed, by restructuring the banking and enterprise sectors, improving financial discipline in the economy, and restoring fiscal sustainability. The authorities are aware of the challenges and difficult decisions ahead, and have appropriately emphasized the development of an adequate social safety net as a means of maintaining broad support for their reform policies.

"In addition to strong policy efforts by the Yugoslav authorities, progress toward sustainable growth and external viability will require strong support from creditors and donors, and external debt sustainability will not be achieved without concessional debt relief from bilateral creditors. The forthcoming Donor Conference on June 29 will provide the international community the opportunity to demonstrate its support by committing program and project assistance in line with FRY's estimated needs," Mr. Fischer said.

ANNEX

Program Summary

The program aims to achieve rapid disinflation and a moderate recovery in output. Real GDP is expected to grow by around 5 percent in 2001, owing mainly to a rebound in agricultural output after last year's drought. The rest of the economy will probably grow by 2-3 percent, with the positive effects from the removal of the economic sanctions being moderated by the effects of enterprise restructuring as well as capacity constraints. The program aims at lowering 12-month retail price inflation, by end-2001, to around 30-35 percent in Serbia and 6½ percent in Montenegro.

Macroeconomic policies in Serbia will be constrained by the severe demonetization and new burdens on the budget. Fiscal and monetary policies will impose strict limits on credit expansion to the government and the rest of the economy. Specifically, the fiscal program emphasizes reliance on foreign assistance and privatization receipts to meet the new burdens on the budget, and limits the government's recourse to the banking system to the equivalent of 0.6 percent of GDP in 2001. Montenegro is set to implement important policy measures, including on the fiscal front regarding expenditure cuts in the areas of subsidies, investment, and other discretionary spending.

Monetary policy will be geared to lowering inflation. The monetary program for Serbia cautiously assumes a gradual recovery of confidence in the dinar. Exchange rate policy will be reviewed on a quarterly basis owing to uncertainties about underlying external sector developments. In Montenegro, the reliance on the deutsche mark as the sole legal tender will contribute to financial discipline.

On the structural front, Serbia has already implemented a major budget and tax reforms to enhance fiscal efficiency and transparency; liberalized very restrictive foreign exchange and trade systems; freed most prices; generally raised public utility tariffs; and initiated a series of large increases in electricity prices. The Serbian authorities have started to carry out a bank resolution strategy and to improve legal and regulatory framework for privatization, and expect to make significant progress in both these areas during the life of the program. Montenegro intends to continue enterprise privatization, bank restructuring, and further fiscal and trade reforms.

Despite the envisaged strong policy effort and considerable commitments of external assistance, the Federal Republic of Yugoslavia faces a sizable financing gap of about US$10.7 billion in 2001, reflecting both large import needs and external debt servicing obligations (including external debt arrears of US$9.6 billion). The current account deficit (before grants) is projected to widen to 17½ percent of GDP (about US$1.8 billion) in 2001 from 8¼ percent of GDP (about US$700 million) in 2000. The financing gap could be filled partly by program and project assistance, and partly by debt relief.

The Federal Republic of Yugoslavia joined the IMF on December 14, 1992; its quota[1] is SDR 467.7 million (about US$583 million). The Federal Republic of Yugoslavia's outstanding use of IMF credits totals SDR 117 million (about US$146 million).

[1] A member's quota in the IMF determines, in particular, the amount of its subscription, its voting weight, its access to IMF financing , and its allocation of SDRs.

Table 1. Federal Republic of Yugoslavia (Serbia/Montenegro): Selected Economic and Financial Indicators, 1996-2001 1/

	1996	1997	1998	1999	2000 Prel.	2001 Prel. Proj.
Real economy						
GDP, in millions of US dollars	14,455	16,556	13,889	10,155	8,071	10,231
Average net real wage, 1994 =100	120	146	150	129	150	150
Average net wage in DM, at gray market exchange rates	155	206	169	109	99	149
			(Percent change)			
Real GDP	7.8	10.1	1.9	-15.7	5.0	5.0
Industrial production	7.6	9.5	3.6	-22.5	10.9	0.0
Retail prices (annual average)	92.7	18.5	29.8	42.4	71.8	86-89
Retail prices (end of period)	...	...	...	49.9	113.5	30-35
Unemployment rate (in percent) 2/	25.8	25.8	25.1	26.5	27.3	...
			(Percent of GDP)			
General government finances 3/						
Revenue 4/	...	...	...	...	38.8	39.9
Expenditure	...	...	...	...	39.7	45.9
Of which : Budget for reconstruction and recovery	...	...	...	...	0.0	2.3
Cash balance	...	...	...	...	-0.9	-6.1
Domestic financing	...	...	...	...	0.1	0.6
Foreign financing	...	...	...	...	0.0	2.9
Foreign grants	...	...	...	...	0.8	1.2
Privatization receipts	...	...	...	...	0.0	1.4
Commitment balance 5/	...	...	...	...	-3.0	-6.1
			(Percent change)			
Money supply (end-of-period)						
M1 6/	...	...	...	47.3	85.1	36.0
M2 6/ 7/	...	...	...	67.6	61.4	20.4
Balance of payments			(In billions of U.S. dollars)			
Merchandise exports 8/	2.0	2.4	3.0	1.7	1.9	2.1
Merchandise imports	-4.1	-4.8	-4.8	-3.3	-3.8	-4.5
Trade balance	-2.1	-2.4	-1.9	-1.6	-1.8	-2.4
Current account balance, after grants 9/	-0.6	-1.6	-0.7	-0.8	-0.4	-1.2
(In percent of GDP)	-4.1	-9.4	-5.0	-7.5	-5.0	-11.4
Current account balance, before grants 9/	-0.6	-1.6	-0.7	-0.8	-0.7	-1.8
(In percent of GDP)	-4.1	-9.4	-5.0	-7.5	-8.3	-17.7
Foreign debt (year-end) 10/	...	...	...	...	11.7	12.5
Gross official reserves	...	...	...	0.3	0.5	0.7
(In months of imports of goods and services)	...	...	...	1.1	1.5	1.7

Sources: Federal Statistical Office; National Bank of Yugoslavia; Ministry of Finance of the Federal Republic; Ministry of Finance of the Republic of Serbia; and Fund staff estimates.

1/ With the exception of money supply and foreign debt, data for 1999-2001 exclude Kosovo. GDP excludes Kosovo throughout.
2/ Excludes workers on "forced holiday" (about 20-25 percent of the labor force in recent years).
3/ Fiscal operations of all levels of government, except for Montenegro where it excludes local governments.
4/ Excludes foreign grants.
5/ Excludes arrears of local governments and most interest payments on foreign debt due but not paid.
6/ From 1999 onwards excludes Montenegro.
7/ Frozen foreign-currency deposits are excluded and other foreign-currency deposits are valued at parallel market rates until September 2000 and at YUD 30 per DM thereafter.
8/ From 1996, includes previously unrecorded exports of about US$0.2 billion.
9/ In 2000-01, includes previously unrecorded transfers of US$0.6 billion.
10/ Includes arrears on unpaid imports of fuel and gas.

Statement by Roberto F. Cippà, Executive Director and Srboljub Antic, Advisor for the Federal Republic of Yugoslavia
June 11, 2001

After ten years of conflicts and economic decline, the Federal Republic of Yugoslavia (FRY) is facing major challenges as it needs to strengthen the nascent democracy, stabilize the economy and improve the standards of living of the population. First and foremost, the FRY needs to maintain peace on its territory and at its borders. It also needs social peace, without which it would not be possible to implement the painful economic reforms. Having inherited an economy which is devastated and burdened by extremely heavy external and internal obligations, my authorities are fully aware that even the strongest domestic adjustment effort would not be sufficient to restore the health of the economy and to put it back on the path of sustainable growth. The external support will have to play a crucial role. The cooperation with the IMF is of vital importance not only because of its direct contribution, in the form of financial resources and technical advice, but also because of its expected catalytic impact on the provision of assistance from other sources. Our authorities highly appreciate the constructive approach of Fund's management and staff and thank all members of the mission for their hard work and useful policy advice. Since time is probably now the most valuable commodity in the FRY (the authorities know that they must act swiftly if they want to maintain the popular support) it was also very important that the agreement on the new program could be reached in a reasonably short time. To underline the importance of the open policy dialog with the Fund and to stress their commitment to transparency, my authorities consented to the publication of all documents prepared for today's Board discussion.

Progress in reform and reconstruction of the economy

As recognized in the staff report, a lot has already been achieved in the process of economic stabilization and in establishing the foundations of a modern, market-based economy in the relatively short time since the return of democracy in the FRY. This progress is even more impressive when taking into account the extremely unfavorable starting position and the fact that the authorities have had to operate in a very difficult political environment. The lingering uncertainties concerning the future of the federation, the growing economic independence of Montenegro and the far-reaching economic and administrative separation of the Kosovo province made the design and implementation of economic policies for the whole FRY very difficult. This also complicated the negotiations with the Fund.

The recent progress in macroeconomic stabilization is most visible in the successful containment of the core inflation as well as in the gradually growing confidence in the domestic currency and in the steady increase in foreign exchange reserves. This has been possible thanks to the implementation of relatively tight fiscal and monetary policies. Significant progress has also been made in advancing the structural reform agenda and establishing the legal and institutional basis for the market economy. In Serbia this is exemplified, among others, by the implementation of a major tax reform, by far-reaching liberalization of foreign exchange and trade regimes and by the initiation of the comprehensive overhaul of the banking sector. Montenegro is well advanced in preparations to introduce a modern treasury system and has taken measures to deal with the problems of its largest bank.

Among the most recent achievements it is worth to mention the comprehensive agreement on the division of assets of the former Yugoslavia. This agreement, which follows the earlier agreement on the distribution of the Yugoslav gold held in the BIS, has been initialed by the five SFRY successor states in Vienna on May 25, 2001. This "umbrella" agreement covers a wide range of issues, including property, pensions, archives, copyrights and patents etc. and offers a mutually acceptable solution to this complex and controversial issue.

While the proposed stand-by arrangement (with four equal tranches) does not envisage any frontloading of financial assistance, it would be fair to say that the implementation of the agreed program has been frontloaded, as manifested by the observance of a number of very important prior actions and preconditions. This includes the already mentioned tax reform and trade liberalization measures as well as the adoption of the relatively tight Serbian budget, the decision to freeze all salaries paid out of the federal budget (which include the military) and the introduction of drastic increases in electricity tariffs (by 60 percent in April and by a further 40 percent on June 1, 2001). Even though the decisive adjustment of the administrative prices had a very negative impact on the headline inflation in April (and is expected to have a similar effect in June) its implementation will significantly improve the financial position of Serbia's electric utility, thus allowing for the reduction in budgetary subsidies and quasi-fiscal deficits.

Main features of the new program

The program builds upon the recent progress in macroeconomic stabilization and aims at further disinflation and moderate output recovery while proceeding with external consolidation and protecting the most vulnerable groups of the population. In the structural area most important will be the achievement of a decisive progress in banking sector and enterprise restructuring. Equally important will be to continue the process of liberalizing the economy and eliminating price distortions and other impediments to growth. The following key features characterize our authorities' approach to their new economic program:

> **Full ownership of the program.** The Yugoslav (i.e. federal), Serbian, and Montenegrin authorities are fully committed to the implementation of the agreed program. They understand the importance of the envisaged reforms and they are guided by the strong desire to reinvigorate the FRY economy and to reintegrate it in the world economy. The current reform effort enjoys broad political support which should make it more resilient to various challenges and give it a greater chance of success. The ownership of the program is strengthened by its special design which, contrary to the experience of most transition countries, aims at avoiding any major drop in output and real incomes. In light of the already drastically reduced levels of GDP, real wages and social benefits, any further deterioration would hardly be accepted by the population.

Strong desire to achieve and share some early benefits of economic reforms. In view of our authorities, after years of economic malaise, isolation and falling standards of living, the ability of showing some real achievements is of crucial importance for both restoring market confidence and maintaining broad support for the reform effort.

Focus on measures and policies aiming at making full use of the existing human capital. Our authorities believe that the well-educated and highly skilled labor force is the FRY's biggest asset, which, when combined with adequate capital resources, improved infrastructure and proper regulations should ensure the international competitiveness of the Yugoslav economy. To achieve that, our authorities plan to increase spending on education, training and health and also aim at creating a market-friendly regulatory environment, so as to increase private investments and release the productive forces of the economy.

Strong commitment to transparency and improved governance.
The FRY government is already implementing and designing strong measures to deal with past and present abuses of the economic and legal systems and to prevent their occurrence in the future. These measures are aimed first and foremost at fighting the perils of corruption and at reducing the scope of the gray economy.

As explained in detail in the MEFP, **fiscal policy** in 2001 is expected to remain relatively tight and support the authorities' disinflation efforts. The financing from the domestic banking sector is set to be limited to only 0.6 percent of GDP, with the rest of the general government deficit projected to be covered by external assistance and privatization revenues. Contingent on the availability of external resources, the Serbian budget also envisages the possibility of implementing additional investment projects under the separate heading of "budget for recovery and reconstruction". The containment of fiscal expenditures has been made difficult by the addition of new large burdens relating to spending on foreign debt servicing, foreign exchange deposits repayment, social safety, bank restructuring and elimination of quasi-fiscal deficit. The quite significant increase in the expenditures to GDP ratio envisaged for 2001 reflects both the costs of dealing with many unresolved problems inherited from the previous regime and the effects of measures aimed at improving the transparency of fiscal accounts. The latter measures include the incorporation of all extra-budgetary programs financed by special surtaxes into the regular budget and the elimination of all earmarking of revenues (in Serbia). An important contribution to the effort to contain fiscal spending is expected to come from the wage policy. All wages paid by the federal government have been frozen at their January level, while the wage bill in the Serbian public sector is due to remain unchanged in real terms. Confronted with a very difficult fiscal position and prospects of shrinking foreign assistance, the Montenegrin authorities are also planning to tighten their wage policy and to introduce severe cuts in other expenditures. While the fiscal situation in Montenegro in the first four months of this year remained quite difficult, the results achieved by Serbia were somewhat better then expected. Thanks to that, the authorities could refrain so far this year from making use of the provision, which gives them a limited access to financing from the central bank, and were even able to build up their deposits in the banking system.

Monetary and exchange rate policy will continue to be set with the aim of fostering the disinflation process. The dinar/DM rate is expected to remain relatively stable, with the central bank continuing its active presence in the market in order to ensure that the NFA targets are observed and that external competitiveness is maintained. However, in line with the adopted managed floating regime, there will be no formal exchange rate target and our authorities have reached an understanding with staff that the exchange rate policy will be subject to quarterly reviews. The developments in the first four months of this year, with exports increasing by 12.3 percent and imports by 6 percent, do not point to any immediate need to adjust the value of the dinar. Comparing to the way this issue has been presented in the staff report, we would place somewhat more emphasis on the recovery of confidence in the domestic currency and the start of remonetization of the economy. The substantial increase in foreign exchange reserves, as well as pressures for a nominal appreciation of the dinar, reflect tight monetary conditions. As a result, sales of foreign exchange by the private sector in exchange bureaus have consistently exceeded demand for foreign exchange in the inter-bank market.

The tight monetary and fiscal policies — the contraction in NDA since the beginning of the year was not anticipated under the program — have been beneficial in terms of strengthening the external position and limiting core inflation, but have had an adverse impact on domestic economic activity. Industrial activity in the first four months of 2001 was 1.5 percent lower than in the corresponding period of the previous year. We recognize that stagnant production in large part reflects structural factors. Nevertheless, our authorities expect that the further strengthening of the foreign exchange position, which should result in part from the implementation of the recently initialed succession agreement, will give them more flexibility in shaping the demand management policies without breaching any of the agreed program targets. This should create some room for providing the necessary support to structural reform, especially the rehabilitation of the banking system.

Our authorities fully appreciate the need to quickly move forward with the implementation of **structural reforms**. Such reforms should be directed both at reducing the vulnerabilities of the economy and pressures on the budget and at improving the overall efficiency and creating a strong base for a sustainable export-led growth. A good start has already been made with the introduction of a comprehensive tax reform in Serbia. The authorities intend now to focus on advancing the bank and enterprise sector restructuring and on promoting the development of the private sector, including through privatization. With regard to the bank restructuring, the diagnostic phase has been largely completed with the division of all banks into four categories depending on their capital base, prospects for regaining solvency and strategic importance. Only nine out of 74 commercial banks have been found generally healthy and adequately capitalized. Restructuring plans are now being worked out for the remaining banks and based on the evaluation of such plans the government will decide on the further course of action. It is expected the intervention of some of the largest banks and the initiation of liquidation procedures for a number of insolvent banks may take place still in the course of this month.

Serbia's new approach to privatization is visible in the new legal framework, which has been worked out in cooperation with the World Bank and is expected to be formally adopted in the next few weeks. It is envisaged that the focus will be on establishing clear ownership structures of privatized companies by offering at least 70 percent of equity to strategic investors. The economic restructuring will also be facilitated by the projected changes in the labor legislation and by the revision of the existing commercial and bankruptcy laws. Plans to introduce a new company law and a new bankruptcy code are also well advanced in Montenegro.

Crucial role of external support

The staff report makes it crystal clear that the program has little chance, if any, to succeed without generous and timely support from the international community. Our authorities are very thankful for the already provided and/or committed assistance, mainly in the form of humanitarian aid and technical advice but also through agreements paving the way to clearing the arrears to international financial institutions. However, much more will be needed. The most important and desirable form of external support would be the provision of substantial debt relief. As documented by staff, because of the extremely high level of foreign debt (equivalent to about 145 percent of GDP and over 460 percent of exports) even the most generous conventional rescheduling would not be sufficient to secure the medium-term viability of the FRY's external position. Substantial reduction of the debt burden is clearly needed both to fill the sizable external financing gaps and to assure the viability of the fiscal position. It should be stressed that even after the reduction on Naples terms the debt burden would remain very high (debt to GDP ratio at 73 percent in 2001 and debt service ratio staying above 22 percent for the rest of the current decade). The example of another member of our constituency, Poland, clearly shows that the provision of debt relief can be beneficial for both sides. After the debt reduction, Poland has quickly reentered the growth path and regained access to private capital markets. It has since then not only fully serviced its current debts but has also indirectly "repaid" all its old obligations by opening access to its large domestic market and by offering very attractive investment opportunities.

Besides debt relief, the FRY will also need substantial amounts of new financing, which, at least in the initial phase, should mainly take the form of grants and concessional loans. Under the stand-by program, our authorities committed themselves not to contract or guarantee any new indebtedness on commercial terms (with the exception of loans from four international financial institutions). Our authorities hope that the donor conference, to be held on June 29, will result in commitments to provide additional financial assistance in the amount of about $1.2 billion. As confirmed by the World Bank, similar amounts will be needed annually over the course of the next three to four years. These additional resources would in part be used to fill the remaining financing gaps, but they are mainly needed to cover the enormous costs of reconstructing the FRY economy. In particular, large financial resources will be needed for rebuilding the damaged and/or obsolete infrastructure (power grid, roads, bridges etc.). Substantial funds are also needed for the restructuring of the banking and enterprise sectors and to provide some social cushion during the most difficult period of transition.

Our authorities strongly believe that the official concessional assistance will increasingly be supplemented, and ultimately replaced, by growing private capital inflows, most preferably in the form of direct foreign investments. The envisaged changes in the regulatory framework, and in particular the new privatization law, should help in attracting such inflows by improving the business climate and by offering enticing investment opportunities.

On behalf of our authorities, we would like to thank the Fund management and staff for making a strong case for the provision of substantial debt relief and additional donor assistance as the condition sine qua non for the success of the Fund-supported program. Our authorities hope that this strong endorsement on the part of the Bretton Woods institutions, set against the background of the FRY's own strong and determined adjustment effort, will encourage the international donor and creditor community to favorably consider the requests for the provision of debt relief and additional financial resources. As we already stressed at the beginning, the time factor plays a very important role in this whole process. Our authorities would hope that the speed and determination, with which they implement the fundamental economic, social and legal reforms, could be matched by an equally decisive and timely action on part of the international community.