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Serbia and Montenegro: Third Review Under the Extended Arrangement and Requests for Waiver of Performance Criterion and Rephasing of Purchases—Staff Report; Staff Supplement; Press Release on the Executive Board Discussion; and Statement by the Executive Director for the Serbia and Montenegro

In the context of the third review under the Extended Arrangement and requests for a waiver of a performance criterion and rephasing of purchases with the Serbia and Montenegro, the following documents have been released and are included in this package:

- the staff report for the third review under the Extended Arrangement and requests for a waiver of a performance criterion and rephasing of purchases, prepared by a staff team of the IMF, following discussions that ended on **June 7, 2004,** with the officials of the Serbia and Montenegro on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on May 21, 2004**. 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 supplement of **June 3, 2004** updating information on recent developments.

- a Press Release summarizing the **views of the Executive Board as expressed during its June 7, 2004 discussion** of the staff report that completed the request and review.

- a statement by the Executive Director for the Serbia and Montenegro.

The document(s) listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of the Serbia and Montenegro*
Memorandum of Economic and Financial Policies by the authorities of the Serbia and Montenegro*
Technical Memorandum of Understanding*

*May also be included in Staff Report

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

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INTERNATIONAL MONETARY FUND

SERBIA AND MONTENEGRO

Third Review Under the Extended Arrangement and Requests for Waiver of a Performance Criterion and Rephasing of Purchases

Prepared by the European and Policy Development and Review Departments

Approved by Carlo Cottarelli and Donal Donovan

May 21, 2004

The discussions were held in Belgrade and Podgorica during October 10–29, 2003 and March 15–26, 2004 and in Washington, DC during April 19–26, 2004.

The staff team—Mr. E. Zervoudakis (head), Mr. B. Horváth, Ms. X. Li, Mr. T. Mattina (all EUR), Mr. D. Chua (FAD), and Ms. L. Cui (PDR)—was assisted by Mr. J. Charap, the Fund resident representative, and cooperated closely with World Bank missions. Mr. S. Antic, Advisor to the Executive Director for Serbia and Montenegro (SM), attended the discussions.

The SM delegation in the March–April discussions was headed by National Bank of Serbia (NBS) Governor Jelasić and included: (i) at the union level, International Economic Relations Minister Ivanović; (ii) in Serbia, Vice Premier Labus, Finance Minister Dinkić, Economy Minister Maršićanin, International Economic Relations Minister Bubalo, Capital Investments Minister Ilić, Social Affairs and Employment Minister Lalović, and Energy Minister Naumov; and (iii) in Montenegro, Vice Premier Ivanisević, Finance Minister Luksić, and Chairman of the Central Bank Council Krgović.

SM accepted the obligations under Article VIII, Sections 2, 3, and 4 on May 14, 2002.

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Appendices

I. INTRODUCTION

1. On July 30, 2003, the Executive Board completed the second review (and the fourth and fifth financing reviews) under the EA approved in May 2002 (Appendix I).[1] SM has made six purchases under the arrangement. The seventh and eight purchases (linked to the end-September and end-December 2003 tests) depend on observance of the end-December 2003 performance criteria (PCs) and completion of the third review (and the sixth and seventh financing reviews). Although understandings on most aspects of policies for the third review were reached during an October 2003 mission, the Board could not consider the review in January 2004 as envisaged owing to early Serbian elections that prevented adoption of the 2004 budget and other prior actions. The discussions resumed in March after a new government took office (see below) and concluded in April.

2. In the attached letter of May 21, 2004, and the accompanying Memorandum on Economic and Financial Policies, the authorities outline policies through end-2004 (Appendix VI). On this basis, they request (a) waiver for the nonobservance of the end-December 2003 PC on net bank credit to government; (b) completion of the third program review (and the financing reviews); (c) re-apportionment of the ninth purchase equally among the EA's remaining four purchases; and (d) conditioning of the purchase linked to the end-June 2004 tests on completion of the fourth review.

3. **The World Bank is involved closely in SM's reform efforts** (Appendix II). Contingent upon policy performance, the Bank has envisaged concessional lending of up to $540 million for FY 2002–04, of which $425 million has already been approved, in support of fiscal consolidation, private and financial sector development, and reforms in the social, energy and environment sectors. In the context of the next Country Assistance Strategy (FY2005–07) , the Bank plans to phase in nonconcessional lending. The Fund and the Bank Boards endorsed SM's Poverty Reduction Strategy Paper (PRSP) in March 2004.

4. **A minority Serbian government was formed in March following elections in December.** It is comprised of reformist parties, led by former Yugoslav President Kostunica, and supported in parliament by the Socialists. The outgoing coalition's key reformist party—founded by slain Premier Djindjić—is now in opposition, along with the nationalist Radical Party. Serbian presidential elections are scheduled for June 13, 2004. Meanwhile, Montenegro's ruling coalition retains a majority with a remaining term of three years. Cooperation between Serbia and Montenegro has improved following adoption of a new constitution last year.[2]

[1] The extended arrangement was for SDR 650 million (139 percent of quota), available in 13 purchases of SDR 50 million each.

[2] The constitution for the union of Serbia and Montenegro, approved in February 2003, provides for common defense and foreign policies; acknowledges the existence of different

(continued)

II. Background

5. **Both inflation and growth were lower than programmed in 2003, but recent data point to a pickup in growth** (Table 1, Figures 1–4)**.** Twelve-month RPI *inflation* was almost halved to 7.8 percent at end-2003—compared to a 9–11 percent target—notwithstanding the dinar's accelerated depreciation, and remained at around 8 percent in April. *Real GDP* grew by 3 percent in 2003 reflecting mainly buoyant services. The shortfall in relation to the 3½–4½ percent target stemmed from a drought-induced 8 percent decline in agricultural output. The latest data point to strong growth in industry in 2004 Q1 after a relatively weak performance in 2003. Meanwhile, economy-wide wage growth in 2003 (13 percent in real terms) outpaced productivity gains (8 percent), although by much less than in 2002.

6. **The current account deficit has remained large** (Table 2)**.** Import volume growth decelerated to 7½ percent in 2003—from 23 percent in 2002—but was higher than projected. Restructuring-induced losses in the export base and weak foreign demand dampened export volume growth to 3 percent from 13 percent in 2002, leaving exports as a percent of GDP low by historical standards. Private remittances were buoyant at 11.2 percent of GDP. The current account deficit (before grants) thus remained at 12¾ percent of GDP in 2003, exceeding the program target by 1½ percentage points (of this, about 1 percentage point reflects an import surge in December attributable to changes in statistical procedures and a speculative advancement of imports owing to election-related uncertainties). According to preliminary data, which are subject to substantial uncertainty, import volume in January–February 2004 declined by 24 percent from the December peak but was 15 percent higher than a year earlier, while export volume was stagnant.[3]

7. **Foreign reserves surged during 2003, aided by large FDI inflows, but came under pressure in early 2004.** FDI reached $1.4 billion (7 percent of GDP) in 2003, twice the amount programmed, reflecting sizeable privatization receipts, sales of shares in two employee-owned breweries, and greenfield investment. Together with the valuation effect from a weaker dollar, this helped raise official foreign reserves during 2003 by one-half to $3.6 billion (4.4 months of projected 2004 imports) by year-end, compared with a program

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monetary, exchange, customs, and tax regimes (consistent with a free trade area); and envisages harmonization of the economic systems of the two states with that of the EU. After three years, each state may choose to gain independence following a referendum. Serbia continues to use the dinar, while Montenegro uses the euro. Montenegro accounts for about 7 percent of SM's economy.

[3] From January 2004, foreign trade data have been published with delay and are difficult to analyze owing to changes in statistical procedures, lack of recent data on Montenegro, and changes in the trade regime between Serbia and Montenegro since April 2003 (including import tariff unification) that have reduced incentives to channel Serbian imports through Montenegro.

target of $2.9 billion. Pressures on the foreign exchange market—stemming from heightened political uncertainty and large deficit spending in December—resulted in $187 million net NBS sales in the interbank market in January–March 2004. With improved market conditions, the NBS purchased $64 million in April.

8. **All but one of the end-December 2003 PCs were observed, while indicative targets were largely met** (Annex A to Appendix VI). PCs on credit, fiscal and external sector targets were met, except for the ceiling on net bank credit to the government, which was exceeded by 0.4 percent of GDP. Despite a year-end surge on the back of the fiscal overrun, the NDA of the NBS remained below program targets, with excess privatization proceeds deposited in the NBS in line with the program (Table 5). Indicative targets on banking system NDA and central government bank deposits were met, but those on state enterprise wage bills and on government expenditure arrears were breached by small margins.

9. **Fiscal policy, broadly on track for most of 2003 but turning expansionary in the run-up to the elections, was tightened in early 2004** (Tables 7a–d). SM's fiscal deficit was 4.2 percent of GDP in 2003, 0.3 percentage points lower than targeted. However, this undershooting reflected delays in (off-budget) foreign loan-financed projects (FLFPs).[4] Excluding such projects, the deficit was 3.7 percent of GDP, 0.3 points higher than targeted. This was due to election-related spending and advanced spending ahead of tight temporary financing arrangements in 2004 Q1 (mandated by the lack of a 2004 budget). These arrangements restrained expenditure and contained the deficit to about 0.1 percent of annual GDP in 2004 Q1. Revenues were in line with the program in 2003, and remained on track in 2004 Q1.

10. **Financial intermediation increased further in 2003, albeit at a slower pace.** M2 (including foreign currency deposits, FCDs) and dinar M2 grew by 29 percent and 13 percent respectively, apparently reflecting growing confidence in banks but also the public's preference for foreign currency deposits as a store of value (Table 6).[5] Higher effective lending rates on euro-linked loans—on account of the dinar depreciation—contributed to decelerating credit to the non-government sector.[6] The dinar depreciated by 11 percent against the euro during 2003 (2 percent in real terms against a €/$ basket), compared with only 5 percent during the preceding two years (50 percent real appreciation, albeit from a

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[4] Of the overall deficit, 3.8 percent of GDP was accounted by Serbia and 0.4 percent by Montenegro (5.2 percent of its own GDP).

[5] The share of FCDs in M2 rose to 50 percent by end-2003.

[6] Commercial banks have a broadly balanced foreign currency exposure. Euro-indexed loans to companies not engaged in foreign trade amount to the equivalent of 3½ of annual GDP.

highly undervalued level). During January–April, 2004 the dinar depreciated by another 3 percent against the euro (2 percent in real effective terms).

11. **Progress in privatization exceeded expectations, but other structural reforms slowed in late 2003 owing to political developments.** Cash privatization receipts—boosted by the sale of two tobacco companies—reached 4 percent of GDP in 2003, more than twice the budget assumption. Other successes included the introduction of a new Serbian payments system, pension reform in both republics, and harmonizing trade regimes within the union. While structural benchmarks (SBs) in the period through end-December 2003 were mostly met, albeit some with delay, two SBs for Serbia—on the Treasury's centralized payroll system [7] and on offering majority stakes in 3 banks—were not met, and a third—a resolution plan for the largest Serbian bank—is expected to be met after having been elevated to prior action for the review (Annex C to Appendix VI). With no parliamentary session for several months, the adoption of key legislation on bankruptcy and energy was also delayed.

III. Policy Discussions

12. **A difficult political setting, improving but still fragile economic conditions, and an unfinished reform agenda formed the backdrop of the discussions**:

- The new Serbian authorities, while underscoring their commitment to reform, stressed the political constraints faced by the minority government and the population's disillusionment with the slow and uneven improvement in living standards. The Montenegrin authorities felt compelled to reduce the tax burden on enterprises to revitalize their economy.

- Disinflation and the foreign reserve buildup have been impressive but output and export growth has been modest and, with the current account deficit still large, the external position remains fragile. Although transitory factors—restructuring-related output losses and weak export market growth—have contributed to these developments, the magnitude of the imbalances clearly calls for demand restraint and strengthened external competitiveness.

- The structural policy challenges—especially the restructuring of insolvent enterprises, bank rehabilitation and privatization, and the streamlining of government spending—are daunting but need to be addressed early to enhance the economy's supply response.

13. **Against this background, understandings were reached on 2004 policies**. The Serbian authorities agreed that prudent macroeconomic policies and intensified reform efforts

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[7] Owing to capacity limitations; a forthcoming TA mission on public expenditure management will assess how this situation can be addressed.

were key to achieving sustainable growth and that it was important to resist political pressures for policy relaxation. The Montenegrin authorities agreed to implement tax cuts in conjunction with compensating fiscal measures to safeguard the fiscal position.

A. Macroeconomic Objectives and Policies

14. **The authorities' economic objectives for 2004—consistent with the updated medium-term framework—envisage containment of inflation, accelerated growth, and a strengthening of the external position** (Text Table 1).

- *Growth* of 4–5 percent would reflect a further recovery in industry and sustained growth in services—based on the investment and restructuring of recent years offsetting restructuring-induced output losses—and an expected rebound in agricultural output. Developments in early 2004 are consistent with the upper end of the target range.

- The *inflation* target of 8–9 percent appears ambitious—in part owing to the large excise increases—but achievable in light of recent developments.

Text Table 1. Serbia and Montenegro: Key Macroeconomic Objectives and Policies, 2002–05

	2002	2003		2004		2005
	Actual	Staff Report	Prel Act.	Staff Report	Rev. Prog.	Rev. Prog.
			(Percentage change)			
Real GDP Growth	4.0	3½–4½	3.0	4.0	4 - 5	4 - 5
Inflation (end period)	14.2	9–11	7.8	7.0	8 - 9	5.0
Of which : Montenegro	9.4	9.0	8.0	5.0	4.0	3.5
Domestic investment	16.1	18.8	15.7	17.8	16.8	17.5
Domestic savings	-7.0	-1.8	-7.0	-2.0	-4.0	-2.6
National savings	7.2	10.7	5.5	9.1	7.3	9.0
Current account deficit (before grants)			(In billions of US$)			
US$ billion	2.0	2.3	2.6	2.2	2.6	2.4
In percent of GDP	12.8	10.8	12.6	10.2	11.0	10.0
Excl. net interest payments (percent of GDP)	11.7	9.2	11.2	7.9	8.7	7.3
Gross official reserves	2.3	2.9	3.6	3.2	3.6	4.2
In months of projected imports	3.1	3.7	4.4	3.8	4.3	4.7
Total external debt (in percent of GDP)	75.5	61.3	69.0	52.7	55.1	54.1
Net external debt (in percent of GDP)	56.0	43.7	47.6	34.0	36.2	32.7
			(In percent of GDP)			
Fiscal deficit	4.5	4.5	4.2	4.3	3.4	2.4
Government credit from the banking system	-0.5	0.0	-1.4	0.5	0.9	-0.6
Public debt	84.5	70.0	79.0	60.8	65.0	59.5
NFA growth	52.4	6.9	52.9	…	-8.3	…
NDA growth	-4.2	4.3	-42.8	…	15.5	…
Reserve money growth	48.1	11.3	10.1	…	7.3	…

Sources: SM authorities; and IMF staff estimates.

- The projected decline in the *current account deficit* (before grants) to 11 percent of GDP in 2003 would reflect import deceleration and continued export recovery, in response to tighter fiscal and credit conditions, competitiveness gains, and improved external conditions. About 40 percent of the deficit is expected to be financed by foreign grants and FDI, and the remainder by official and commercial loans, and private capital inflows.

- *Official foreign reserves* are targeted to remain at the equivalent of 4½ months of projected imports by end-2004.

15. **The 2004 program features fiscal tightening, strict NDA limits, and a further improvement in external competitiveness.** Consistent with the targeted decline in the current account deficit and with available noninflationary financing, the fiscal deficit is envisaged to decline by 0.8 percentage points, notwithstanding higher spending on foreign loan-financed projects; excluding such projects, the deficit would decline by 1.2 percentage points. Exchange rate policy will be consistent with external competitiveness requirements. Wage bills in public enterprises will be contained in line with projected inflation. To safeguard medium-term objectives, the authorities intend to revive reforms in the enterprise and banking sectors, including through a revamped bankruptcy process. In Montenegro, public employment will be streamlined to strengthen the fiscal balance.

16. **The external and public sector debt sustainability outlook remains vulnerable** (see also Appendixes IV and V). Net foreign debt (gross debt minus banking system foreign reserves) in relation to GDP declined by 8 percentage points to 48 percent of GDP, but this reflected mainly the effects of the real appreciation of the dinar (on an annual average basis). In 2004, the envisaged debt write-offs are projected to reduce the net external debt ratio to 36 percent of GDP, but the underlying ratio would rise by about 2 percentage points of GDP,[8] in part because the external current account deficit that is not covered by FDI, grants, and other non-debt creating inflows would remain sizable (at 4.4 percent of GDP).[9] The underlying debt dynamics could be even less favorable to the extent that some non-debt creating capital inflows (errors and omissions and other capital inflows, amounting to 2 percent of GDP in 2004) represent a running down of foreign assets held by residents outside the domestic banking system, rather than unrecorded but sustainable BOP inflows. These trends underscore the urgent need to make further progress with enterprise restructuring, so as to boost output and export potential, while supporting the external adjustment through appropriate macroeconomic policies. Assuming the program policies, net

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[8] The "underlying debt" is also adjusted for exchange rate changes.

[9] The external and public debt-to-GDP ratios in 2004 are higher than in IMF COUNTRY REPORT NO 03/296 by 2–4 percentage points owing mainly to weaker-than-envisaged nominal GDP growth and exchange rate valuation effects.

external debt is projected to decline gradually over time (Tables 1 and 2, Appendix IV).[10] But, in a "tailored" scenario—with a higher-than-programmed fiscal deficit in 2004 (broadly as implied by the 2004 budget, see ¶18), unchanged exchange rate policy from 2003, and only gradual tightening of policies thereafter—the current account deficits would be significantly higher than in the baseline. Even if these deficits can be financed—which could be difficult, thus raising concerns of financial instability—the rise of the debt/GDP ratio would significantly increase the country's external vulnerability.

B. Fiscal Policy

17. **The 2004 program seeks a reduction in the SM fiscal deficit by 0.8 percentage points to 3.4 percent of GDP** (Text Table 2)**.**[11] This adjustment will be achieved through higher revenue; expenditure is projected to remain roughly unchanged in relation to GDP, with current spending declining by ¾ percentage points to make room for higher investment.[12] Half of the deficit will be financed by foreign assistance and half by net domestic bank borrowing (largely a drawdown of past privatization proceeds) and new privatization receipts (¶12).[13] Excess privatization receipts will be used primarily to reduce net government indebtedness.[14]

[10] These projections assume the continuation of nondebt inflows (errors and omissions and other capital inflows of about 1.5–2 percent of GDP. As noted with respect to 2004, the net debt dynamics would be less favorable if these inflows represented the decumulation of foreign assets.

[11] Of this, 3.1 percent would be incurred by Serbia and 0.3 percent by Montenegro (equivalent to 4.6 percent of its own GDP).

[12] The inclusion of previously off-budget fiscal operations in Montenegro raises the expenditure/GDP ratio by 0.2 percent of GDP in 2004.

[13] Henceforth, unless otherwise noted, references to paragraphs pertain to the MEFP in Appendix VI.

[14] Excess privatization proceeds may also be used to cover investment and restructuring costs in consultation with the Fund and the World Bank in the context of program reviews (¶12).

Text Table 2. Serbia and Montenegro: Consolidated General Government Fiscal Operations in 2000–05 1/

(In percent of GDP) 2/

	2002	2003		2004 3/	2005
		Staff Report	Prel.	Rev. Prog.	
Total revenue	42.8	40.7	42.6	43.6	42.4
Tax revenue	39.6	37.4	38.7	39.5	39.1
Nontax revenue	3.2	3.4	3.5	4.1	3.2
Capital revenue	0.0	0.0	0.4	0.1	0.1
Total expenditure and net lending	47.3	45.3	46.8	47.0	44.8
Purchases of goods and services	18.3	17.6	18.1	17.8	17.1
Of which: Wages and salaries	10.3	10.6	10.3	10.6	10.1
Interest payment	1.0	1.2	1.0	1.1	1.7
Subsidies	4.4	3.1	3.5	3.6	2.6
Transfers to households	19.6	19.7	20.6	20.2	19.0
Capital expenditure	3.4	3.0	2.2	2.9	4.0
Other	0.5	0.7	1.3	1.3	0.4
Unclassified expenditure (incl. statistical discrepancy)	0.1	0.0	0.0	0.0	0.0
Overall cash balance	-4.5	-4.5	-4.2	-3.4	-2.4
Financing	4.5	4.5	4.2	3.4	2.4
Domestic financing	-0.5	-0.1	-1.4	0.9	-0.6
Foreign grants	1.1	0.9	0.2	0.3	0.5
Net foreign financing	1.8	2.0	1.1	1.6	1.5
Budgetary loans	1.0	0.9	0.7	0.7	0.3
Project loans	0.8	1.1	0.5	0.9	1.3
Privatization receipts	2.2	1.7	4.3	0.7	1.0
Memorandum items:					
Overall cash balance before grants and project loans	-3.7	-3.4	-3.8	-2.5	-1.1
Overall cash balance before grants of:					
Serbian general government	-4.2	-4.1	-3.8	-3.1	…
Montenegrin general government	-0.3	-0.4	-0.4	-0.4	…
Overall cash balance of general government in Montenegro (in percent of Montenegro GDP)	-4.0	-5.6	-5.2	-4.6	…

Sources: Federal and Republican Ministries of Finance, and IMF staff estimates.

1/ Consolidated general government includes the Union (previously federal), the republican and local governments, the social security funds and the extrabudgetary programs, except for local governments in Montenegro for which data are not available.

2/ Expressed in terms of GDP of Serbia and Montenegro excluding Kosovo.

3/ 2004 data include previously off-budget fiscal operations in Montenegro amounting to 0.2 percent of GDP.

4/ Includes severance package for laid-off workers due to enterprise reform and bank restructuring.

Serbia

18. **The budget discussions focused on the magnitude of the fiscal adjustment and how to achieve it.** The new government prepared and passed through parliament hastily—to comply with a March 31 legislative deadline—a 2004 budget that was not in line with staff recommendations. The budget lowered taxes, increased spending, and did not adequately

allow for transfers to the social insurance funds, implying a fiscal relaxation by over 1 percentage point of GDP in 2004 (¶13). After arriving at a common economic assessment with the staff in April, the authorities adopted a deficit target of 3.1 percent of GDP in 2004, compared with 3.8 percent of GDP in 2003. But, against staff advice, they opted to close the fiscal gap mainly through revenue measures, implying a high expenditure/GDP ratio, broadly unchanged from 2003.[15] The authorities pointed to the needs of the neglected agricultural and transportation sectors, the constraints to expenditure cuts in the current political setting, and the efficiency gains from a direct-to-indirect taxation shift, while also recognizing the importance of streamlining government spending over time.[16] Staff argued that the high expenditure ratio was a serious concern, and that placing the fiscal accounts on a sustainable path would require, in particular, sizable cuts in personnel costs and subsidies. As regards 2005, in line with the objectives of the EA, the mission recommended containing the growth in government wages below inflation, streamlining government employment, and cuts in subsidies with a view to allowing higher capital spending, a lower tax burden, and a lower deficit (Text Table 2).

19. **Revenue administration and public expenditure management will be further strengthened**. In preparation for the VAT introduction in January 2005, supporting legislation is expected to be adopted by end-June (SB-monitored). In addition, enforcement and field audit programs to curb evasion have been revitalized (¶18). Concerning treasury reform, remaining budgetary institutions will be brought into the Treasury Single Account by end-2004. In addition, the Finance Ministry has requested Fund TA to strengthen public expenditure management.

Montenegro

20. **In Montenegro, agreement was reached on a tax reform plan and measures to ensure achievement of the 2004 deficit.** The tax reform entails lower social contribution and PIT rates of 10 percent by end-2004 (implemented in July and December in two 5 percent steps). Together with projected shortfalls in revenue and external financing, a 2004 fiscal gap of about 1 percent of Montenegrin GDP emerged. A Supplemental Budget (a prior action) is to close this gap with revenue and expenditure measures of 0.3 and 0.7 percent of GDP, respectively (¶20–21).

[15] The authorities opted for (a) tax increases (chiefly excises, full-year impact of 1.3 percent of GDP), (b) dividend transfers from profitable enterprises (0.4 percent of GDP), and (c) scaling back of budgeted subsidies and net lending to agriculture, subsidies for the state railway company, road building projects, and other recurrent expenditures (0.7 percent of GDP, ¶16). The expenditure cuts will be implemented by keeping spending below budgetary allocations in line with provisions of the organic budget law.

[16] Recent tax measures (full-year basis) lower the direct taxes/GDP ratio by 0.7 percentage points in 2004 and raise the indirect tax ratio by 1.2 points.

C. Monetary and Exchange Rate Policies

21. **Discussions focused on Serbia's 2004 monetary program and bank liquidity monitoring and management**. Reserve money is targeted to rise by 7.3 percent in 2004, below the increase in nominal GDP as banks economize on their costly excess reserve holdings at the NBS. With NFA rising only marginally, the increase in reserve money would be driven mostly by NDA (Text Table 3). With velocity assumed to increase slightly, dinar-denominated M2 and domestic credit to the economy are projected to rise by 11½ percent.

22. **Exchange rate policy will continue to balance the inflation and the external objectives.** The NBS and the mission agreed that, while recent developments in the foreign exchange market suggested that confidence remains fragile, the notable progress in disinflation has allowed some shift in emphasis away from the anchoring role of the exchange rate. The NBS therefore undertook to adjust the exchange rate taking into account conditions in the interbank market, and developments in trade, prices, and domestic costs with a view to improving competitiveness consistent with the inflation objective.

Text Table 3. Monetary Indicators, 2002–04

	2002	2003						2004			
		Mar.	June	Sep.		Dec.		Mar.	June	Sep.	Dec.
				Staff Report		Staff Report		Prel.	Program		
(Cumulative contribution to reserve money growth based on monthly average data, in percent)											
NFA 1/	52.4	-11.1	-9.7	-5.3	27.0	6.9	52.9	-15.2	-14.2	-12.0	-8.2
NDA 1/	-4.2	12.4	11.2	12.1	-18.8	4.3	-42.8	5.9	10.8	14.8	15.5
Reserve money 1/	48.1	1.3	1.5	6.7	8.2	11.3	10.1	-9.2	-3.5	2.8	7.3
(Cumulative change during the year based on monthly average, in percent)											
Currency in circulation 1/	49.4	0.2	-1.2	3.2	3.3	9.4	4.4	-7.0	1.0	6.0	10.0
(Cumulative change in millions of U.S. dollars from year-beginning; end-Dec.-previous year exchange rates)											
NFA 3/	354.9	-208.5	-177.2	-86.3	463.0	42.0	446.2	-198.1	-137.7	-117.0	-69.0
Gross official reserves 3/	864.7	-192.5	-23.2	197.3	771.9	343.2	835.1	-173.0	-140.9	-26.5	59.6
(Cumulative percentage change from year-beginning)											
Memorandum items:											
Retail prices	14.2	1.8	3.9	6.8	5.7	9.0	7.8	1.7	3.8	5.9	8.5
Velocity (GDP/Reserve money) 2/	18.2	18.8	19.1	19.3	18.3	19.2	18.3	22.8	19.6	19.3	19.1
Cumulative change 4/	-24.8	3.4	5.3	6.3	0.6	5.8	0.8	16.5	0.3	-1.2	-2.4

Sources: National Bank of Serbia; and IMF staff estimates and calculations.

1/ In 2002, actual changes are based on monthly averages with end-year data as the base.
Figures reflect an assumed required reserve ratio of 23 percent in 2003 and catual ratio of 18 percent in 2004.

2/ Based on estimated annualized monthly GDP and monthly average reserve money.

3/ Figures for 2003 exclude unfrozen foreign currency assets ($90.29 million) received in April 25, 2003.

4/ In 2004, the change in velocity is based on a velocity of 20.4 (corresponding to a required reserve ratio of 18 percent) at end-2003.

D. Bank Reform

23. **Bank restructuring and privatization are gathering pace following several months of inactivity(¶26).**[17] The resolution plan for the largest Serbian bank, adoption of which by the BRA Board is a prior action for concluding the third review, will strictly limit the bank's operations, preclude recapitalization prior to privatization, and strengthen governance in the interim. By end-June 2004, reporting and control mechanisms will be similarly strengthened in all banks with majority state ownership to preserve their value prior to privatization/resolution, and essentially all London Club obligations will be converted into state equity, removing an impediment to privatization. On this basis, and following the May launch of the first bank privatization tender, the government will publish its strategy to divest the state's equity stakes in the remaining 15 banks.

24. **The NBS will focus on enhancing supervision capacity and enforcing prudential regulations.** Financial sector vulnerability indicators are being developed and full-scope on-site examination has commenced. Work is also underway to identify banks' ownership structure so as to enforce regulations on lending to connected parties. IAS accounting is fully implemented by the financial sector and will be implemented in nonfinancial institutions in 2005. The authorities undertook to speed up implementation of the Supervisory Development Plan, developed with World Bank assistance.

25. **In Montenegro, progress in bank privatization and supervision continues (¶29).** The government intends to launch international tenders by end-2004 to sell one of the largest banks, and to prepare a strategy by end-2004 to divest all remaining state minority holdings in banks. Efforts to collect assets carved out from the banking sector will be intensified. The CBM has implemented most of the Basel Core Principles, and is working on implementing the remaining ones. A Financial Investigation Unit was recently created as envisaged by the Anti-Money Laundering Law.

E. Enterprise Reform

26. **With increasingly less attractive enterprises in the pipeline, privatization receipts are expected to decline in 2004.** Following rapid privatization of socially-owned enterprises through tenders, auctions, and share sales in 2003, the process slowed considerably in early 2004, reflecting political developments and a legal challenge to the modalities of share sales. Despite the new government's renewed commitment to privatization, successful privatizations of socially-owned enterprises are expected to decline given the predominance of heavily indebted and overstaffed enterprises in the pipeline. A recent Serbian government decree that regulates haircuts on public utility claims should

[17] One third of the Serbian banking system is state-owned and another 40 percent is foreign-owned. Most state banks are being prepared for privatization, with the remaining ones expected to be merged or resolved.

facilitate the privatization of indebted enterprises. Twelve large socially-owned enterprises will be offered for sale through tenders and over 360 small and medium-sized ones through auctions. The sale of residual state-owned shares has resumed after a 4-month hiatus with the resolution of legal issues. Although several large privatization transactions—in the state telecom and energy sectors—will be prepared during the year, given the lead time needed for transparent execution, these are expected to be completed only in 2005. In total, cash receipts from enterprise privatization are expected to amount to some €150 million in 2004 (¶32).

27. **A functioning bankruptcy process is to be in place by late 2004.** A new bankruptcy law, in line with World Bank recommendations, is to be adopted by end-June 2004 (PC-monitored). To ensure its effective implementation, a supervisory body for bankruptcy trustees and an agency to act as trustee for socially or state-owned enterprises will become operational by end-November 2004 (SB-monitored). While the bankruptcy process will remain under the authority of courts, judges would rule on key issues only, on the basis of cases prepared by trustees, to ensure rapid resolution (¶34).

28. **The government will accelerate the restructuring of public utilities.** Spin-offs and subsequent privatization of non-core activities will be facilitated by a new Company Law. The electricity company (EPS) has undergone some restructuring, mainly with the spin-off of all underground mining operations. A planned 10 percent increase in average electricity prices at end-June 2004 (PC-monitored) will enable EPS to maintain adequate maintenance and investment levels while servicing its debts fully. Collection rates will be raised through stronger enforcement of penalties, cutting off supply to users with large arrears, or, in some cases, initiating their bankruptcy. A new Energy Law will set the basis for a regulatory framework for that sector. Finally, the government's revised railway transport strategy, involving line closures and opening competition with alternative service providers, will enable a further reduction in budgetary subsidies to the railways (0.7 percent of GDP in 2004 compared with 0.9 percent in 2003). To contain inflation pressures and encourage further labor shedding, the growth in state enterprise wage bills will continue to be limited to projected inflation in 2004 (¶31).

IV. Financing Assurances

29. **The London Club negotiations are expected to resume soon.** The outgoing government submitted a detailed debt restructuring proposal to creditors on Paris Club terms but political developments precluded an agreement (¶7).[18] The new government has indicated its intention to restart discussions in June and, to this end, has appointed a new negotiating team and scheduled meetings with the creditors. Agreement was reached recently between SM and China to restructure short-term oil credits on terms comparable to those offered by the Paris Club. Discussions on the restructuring of SM's short-term debt to Russia have made progress.

[18] At end-May 2003, 14 of 17 agreements with Paris Club creditors had been concluded or initialed.

30. **Overall, the external financing outlook remains satisfactory**. Excluding the scheduled purchases from the IMF, total external grants and loans will reach $1 billion, including $240 million of budgetary assistance, based on existing commitments or indications from key donors (Tables 2–3). These inflows, together with FDI and other capital inflows, will help keep gross official reserves at an adequate level ($3.6 billion, equivalent to 4.3 month of imports) at end-2004.

V. Program Conditionality

31. The program will continue to be monitored through the established quarterly quantitative PCs and indicative targets, with the PC on nonconcessional foreign borrowing being revised to include two subceilings (i.e., on such borrowing from multilateral institutions and other creditors). PCs, indicative targets and structural benchmarks have been set for the whole year (Annexes B and D to Appendix VI). Owing to delays in completing the third review, it is proposed that that the last five purchases originally envisaged under the EA be apportioned into four equal purchases over the remainder of the EA (Table 12). The fourth review is expected to focus on budgetary developments, exchange rate policy, and bank restructuring. The fifth review will cover policies for 2005.

VI. Staff Appraisal

32. **Serbia and Montenegro's recent economic performance has been mixed**, combining excellent progress in some areas—notably in lowering inflation, attracting FDI, and strengthening foreign reserves—with an uncomfortably large current account deficit and modest growth in output and exports from low levels. These problems reflect, by and large, persistent structural weaknesses. It is thus regrettable that structural reform has been slowed by political developments since mid-2003. In this context, it is important to resist pressures for policy relaxation, which would undermine sustainable growth prospects and run the risk of financial instability. The staff therefore welcomes the authorities' decision to adopt prudent macroeconomic policies and to reinvigorate structural reforms with the objective of reducing the current account deficit and achieving fiscal and external sustainability. Given the fragile external position, it is critical to monitor closely balance-of-payments developments and to adjust policies promptly if needed. Improving rapidly the quality and timeliness of foreign trade data is also essential in this regard.

33. **The envisaged tightening of fiscal policy is broadly appropriate—albeit overly reliant on revenue measures.** Achieving the fiscal deficit target—well within reach given the overperformance in early 2004—will help narrow the current account deficit and place the fiscal and external accounts on sustainable paths. However, while incorporating a desirable shift of spending from current to investment uses, the fiscal adjustment relies entirely on revenue measures, leaving the expenditure/GDP ratio roughly unchanged at a high level. Achieving fiscal sustainability will be difficult without reducing subsidies, containing the growth in social transfers, and streamlining public employment while improving the quality of public services. The 2004 fiscal program hinges on a number of commitments that should be adhered to on a timely basis, in light of risks related to the

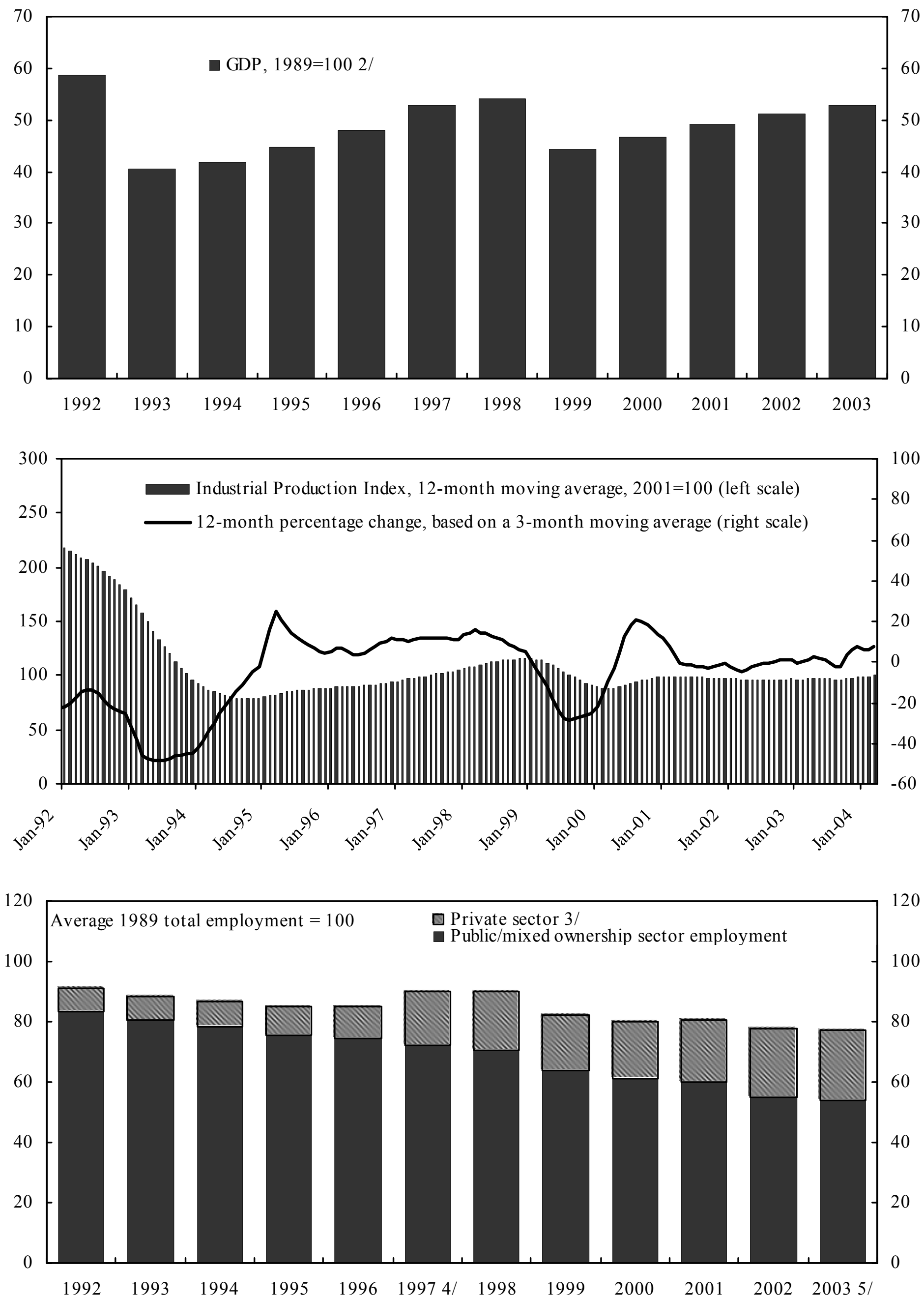
macroeconomic outlook and to the revenue effects of tax reforms. In this regard, staff welcomes the authorities' intention to maintain spending below budgetary allocations, and to reduce the government's net indebtedness using excess privatization proceeds pending assessment of macroeconomic prospects in the context of the next review. Regarding Montenegro, the staff welcomes the adoption of fiscal measures to ensure adherence to the deficit target and the authorities' undertaking to proceed with a tax reduction package in conjunction with credible offsetting measures.

34. **Monetary and exchange rate policies in Serbia face new challenges**. The large current account deficit and the uncertainty about money demand underscore the need for caution. Staff therefore welcomes the NBS's intention to maintain tight credit conditions and support an improvement in external competitiveness with a view to achieving the inflation objective and safeguarding its foreign reserves. Bank supervision should be vigilant and proactive, with strict enforcement of prudential regulations to ensure that new lending remains sound.

35. **Structural reform momentum should be regained.** The authorities' plan to privatize the 16 nationalized banks, while ensuring proper governance in the meantime, is key to building a healthy banking system. In this regard, key steps will be the restructuring and preparation for privatization of the largest domestic bank and the early sale of the government stakes in several large banks to reputable strategic investors. Further progress in privatization and enterprise restructuring requires addressing nonperforming enterprise liabilities—a critical bottleneck—without creating disincentives for debt servicing. To this end, state creditors should implement transparent agreements on haircuts for large socially-owned enterprises; these and any tax arrears write-offs should be conditional on privatization or bankruptcy. More generally, more needs to be done to improve the business environment for private sector development, with the support of the World Bank. In addition, rapid progress is needed on the much-delayed legislative agenda, to ensure successful implementation of the VAT in 2005, set the basis for a functioning bankruptcy process, restructure the energy monopolies, and establish a proper regulatory framework for that sector.

36. **The staff recommends completion of the third review under the extended arrangement, including the financing reviews, and a waiver for the nonobservance of a performance criterion on net bank credit to the government.** The SM authorities have broadly adhered to the implementation of the program supported by the EA. The effects of the nonobservance of a performance criterion were temporary, as fiscal developments were brought on track in early 2004. The authorities have now adopted economic objectives and policies for 2004 that are consistent with further progress toward sustainable growth and a viable external position. They have also been negotiating in good faith with their London Club and other creditors with a view to restructuring their debt on terms comparable to those granted by the Paris Club, while the external financing of the program is adequate.

Figure 1. Serbia and Montenegro: Selected Economic Activity Indicators, 1992–2004 1/



Sources: Serbian and Federal Statistics Office.

1/ Data refer to the territory of Serbia and Montenegro excluding Kosovo after February 1999.

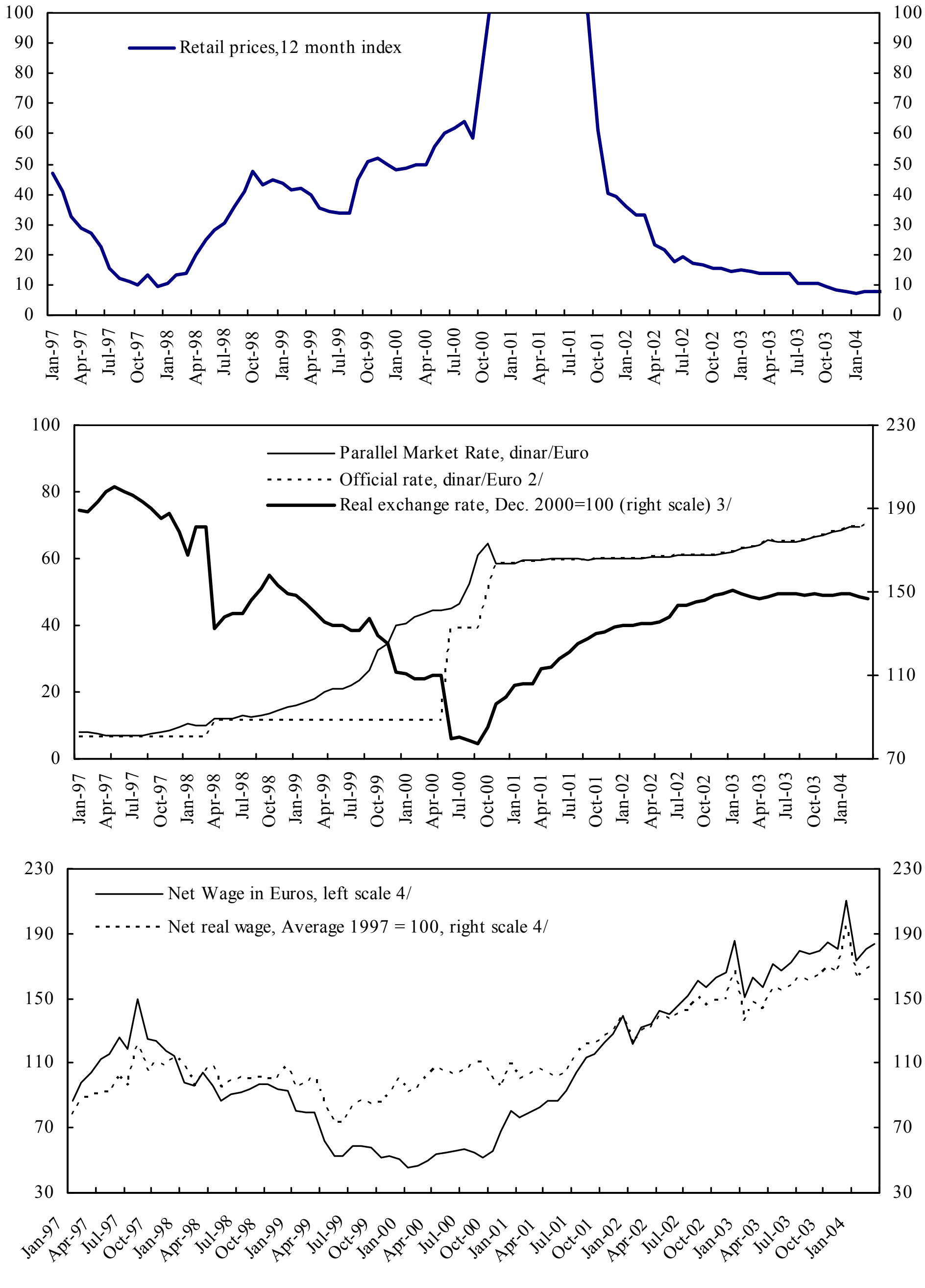
2/ Growth rates for 1990-94 refer to Gross Social Product (GSP), which excludes public and other services.

3/ The data exclude farmers and other self-employed. Including self-employed, the private sector accounted for about 45 percent of total employment in 2002.

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

5/ 2003 data up to May.

Figure 2. Serbia and Montenegro: Prices, Exchange Rates, and Wages
January 1997–March 2004 1/



Sources: Serbian and Federal Statistics Office; and IMF staff calculations.

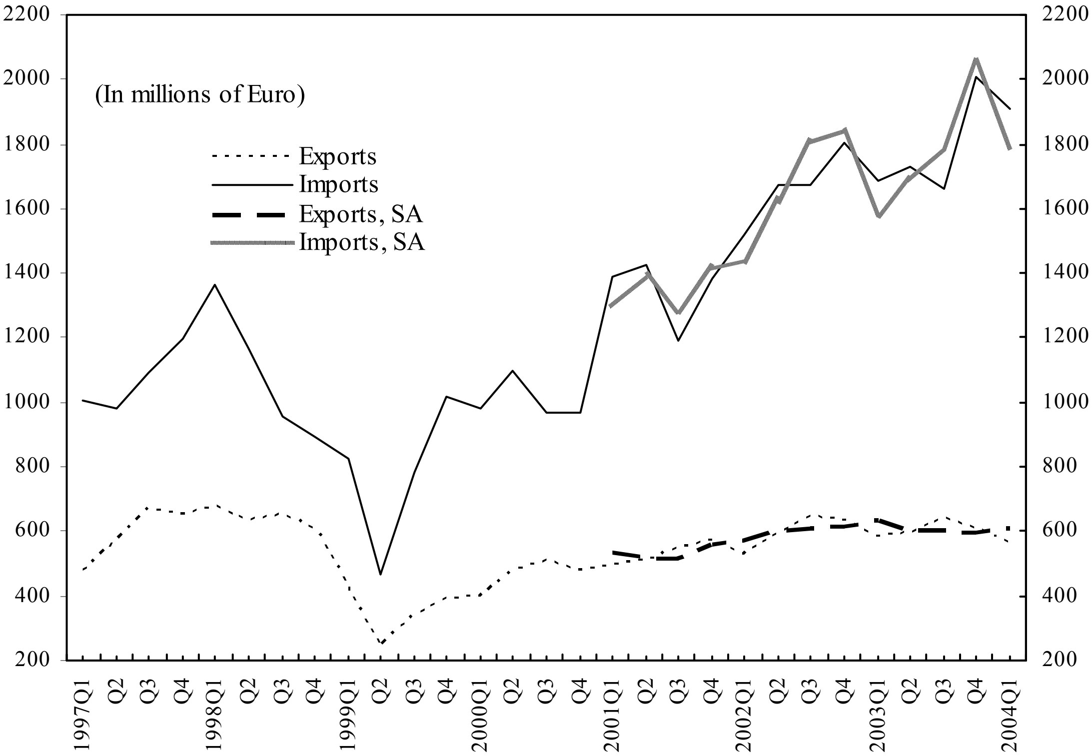
1/ Data after February 1999 exclude Kosovo.

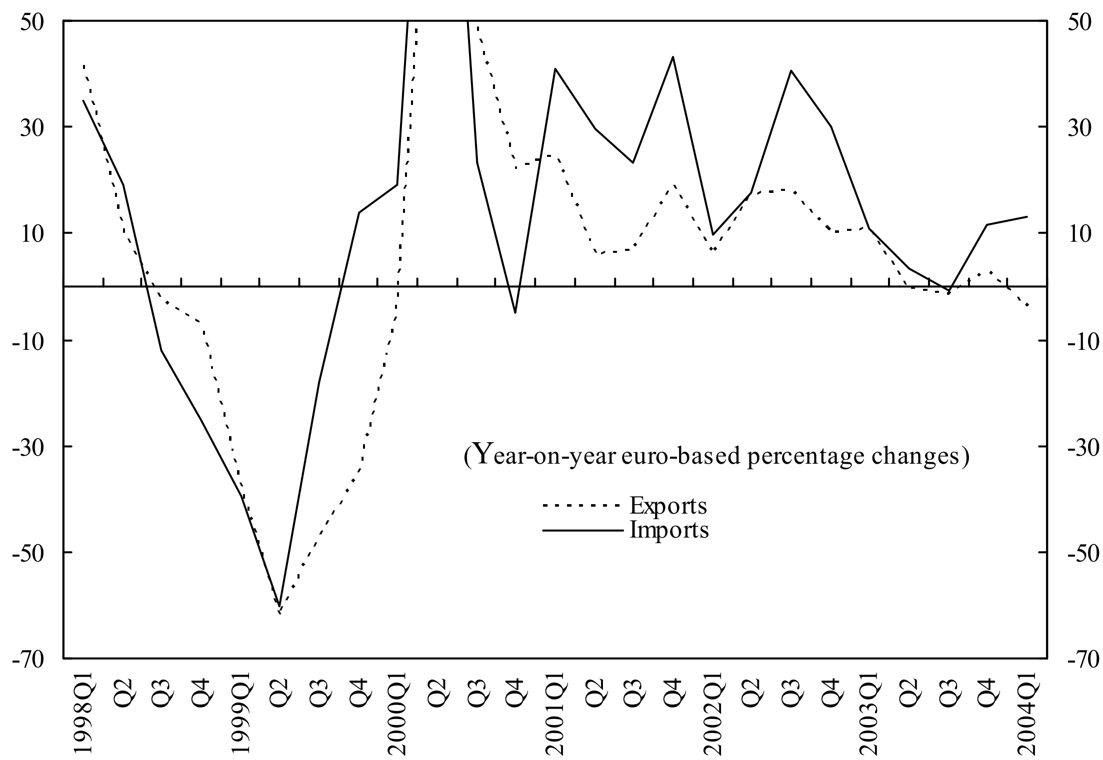
2/ The official exchange rate includes a premium which was applied in most but not all official transactions between May-November 2000. The exchange rate was unified on December 5, 2000.

3/ The index is calculated on the basis of a euro/dollar (80/20 percent) basket using a weighted average of the official, commercial and parallel rates through December 5, 2000, and the unified official exchange rate thereafter. Increase denotes appreciation.

4/ Wage data include fringe benefits from June 2001. For the conversion to euro wages, a weighted average of the parallel, commercial and official exchange rates was used through December 2000.

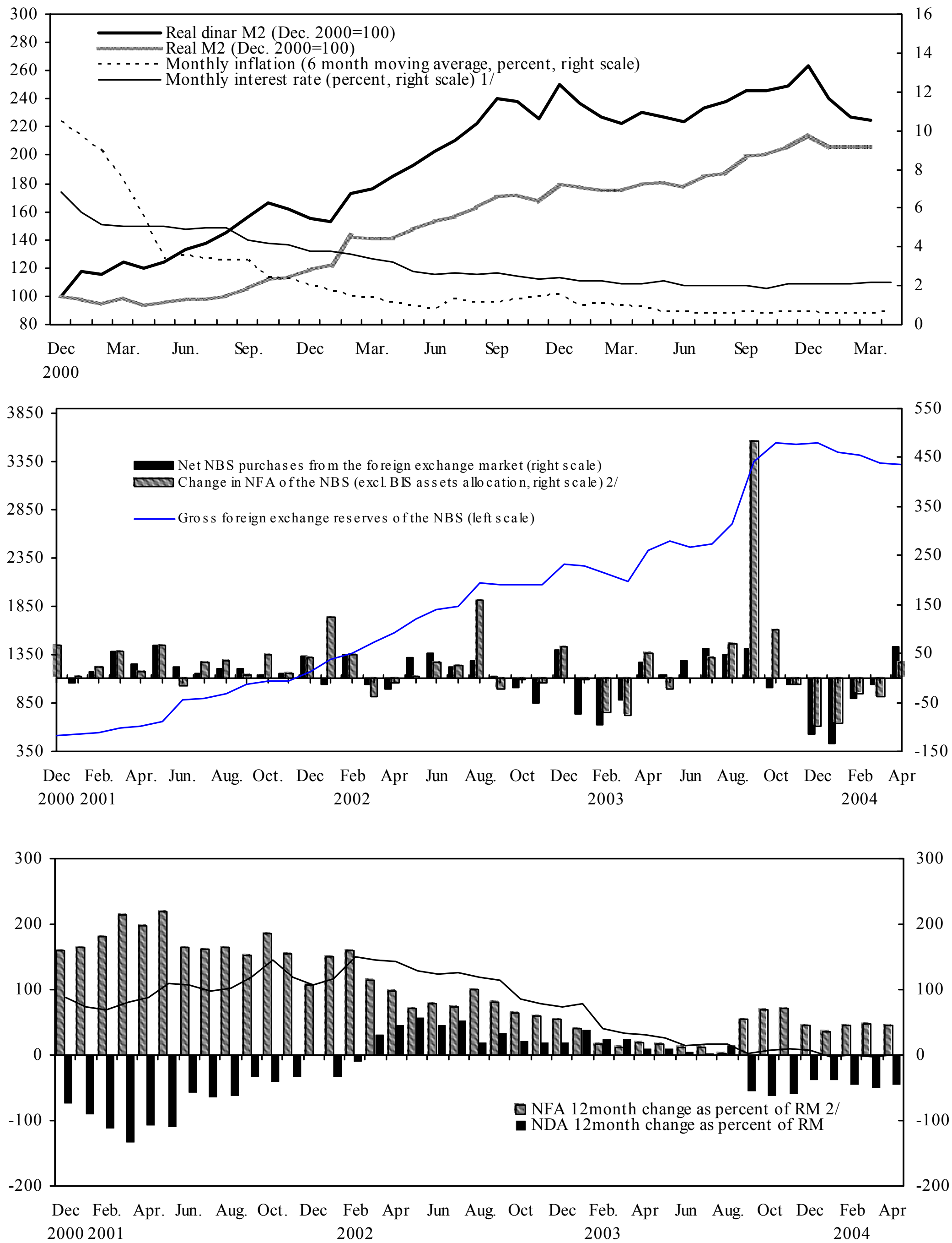
Figure 3. Serbia and Montenegro: Exports and Imports, 1997–2004





Sources: Federal Office of Statistics; National Bank of Serbia; and IMF staff calculations.

Figure 4. Serbia: Real Dinar Broad Money, Foreign Reserves, and Reserve Money Growth, December 2000–04



Sources: National Bank of Serbia; Serbian Statistics Office; and IMF staff estimates and calculations.

1/ Weighted average of monthly interest rates of Commercial Paper, Bank Bills, and Certificates of Deposit.

2/ NFA is at Dec. 01 exchange rates and excludes BIS assets allocation and write-off related to bank closures.

3/ Reserve money is based on monthly averages and adjusted to be comparable with the widening of the reserve base in April 2002 and to changes in the reserve ratio.

Table 1. Serbia and Montenegro: Selected Economic and Financial Indicators, 2001–04 1/

	2001	2002	2003		2004
			Staff Report	Prel. Actual	Rev. Prog.
Real economy					
GDP, in billions of DIN	771.8	1,006.9	1,225.9	1,192.8 6/	1,354
Average net real wage, 1997 =100	115	142	…	160	…
Average net wage in Euro	102	149	…	175	…
			(Percent change)		
Real GDP	5.5	4.0	3½ - 4½	3.0 6/	4 - 5
Gross industrial production	0.0	1.7	…	-2.7	…
Retail prices (period average)	91.1	21.2	12-13	11.3	8 - 8½
Retail prices (end of period, 12-month)	39.0	14.2	9-11	7.8	8 - 9
Unemployment rate (in percent)	31.3	28.9	…	34.5	…
			(Percent of GDP)		
General government finances 2/					
Revenue	38.9	42.8	40.5	42.6	43.6
Expenditure	40.3	47.3	45.1	46.8	47.0
Cash balance	-1.4	-4.5	-4.5	-4.2	-3.4
Foreign grants	0.7	1.1	0.7	0.2	0.3
Foreign loans (net)	0.0	1.8	2.0	1.1	1.6
Of which: Foreign financed projects	0.0	0.8	1.1	0.5	0.9
Privatization receipts	0.0	2.2	1.8	4.3	0.7
Domestic financing (Net)	0.7	-0.5	0.0	-1.4	0.9
Commitment balance 3/	-1.4	-4.5	-4.5	-4.2	-3.4
			(12-month percent change)		
Money supply (end-of-period) 4/					
M1	114.4	79.8	11.2	13.3	11.2
M2	76.6	78.0	10.9	28.6	18.9
Balance of payments			(In billions of U.S. dollars)		
Merchandise exports	2.0	2.4	3.2	2.9	3.5
Merchandise imports	-4.8	-6.3	-7.9	-8.0	-8.8
Trade balance	-2.8	-3.9	-4.8	-5.0	-5.3
Current account balance, after grants	-0.5	-1.4	-1.7	-2.1	-2.2
(In percent of GDP)	-4.6	-8.8	-8.2	-10.2	-9.6
Current account balance, before grants	-1.1	-2.0	-2.3	-2.6	-2.6
(In percent of GDP)	-9.7	-12.8	-10.9	-12.6	-11.0
Foreign debt (year-end) 5/	11.9	9.6	12.8	14.3	12.8
Gross official reserves	1.2	2.3	2.9	3.6	3.6
(In months of imports of goods and services)	2.4	3.2	3.6	4.4	4.3

Sources: Federal Statistical Office; National Bank of Serbia; Federal and State Ministries of Finance; and IMF staff estimates.

1/ With the exception of foreign debt, data exclude Kosovo.
2/ Fiscal operations of all levels of government, except for Montenegro where it excludes local governments. 2004 data include previously off-budget fiscal operations in Montenegro amounting to 0.2 percent of GDP.
3/ Excludes arrears of local governments and interest payments due but not paid on foreign debt still under restructuring.
4/ Excludes Montenegro.
5/ The data reflect the first phase of the Paris Club reduction in 2002. Debt relief on comparable terms from other bilateral creditors did not materialize in 2003 as assumed in the original program, but is assumed to take effect in 2004.
6/ Revised estimate.

Table 2. Serbia and Montenegro: Balance of Payments, 2000–05
(In millions of U.S. dollars, unless otherwise indicated)

	2000	2001	2002	2003		2004		2005
				Staff Report	Prel Est	Staff Report	Revised Program.1/	Revised Program.1/
Trade balance	**-1,788**	**-2,834**	**-3,908**	**-4,750**	**-5,040**	**-4,852**	**-5,322**	**-5,310**
Exports f.o.b.	1,923	2,003	2,412	3,185	2,917	3,796	3,483	3,935
(percent growth)	14.7	4.2	20.4	32.1	20.9	19.2	19.4	13.0
(percent growth in euro)	32.5	7.5	14.2	11.5	1.0	16.3	8.0	13.0
Recorded	1,723	1,903	2,275	3,115	2,722	3,796	3,483	3,935
Unrecorded	200	100	137	70	195	0	0	0
Imports f.o.b.	-3,711	-4,837	-6,320	-7,935	-7,957	-8,648	-8,805	-9,245
(percent growth)	12.6	30.4	30.7	25.6	25.9	9.0	10.7	5.0
(percent growth in euro)	30.0	34.5	23.9	5.0	5.2	6.1	0.1	5.0
Services (non-factor services, net)	**331**	**417**	**292**	**464**	**335**	**574**	**464**	**568**
Receipts	624	740	829	1,165	1,053	1,339	1,284	1,438
Expenditure	-293	-323	-537	-701	-718	-765	-820	-870
Net factor income	**-1**	**-26**	**-111**	**-246**	**-237**	**-382**	**-475**	**-511**
Of which: Net interest	11	-26	-111	-246	-237	-382	-475	-511
Earnings	53	48	62	103	60	122	83	137
Payments 2/	-42	-74	-173	-350	-297	-504	-558	-648
Unrequited private and official transfers, net	**1,119**	**1,915**	**2,343**	**2,260**	**2,821**	**2,442**	**2,756**	**2,897**
Private remittances, net	**848**	**1,324**	**1,719**	**2,260**	**2,328**	**2,442**	**2,756**	**2,897**
Inflows	1,132	1,698	2,089	2,650	2,736	2,832	3,156	3,297
Outflows	-284	-374	-370	-390	-408	-390	-400	-400
Current account balance, before grants	**-610**	**-1,119**	**-2,007**	**-2,272**	**-2,614**	**-2,218**	**-2,577**	**-2,356**
(In percent of GDP) 3/	-7.1	-9.7	-12.8	-10.9	-12.6	-10.2	-11.0	-10.0
Official grants 4/	271	591	624	0	493	0	0	0
Foreign direct investment, net 5/	25	165	562	623	1,395	747	713	1,181
Inflows			562	751	1,532	772	744	1,212
Of *which* : Privatization proceeds from tender and auction			289	372	777	345	287	687
Greenfield Investment			255	363	270	350	332	450
Portfolio investment			18	0	378	22.8	75	25
Reinvestment				6	107	42	50	50
Outflows				-128	-136	-25	-31	-31
Foreign loans, net	180	374	537	187	772	274	238	67
Medium and long term, net	213	299	379	97	706	184	193	22
Disbursements	227	332	421	253	911	298	500	500
Of *which* : Official creditors 4/		205	0	139	396	0	0	0
Amortization	-14	-33	-43	-157	-204	-114	-307	-478
Short term, net	-33	75	158	90	66	90	45	45
Other capital inflows 6/	49	629	892	315	240	150	160	160
Commercial banks, net		-274	-144	0	-40	-60	92	0
Capital account balance	**255**	**894**	**1,846**	**1,124**	**2,368**	**1,112**	**1,203**	**1,408**
(Capital account in euro terms)	276	998	1954	988	2094	949	962	1126
Errors and omissions	267	239	320	409	611	300	337	290
Overall balance	**183**	**605**	**784**	**-739**	**857**	**-806**	**-1,037**	**-658**
Financing	**-183**	**-5,981**	**-855**	**-5,006**	**-922**	**-193**	**-4,883**	**-577**
Net foreign assets (increase, -)	-246	-395	-816	-333	-922	-193	-44	-577
Central Bank, net		-395	-816	-333	-922	-193	-44	-577
Gross foreign reserves (increase, -)	-227	-523	-1,111	-611	-1,270	-327	-50	-648
Of which: IMF purchases	152	128	295	279	348	350	241	278
Gross foreign liabilities (increase +)	-19	128	295	279	348	134	6	71
IMF repayment	20	0	0	0	0	-216	-235	-207
Arrears (reduction, -) 7/	63	-5,587	-39	-4,673	0	0	-4,839	0
Financing expected / to be secured			0	999	0	925	995	897
Official grants 4/			0	575	0	351	338	351
Official borrowing (excluding IMF) 4/			0	424	0	574	657	546
Residual gap		5,377	71	4,746	65	73	4,925	338
Arrears settlement with creditors 7/		5,377	39	4,673	0	0	4,839	0
Debt relief from creditors		0	32	73	65	73	86	105
Memorandum items:								
Trade deficit	-1,788	-2,834	-3,908	-4,750	-5,040	-4,852	-5,322	-5,310
(In percent of GDP) 3/	-21	-24	-24.9	-22.9	-24.3	-20.8	-22.8	-22.5
Current account balance, after grants	-339	-528	-1,383	-1,697	-2,121	-1,867	-2,239	-2005
(In percent of GDP) 3/	-3.9	-4.6	-8.8	-8.1	-10.2	-8.6	-9.6	-8.5
Gross international reserves, USD mn (end period)	516	1,169	2,280	2,891	3,550	3,218	3,600	4,248
in months of prospective imports of goods & services	1.2	2.4	3.2	3.7	4.4	3.9	4.3	4.7
Debt service, cash	56	107	183	433	436	761	1,014	1,228
(In percent of GDP) 3/	0.6	0.9	1.2	2.1	2.1	3.5	4.3	5.2
Principal 8/	14	33	43	157	204	330	542	685
Interest	42	74	141	277	232	431	473	543

Sources: SM authorities; and IMF staff estimates.

1/ Revised program figures take into account valuation impact of dollar exchange rate.

2/ Up to 2001, figures indicate debt service actually paid. For 2002 and onwards, debt service recorded above-the-line is after the 51 percent debt reduction granted by bilateral and commercial creditors, but before the capitalization of moratorium interest (the effect of the latter is recorded as "debt relief from creditors").

3/ Program figures are adjusted to reflect the official revision of the GDP series.

4/ Official grants and loans recorded above-the-line are amounts based on already secured commitments; amounts expected from new pledges are shown below-the-line.

5/ For 2003, net of the payment on Telekom Srbija.

6/ For 2001-2003, including sales of foreign exchange notes by the public (amount above the level implied by trend growth) reflecting currency substitution. For 2003 also includes the foreign currency inflows corresponding to the unfreezing of the accounts held abroad by SM banks.

7/ Negotiations are on-going to clear all remaining external arrears (to the IFC, the London Club, other commercial creditors, and on short-term debt).

8/ Increase of 2004 principal payments from that envisaged in the 2003 Staff Report was mainly owing to the larger than expected commercial borrowings by private companies in 2003, mostly from their parent companies.

Table 3. Serbia and Montenegro: External Financing Requirements and Sources, 1998–2005
(In millions of U.S. dollars)

	1998	1999	2000	2001	2002	2003 Est	2004 Revised Program	2005 Revised Program
1. Gross financing requirements	**-720**	**-818**	**-1,074**	**-7,261**	**-3,200**	**-4,089**	**-8,007**	**-3,689**
External current account deficit (excluding official transfers)	-660	-764	-671	-1,119	-2,007	-2,614	-2,577	-2,356
Debt amortization	-60	-54	-47	-33	-43	-204	-307	-478
Medium- and long-term debt	-25	-17	-14	-33	-43	-176	-265	-478
Short-term debt 1/	-35	-37	-33	0	0	-28	-42	0
Repayment of arrears	0	0	0	-5,587	-39	0	-4,839	0
Gross reserve accumulation	0	0	-227	-523	-1,111	-1,270	-50	-648
IMF repurchases and repayments	0	0	-129	0	0	0	-235	-207
2. Financing	**720**	**818**	**1,074**	**7,261**	**3,200**	**4,089**	**6,686**	**2,176**
Official grants 2/	0	0	271	591	624	493	0	0
Foreign direct investment (net)	113	112	25	165	562	1,395	713	1,181
Disbursement from private creditors	78	30	49	202	236	580	545	545
Medium and long-term financing	78	30	49	127	78	514	500	500
Short-term financing and other capital inflows	0	0	0	75	158	66	45	45
Disbursement from official creditors 2/	50	29	227	205	343	396	0	0
Multilateral 3/	…	…	…	205	285	341	0	0
Other	…	…	…	0	58	55	0	0
IMF disbursement	0	0	150	128	295	348	0	0
Accumulation of arrears (exceptional)	86	126	62	0	0	0	0	0
Debt Relief	0	0	0	5,377	71	65	4,839	0
Other flows 4/	393	521	290	594	1,069	811	589	450
3. Financing Gap	**0**	**0**	**0**	**0**	**0**	**0**	**1,322**	**1,513**
Expected disbursements of grants from donors 2/	0	0	0	0	0	0	338	351
EU	0	0	0	0	0	0	167	0
Others (mostly official bilateral creditors)	0	0	0	0	0	0	171	351
Expected disbursement of loans from donors 2/	0	0	0	0	0	0	897	824
World Bank	0	0	0	0	0	0	183	160
IMF	0	0	0	0	0	0	241	278
EBRD	0	0	0	0	0	0	148	117
EIB	0	0	0	0	0	0	178	117
EU	0	0	0	0	0	0	42	0
Others (mostly official bilateral creditors)	0	0	0	0	0	0	106	152
Debt relief	0	0	0	0	0	0	86	105
4. Residual Financing Gap	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**234**

Sources: SM authorities; and IMF staff estimates.

1/ Original maturity of less than 1 year.

2/ Official grants and loans recorded above-the-line are amounts based on already secured commitments; amounts expected from new pledges are shown below-the-line.

3/ Not including amortization of the debt to IMF.

4/ Includes other capital inflows, errors and omissions, and change in net foreign assets of commercial banks.

Table 4. Net Foreign Assets of National Bank of Serbia—Actual and Program Floors, December 2002–December 04

(In millions of U.S. dollars at program exchange rates, end of period)

	2002			2003								2004						
	December			Jan.	Mar.	June	Sep.	Sep.	Dec.	Dec.	Dec.	Jan.	Feb.	Mar.	Apr.	June	Sep.	Dec.
		End-02 Ex. Rates						Staff Report			est. end-03	Prel	Prel	Prel	Prel	Program		
		EOP	Avg.								Ex. Rate 4/							
Net foreign assets of the NBS 1/	1,411	1,613	1,535	1,544	1,421	1,454	2,113	1,539	1,685	2,176	2,537	2,464	2,427	2,404	2,488	2,485	2,519	2,581
Net foreign assets of the NBS for program purposes 2/	938	1,056	1,005	1,006	848	879	1,519	970	1,098	1,502	1,747	1,636	1,595	1,549	1,589	1,609	1,630	1,678
Gross foreign assets	2,034	2,280	2,202	2,211	2,088	2,257	3,052	2,477	2,623	3,115	3,550	3,477	3,441	3,377	3,452	3,409	3,523	3,610
Reserve-related liabilities (-)	622	667	667	667	667	803	939	939	939	939	1,013	1,013	1,013	973	964	924	1,004	1,029
Gross reserve liabilities for program purposes (-)	1,095	1,224	1,197	1,205	1,240	1,378	1,533	1,507	1,525	1,613	1,803	1,841	1,846	1,828	1,862	1,800	1,894	1,932
IMF	522	567	567	567	567	703	839	839	839	839	913	913	913	873	864	824	904	929
Other	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
Loan from China deposited by a closed bank	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
Adjustments for program purposes	473	557	530	538	573	575	594	569	586	674	790	827	832	855	898	876	890	903
Foreign currency liabilities to domestic banks	473	557	530	538	573	575	594	569	586	674	790	827	832	855	898	876	890	903
Forex deposits from commercial banks	5	6	6	5	4	4	4	6	6	5	6	6	6	6	22	6	6	6
Unpaid interest	2	2	1	1	1	1	1	2	2	1	2	2	2	2	2	2	2	2
Short-term loan from commercial banks	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Required reserve and payments related deposits	453	526	500	520	564	562	582	538	555	660	774	811	816	839	866	860	874	887
Transaction and transitory deposits	13	23	23	12	4	8	7	23	23	8	8	8	8	8	8	8	8	8
Old obligations commercial banks	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Foreign currency liabilities to nonbank non-government residents	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Net foreign assets of commercial banks of Serbia 3/	709	709	...	719	602	648	748	626	649	750	750	667	632	709	576	658	658	658
Gross reserves	783	783	...	801	687	754	877	700	723	886	886	804	768	846	713	794	794	794
Reserve liabilities	74	74	...	82	85	106	129	74	74	136	136	136	136	136	136	136	136	136

Sources: National Bank of Serbia; and IMF staff estimates and calculations.

1/ Excludes frozen assets and liabilities of Serbia; undivided assets of SFRY; and in 2003 other unfrozen assets received in May 2003.
2/ Program figures are floors.
3/ At current exchange rates.
4/ Includes unfrozen assets from U.S. allocated for NBS in that year; excludes liabilities to and of closed banks and undivided liabilities belong to SFRY.

Table 5. Balance Sheet of the National Bank of Serbia, December 2002–December 04 1/

(In millions of dinars; monthly average)

	2002		2003							2004						
	December		March			Dec				Mar		Apr		June	Sep.	Dec.
	End -02 Ex. Rates				Staff Report			End-03 Ex rates		Prel.		Prel.		Program		
	EOP	Avg. Adj. 9/	EOP	Avg.	10/	EOP	Avg.	EOP	Avg	EOP	Avg.	EOP	Avg.			
Net foreign assets 2/	62,304	59,284	50,006	52,514	63,520	88,623	91,668	95,430	96,435	84,608	85,851	86,844	85,623	87,450	88,848	91,222
Net foreign assets in euro million	1,044	964	813	854	1,033	1,441	1,490	1,397	1,412	1,239	1,257	1,271	1,253	1,280	1,301	1,335
Gross foreign assets 3/	134,491	129,879	123,137	124,829	153,302	183,749	186,103	193,962	194,071	184,510	186,220	188,591	186,448	186,082	191,470	196,433
Gross reserve liabilities (-) 4/	-72,187	-70,594	-73,131	-72,315	-89,782	-95,127	-94,435	-98,532	-97,637	-99,902	-100,369	-101,748	-100,825	-98,632	-102,622	-105,211
Net domestic assets 5/	7,020	1,971	12,945	9,540	-33	-18,605	-28,527	-25,412	-33,293	-27,479	-28,589	-27,190	-26,821	-26,495	-23,953	-23,494
Domestic credit	14,455	…	23,494	…	…	-8,621	…	-10,332	…	…	…			…	…	…
Net claims on government	9,460	…	18,014	…	…	-10,548		-12,125	…	-13,815	…			-13,991	-7,768	-5,359
Claims	20,720	…	23,253	…	…	20,290	…	20,290	…	…	…			…	…	…
Dinar credits	20,720	…	23,253	…	…	20,290	…	20,290	…	…	…			…	…	…
Foreign currency credits	0	…	0	…	…	0	…	0	…	…	…			…	…	…
Liabilities (-)	-11,260	…	-5,239	…	…	-30,838	…	-32,415	…	…	…			…	…	…
Dinar liabilities	-5,101	…	-1,134	…	…	-14,353	…	-14,353	…	…	…			…	…	…
Foreign currency liabilities	-6,159	…	-4,105	…	…	-16,485	…	-18,062	…	…	…			…	…	…
Net claims on banks	6,054	…	6,354	…	…	3,660	…	3,526	…	…	…			…	…	…
Claims	7,731	…	7,740	…	…	5,985	…	5,851	…	…	…			…	…	…
Other dinar credits	5,562	…	5,585	…	…	3,838	…	3,838	…	…	…			…	…	…
Foreign currency credits	2,169	…	2,155	…	…	2,147	…	2,013	…	…	…			…	…	…
Foreign currency credits in euro million	36	…	36	…	…	36	…	29	…	…	…			…	…	…
Liabilities (-)	-1,677	…	-1,386	…	…	-2,325	…	-2,325	…	…	…			…	…	…
Of which : Stock of NBS bills	-1,549	…	-1,288	-1,585	…	-2,223	-2,989	-2,223	…	-2,380	-1,393	-2,462	-2,241	…	…	…
Net claims on the rest of the economy	-1,059	…	-874	…	…	-1,733	…	-1,733	…	…	…			…	…	…
Claims	1,014	…	1,113	…	…	46	…	46	…	…	…			…	…	…
Dinar credits	1,014	…	1,113	…	…	46	…	46	…	…	…			…	…	…
Foreign currency credits	0	…	0	…	…	0	…	0	…	…	…			…	…	…
Liabilities (-)	-2,073	…	-1,987	…	…	-1,779	…	-1,779	…	…	…			…	…	…
Dinar deposits	-2,073	…	-1,987	…	…	-1,779	…	-1,779	…	…	…			…	…	…
Other assets, net	-7,435	…	-10,549	…	…	-9,984	…	-15,080	…	…	…			…	…	…
Reserve money (in dinar)	69,324	61,255	62,951	62,054	63,488	70,018	63,141	70,018	63,141	57,128	57,261	59,653	58,802	60,955	64,895	67,728
Currency in circulation	43,719	37,827	36,917	37,913	41,381	43,712	39,474	43,712	39,474	37,680	36,693	40,962	38,321	39,868	41,842	43,421
Reserve deposits	25,605	23,427	26,034	24,142	22,106	26,306	23,668	26,306	23,668	19,448	20,568	18,692	20,482	21,087	23,053	24,307
Required reserves	15,843	18,043	20,898	19,746	16,715	15,662	15,687	15,662	15,687	14,677	14,944	14,424	14,504	14,746	16,157	17,569
Shortfall (+) or excess (-) in required reserves 6/	4,377	-384	1,398	2,353	0	-550	-525	-550	-525	2,280	1,793	-1,270	-199	0	0	0
Excess reserves 7/	9,762	5,385	5,136	4,395	5,392	10,644	7,927	10,644	7,927	4,772	5,624	4,267	5,978	6,341	6,896	6,738
Memorandum items: (12-months growth rates, unless otherwise indicated)																
Reserve money, nominal 8/	…	…	34.3	37.7	11.3	7.3	10.1	…	…	-2.2	-0.9	0.6	1.0	5.1	4.5	7.3
Reserve money, real 8/	…	…	18.4	21.4	1.2	-0.4	2.2	…	…	-9.1	-7.9	-6.8	-6.2	-2.4	-3.2	-1.1
Currency in circulation, nominal	…	…	22.4	27.9	9.4	0.0	4.4	…	…	2.1	-3.2	5.5	2.1	6.7	7.1	10.0
Currency in circulation, real	…	…	7.9	12.7	0.4	-7.2	-3.2	…	…	-5.2	-10.1	-2.0	-5.2	-0.9	-0.8	1.4
Required reserves, nominal 8/	…	…	105.3	104.5	18.4	9.8	11.1	…	…	-10.3	-3.3	-3.7	-6.5	-1.7	7.7	12.0
Required reserves, real 8/	…	…	81.0	107.3	4.5	1.9	3.1	…	…	-16.6	-10.2	-10.6	-13.2	-8.7	-0.3	3.2
Velocity (based on annualized monthly GDP)	…	…	18.5	18.8	19.2	16.6	18.3	…	…	22.8	22.8	22.1	22.4	19.6	19.3	19.1
Excess reserves, nominal	…	…	-34.7	-37.3	-27.0	9.0	2.4	…	…	-7.1	28.0	-22.5	15.3	12.3	-14.2	-15.0
Excess reserves as a share of reserve deposits (percent)	38.1	…	19.7	18.2	24.4	40.5	33.5	…	…	24.5	27.3	22.8	29.2	30.1	29.9	27.7
Stock of NBS bills as share of reserve money (percent)	…	…	2.0	2.6	…	3.2	4.7	…	…	4.2	2.4	4.1	3.8	…	…	…

Sources: National Bank of Serbia; and IMF staff estimates and calculations.

1/ At program exchange rates

2/ Program figures are floors.

3/ Exclude frozen assets and liabilities of Serbia; undivided assets of SFRY; and in 2003 other unfrozen assets received in May 2003.

4/ Exclude long-term liabilities and undivided liabilities of the SFRY. Including foreign-currency denominated liabilities to resident banks and non-government residents.

5/ Program figures are ceilings. It will be monitored as a monthly average as defined in the Technical Memorandum of Understanding from September 2001 onwards.

6/ Reserves that banks are required to hold in NBS account 201 to satisfy the dinar reserve requirement.

7/ Comprise balances in Giro accounts, business accounts,cash in commercial bank vaults, deposits at overnight accounts in NBS.

8/ The growth rates of reserve money (in dinar) are adjusted for changes in dinar reserve requirements.

9/ Reflects revision to NFA at end-2002, and assumes a reserve requirement of 23 percent at end-2002.

10/ Adjusted for the lowering of the required reserves ratio to 18 percent effective on July 11, 2003.

Table 6. Monetary Survey of Serbia, December 2002–December 2004

(In millions of dinars; end of period) 1/

	2002		2003					2004			
	Dec		Mar.	June	Sep.	Dec.		Mar.	June	Sep.	Dec.
		End-02 Ex. Rates 5/ Adj.					End-03 ex Rates	Est.	Program		
Net Foreign Assets 2/	137,440	136,996	118,779	121,249	165,741	166,773	179,556	170,084	171,733	173,602	176,962
(NFA in euro m.)	2,302	2,227	1,931	1,971	2,694	2,711	2,628	2,490	2,514	2,541	2,590
Assets	183,927	180,694	162,994	174,420	228,165	229,049	242,371	230,706	229,656	235,904	240,610
NBS	137,614	134,491	123,137	133,123	180,021	183,749	193,962	184,510	186,264	192,512	197,217
Commercial banks	46,313	46,203	39,857	41,298	48,143	45,300	48,409	46,196	43,392	43,392	43,392
Liabilities (-)	-46,486	-43,697	-44,215	-53,172	-62,424	-62,276	-62,815	-60,622	-57,923	-62,302	-63,648
NBS	-42,111	-39,333	-39,333	-47,352	-55,371	-55,371	-55,369	-53,176	-50,477	-54,856	-56,202
Commercial banks	-4,375	-4,365	-4,882	-5,820	-7,053	-6,905	-7,446	-7,446	-7,446	-7,446	-7,446
Net Domestic Assets 3/	48,094	49,970	62,538	68,437	48,235	64,887	60,870	61,446	72,957	83,049	90,858
Domestic credit	143,425	144,168	159,508	166,910	148,874	172,456	183,467				
Net credit to government 3/	-1,466	-12,595	-9,120	-9,140	-38,028	-26,025	-24,384	-24,850	-21,898	-15,676	-13,267
Credit	25,247	24,377	28,847	28,499	28,861	25,175	25,204		…	…	…
Dinar credit	23,497	23,497	28,030	28,197	28,272	24,752	24,752		…	…	…
NBS	20,720	20,720	23,253	23,224	23,061	20,290	20,290		…	…	…
Commercial banks	2,777	2,777	4,777	4,973	5,211	4,462	4,462		…	…	…
Foreign currency credits	1,750	880	817	302	589	423	452		…	…	…
NBS	0	0	0	0	0	0	0		…	…	…
Commercial banks	1,750	880	817	302	589	423	452		…	…	…
Liabilities	-26,713	-36,972	-37,967	-37,639	-66,890	-51,200	-49,588		…	…	…
Dinar liabilities	-19,530	-21,079	-23,453	-23,102	-26,481	-25,699	-25,699		…	…	…
NBS	-5,122	-5,101	-1,134	-4,709	-8,583	-14,353	-14,353		…	…	…
Commercial banks	-14,408	-15,978	-22,319	-18,393	-17,898	-11,346	-11,346		…	…	…
Foreign currency deposits	-7,183	-15,893	-14,514	-14,537	-40,409	-25,501	-23,889		…	…	…
NBS	-6,027	-6,159	-4,105	-4,728	-31,733	-16,485	-18,062		…	…	…
Commercial banks	-1,156	-9,734	-10,409	-9,809	-8,676	-9,016	-5,827		…	…	…
Short-term government credits to banks	-83	-191	-167	-236	-236	-251	-251		…	…	…
Purchased bonds for repaying frozen deposits	609	1,384	2,051	2,262	2,818	4,107	4,483		…	…	…
Credit to the non-government sector	144,364	155,570	166,744	174,025	184,320	194,624	203,619	216,285	218,147	224,557	232,551
Households	16,021	16,021	17,746	22,037	24,738	29,101	29,101		…	…	…
Non-profit and other sectors	3,891	4,553	4,266	4,340	3,857	3,749	3,780		…	…	…
Enterprises in dinar	70,892	71,507	79,754	81,995	89,469	93,210	97,510		…	…	…
Enterprises in foreign currency	53,560	63,489	64,978	65,653	66,256	68,564	73,228		…	…	…
Enterprises in foreign currency (euro million)	897	1,063	1,088	1,100	1,110	1,004	1,226		…	…	…
Other items, net.	-95,331	-94,199	-96,971	-98,473	-100,638	-107,568	-118,364	-129,989	-123,292	-125,833	-128,425
Broad Money (M2)	185,535	186,966	181,317	189,686	213,976	231,660	240,426	231,530	244,690	256,651	267,820
Dinar-denominated M2	105,589	105,589	95,597	97,624	109,682	119,763	119,763	103,776	113,542	123,864	133,395
M1	88,839	88,839	82,763	83,102	91,861	100,690	100,690	88,381	95,586	104,188	111,999
Currency outside banks	43,719	43,719	36,917	37,546	39,224	43,712	43,712	37,680	41,942	45,408	48,083
Demand deposits	45,120	45,120	45,846	45,556	52,637	56,978	56,978	50,701	53,644	58,780	63,916
Time and savings deposits	16,750	16,750	12,834	14,522	17,821	19,073	19,073	15,395	17,957	19,676	21,395
Foreign currency deposits (non-frozen)	79,946	81,377	85,720	92,062	104,294	111,897	120,663	127,753	131,147	132,786	134,426
Foreign currency deposits (not-frozen), (euro million)	1,339	1,323	1,393	1,497	1,695	1,819	1,766	1,870	1,920	1,944	1,968
Memorandum items 4/:											
Broad money at current exchange rates (in million dinars)	186,966	186,966	184,898	192,059	219,872	240,426	240,426	234,311	251,768	268,677	285,899
12-month growth rates (in percent)											
Broad Money (M2)	78.0	…	40.9	31.7	28.7	28.6	…	26.7	31.1	22.2	18.9
Dinar-denominated M2	84.9	…	43.2	25.2	12.8	13.4	…	8.6	16.3	12.9	11.4
M1	79.8	…	42.8	22.2	8.7	13.3	…	6.8	15.0	13.4	11.2
Currency outside banks	72.6	…	22.4	14.7	-3.0	0.0	…	2.1	11.7	15.8	10.0
Foreign currency deposits	69.8	…	38.5	39.1	49.6	48.3	…	46.2	46.4	31.4	26.4
Velocity (M1)	12.5	…	14.1	14.3	13.2	12.3	…	14.8	13.9	13.1	12.4
Multiplier (Dinar M2/Reserve money)	1.8	…	1.5	1.7	1.8	1.7	…	1.8	1.9	1.9	2.0
Currency/Dinar deposits (in percent)	65.3	70.7	62.9	62.5	55.7	57.5	…	57.0	58.6	57.9	56.4
Required reserve ratio (effective, in percent)	23.7	25.6	41.3	32.1	24.1	23.9	…	22.2	23.9	23.9	23.9
Excess reserves/Dinar deposits (in percent)	14.6	15.8	8.8	8.3	11.8	14.0	…	9.0	8.9	8.8	7.9
Foreign exchange deposits/Broad money	43.5	43.5	48.3	49.2	50.1	50.2		55.7	54.9	53.9	53.3
Dinar-denominated M2/ annualized monthly GDP	10.0	…	8.2	8.2	9.1	9.7	…	8.0	8.5	9.1	9.6

Sources: National Bank of Serbia; and IMF staff estimates and calculations.

1/ Unless otherwise specified, foreign exchange denominated items are converted at program exchange rates (for each year, the exchange rates prevailing at the end of the proceeding year).

2/ Excluding undivided assets and liabilities of the SFRY and, from 2002 onwards, liabilities to banks in liquidation.

3/ Program figures are ceilings.

4/ Foreign exchange denominated items are vauled at current exchange rates.

5/ Includes foreign exchange liabilities to Paris Club creditors that banks were instructed in mid-November 2002 to book as liabilities to the government in the context of the debt-for-equity swap.

Table 7a. Serbia General Government Fiscal Operations in 2003–04 1/

	Consolidated General government Excluding Montenegro						Consolidated General government Including Montenergro					
	2003		2004	2003		2004	2003		2004	2003		2004
	Staff Report	Prel.	Rev. Prog.	Staff Report	Prel.	Rev. Prog.	Staff Report	Prel.	Rev. Prog.	Staff Report	Prel.	Rev. Prog.
	(Billion dinars)			(Percent of GDP) 2/			(Billion dinars)			(Percent of GDP) 2/		
Total revenue	465.8	475.0	547.9	38.0	39.8	40.5	499.4	507.9	590.0	40.7	42.6	43.6
Current revenue	465.8	470.2	547.6	38.0	39.4	40.5	499.4	503.1	589.2	40.7	42.2	43.5
Tax revenue	426.7	430.1	494.5	34.8	36.1	36.5	458.1	461.0	534.3	37.4	38.7	39.5
Personal income tax	64.7	70.1	74.1	5.3	5.9	5.5	69.4	74.3	79.5	5.7	6.2	5.9
Social security contributions	118.4	115.8	135.5	9.7	9.7	10.0	128.9	126.1	147.3	10.5	10.6	10.9
Corporate income tax	4.6	5.9	7.5	0.4	0.5	0.6	5.6	6.8	8.7	0.5	0.6	0.6
Retail sales tax	130.3	126.3	142.8	10.6	10.6	10.6	137.0	135.3	153.6	11.2	11.3	11.3
Excises	57.9	58.3	76.1	4.7	4.9	5.6	62.4	62.1	81.3	5.1	5.2	6.0
Taxes on international trade and operations	28.8	28.9	33.0	2.3	2.4	2.4	32.5	31.4	36.4	2.7	2.6	2.7
Other taxes	22.0	24.8	25.4	1.8	2.1	1.9	22.4	25.0	27.7	1.8	2.1	2.0
Extrabudgetary taxes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Nontax revenue	39.0	40.0	53.1	3.2	3.4	3.9	41.3	42.1	54.9	3.4	3.5	4.1
Capital revenue	0.0	4.8	0.3	0.0	0.4	0.0	0.1	4.9	0.8	0.0	0.4	0.1
Total expenditure and net lending	518.6	522.9	592.7	42.3	43.8	43.8	554.9	558.4	636.7	45.3	46.8	47.0
Current expenditure	478.8	490.5	545.8	39.1	41.1	40.3	512.3	522.8	585.9	41.8	43.8	43.3
Expenditure on goods and services	201.1	201.7	223.4	16.4	16.9	16.5	216.2	216.3	241.2	17.6	18.1	17.8
Wages and salaries	119.0	113.2	131.2	9.7	9.5	9.7	130.3	123.3	143.6	10.6	10.3	10.6
Other purchases of goods and services	82.1	88.6	92.1	6.7	7.4	6.8	86.0	93.0	97.6	7.0	7.8	7.2
Interest payment	13.3	11.3	13.8	1.1	0.9	1.0	14.5	12.2	15.4	1.2	1.0	1.1
Subsidies and other current transfers	262.3	271.2	302.0	21.4	22.7	22.3	279.3	288.0	322.6	22.8	24.1	23.8
Subsidies	36.5	40.9	47.9	3.0	3.4	3.5	37.5	41.8	48.6	3.1	3.5	3.6
Transfers to households	225.6	230.3	254.0	18.4	19.3	18.8	241.6	246.1	274.0	19.7	20.6	20.2
Capital expenditure	35.2	25.0	37.0	2.9	2.1	2.7	37.0	26.4	39.8	3.0	2.2	2.9
of which: financed by project loans	12.7	4.9	11.4	1.0	0.4	0.8	13.1	5.4	12.6	1.1	0.5	0.9
General reserves	3.7	0.0	4.4	0.3	0.0	0.3	4.3	0.6	5.1	1.7	4.3	0.7
Lending minus repayment	0.9	7.4	5.5	0.1	0.6	0.4	1.3	8.7	6.0	0.1	0.7	0.4
Net transfer to other levels of government	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net transfer from Montenegro	2.5	2.1	3.0	0.2	0.2	0.2	0.0	0.0	0.0	0.0	0.0	0.0
Gap/Statistical discrepancy	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.1	0.1	0.0	0.0	0.0
Overall balance	-50.3	-45.9	-41.9	-4.1	-3.8	-3.1	-55.5	-50.5	-46.7	-4.5	-4.2	-3.4
Excluding project loans	-37.6	-41.0	-30.5	-3.1	-3.4	-2.3	-42.4	-45.1	-34.1	-3.5	-3.7	-2.5
Foreign grants	9.7	1.9	3.0	0.8	0.2	0.2	11.1	2.7	3.6	0.9	0.2	0.3
Overall balance including grants	-40.6	-44.0	-38.8	-3.3	-3.7	-2.9	-44.4	-47.8	-43.1	-3.6	-4.0	-3.2
Financing	40.6	44.0	38.8	3.3	3.7	2.9	44.4	47.7	43.2	3.6	4.0	3.2
Domestic financing	-2.7	-17.5	11.1	-0.2	-1.5	0.8	-2.1	-16.7	12.0	-0.2	-1.4	0.9
Foreign Financing	22.0	12.2	19.4	1.8	1.0	1.4	23.8	13.5	21.8	1.9	1.1	1.6
Privatization receipts	18.9	49.3	8.3	1.5	4.1	0.6	20.4	50.9	9.4	1.7	4.3	0.7

Sources: Ministry of Finance of FRY, Republic of Serbia and Republic of Montenegro; and IMF staff estimates.

1/ Consolidated general government includes the federal, the republican, and local governments (except for Montenegro), the social security funds and the extrabudgetary programs.

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

3/ 2004 data include previously off-budget fiscal operations in Montenegro amounting to 0.2 percent of GDP.

Table 7b. Serbia: Republican Government Fiscal Operations
(In percent of GDP) 1/

	2001	2002	2003		2004
			Staff Report	Prel.	Rev. Prog.
A Total revenue and grants (1+2+3)	**16.2**	**25.6**	**24.5**	**24.5**	**25.7**
1 Total revenue (1.1+1.2)	15.8	24.7	23.5	24.1	25.3
1.1 Current revenue (1.1.1+1.1.2)	15.8	24.7	23.5	24.1	25.2
1.1.1 Tax revenue (1.1.1.1+...+1.1.1.6)	14.8	22.8	21.1	21.5	22.0
1.1.1.1 Personal income tax	4.1	4.4	4.2	4.4	4.0
1.1.1.2 Corporate income tax	0.4	0.4	0.3	0.4	0.5
1.1.1.3 Turnover (retail sales) tax	4.9	9.4	9.2	9.1	9.2
1.1.1.4 Taxes on international trade	0.0	2.4	2.3	2.4	2.4
1.1.1.5 Excises	3.2	4.5	4.7	4.9	5.6
1.1.1.6 Property taxes	1.3	1.0	0.3	0.3	0.3
1.1.1.7 Other taxes	0.9	0.6	0.0	0.0	0.0
1.1.2 Nontax revenue	1.0	1.9	2.4	2.6	3.2
1.2 Capital revenue	0.0	0.0	0.0	0.0	0.0
2 Transfer from Montenegro	0.0	0.0	0.2	0.2	0.2
3 Grants	0.4	1.0	0.8	0.2	0.2
B. Total expenditure and net lending (1+...+6)	**17.0**	**29.1**	**27.8**	**28.0**	**28.6**
1. Total expenditure (2+3+4)	16.2	29.0	27.8	27.4	28.2
2 Current expenditure (2.1+2.2+2.3)	15.7	27.1	25.4	25.6	25.5
2.1. Expenditure on goods and services (2.1.1+...+2.1.4)	6.7	5.9	7.4	7.4	6.9
2.1.1 Wages and salaries	3.5	3.5	4.4	4.6	4.3
2.1.2 Employer contribution	0.7	0.8	0.9	0.8	0.9
2.1.2.1 Contribution	0.0	0.6	0.8	0.8	0.8
2.1.2.2 Tax	0.0	0.2	0.1	0.0	0.1
2.1.3 Severance payments	0.0	0.0	0.0	0.0	0.0
2.1.4 Other purchases of goods and services	2.4	1.5	1.9	1.7	1.4
2.2. Interest payment	0.1	0.7	1.0	0.9	1.0
2.3. Subsidies and other current transfers	8.9	20.6	17.0	17.3	17.7
2.3.1 Subsidies	2.8	3.4	2.6	2.6	2.6
2.3.2 Transfers to households	2.8	3.2	4.2	4.3	3.6
Of which: Repayment for frozen foreign currency deposit	0.5	0.6	0.9	1.2	1.2
2.3.3 Current transfers to other levels of government	3.4	14.0	10.2	10.4	11.4
Federal budget	0.0	6.9	3.1	2.7	3.9
Republican budget	0.0	0.0	0.0	0.0	0.0
Local Budgets	0.1	1.3	1.1	1.2	1.1
Pension Funds	2.8	4.9	4.6	5.4	5.2
Health Fund	0.3	0.4	0.5	0.3	0.2
Labor Market Fund	0.1	0.3	0.5	0.4	0.5
Other transfers	0.0	0.0	0.0	0.0	0.0
3. Capital expenditure	0.5	1.9	2.1	1.6	2.1
Of which: Budget for recovery and reconstruction	0.0	0.7	1.0	0.4	0.8
4. General reserves	0.0	0.0	0.0	0.0	0.3
5. New Serbia expenditure	0.0	0.0	0.2	0.2	0.2
6. Lending minus repayment	0.8	0.1	0.1	0.6	0.4
Overall budget balance excluding grants	**-1.2**	**-4.4**	**-4.1**	**-3.7**	**-3.1**
Overall budget balance including grants (A-B)	**-0.8**	**-3.5**	**-3.3**	**-3.5**	**-2.9**
Overall budget balance excluding grants and project loans	**-1.2**	**-3.7**	**-3.1**	**-3.3**	**-2.3**
Statistical Discrepancy/financing gap (+ = overfinancing)	0.1	0.0 #	0.0	0.0	0.0
Financing (1+2+3)	0.9	3.5 #	3.3	3.6	2.9
1 Domestic financing (net) (1.1+1.2)	0.9	0.0	0.0	-1.6	0.8
1.1 Banking system (1.1.1+1.1.2)	1.1	0.0	0.0	-1.6	0.8
1.1.1 Central Bank of Serbia	1.1	0.0	0.0	-1.6	0.8
1.1.2 Commercial banks	0.0	0.0	0.0	0.0	0.0
1.2 Nonbank	-0.2	0.0	0.0	0.0	0.0
2 Foreign financing (net) (2.1-2.2)	0.0	1.7	1.8	1.0	1.4
2.1 Program	0.0	1.0	0.9	0.6	0.7
2.2 Project	0.0	0.7	1.0	0.4	0.8
3 Privatization receipts 2/	0.0	1.8	1.5	4.1	0.6

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

1/ Expressed in terms of GDP of Serbia and Montenegro excluding Kosovo. Data for 2000 and 2001 exclude union budget.

2/ Total privatization revenue accruing to the republican government.

Table 7c. Montenegro: Consolidated Fiscal Operations 2001–04
(As a percent of GDP)

	2001	2002	2003		2004		
	Actual	Actual	Staff Report	Actual	Budget	Rev. Prog. 3/	Rev. Proj. 4/
Total revenue	**38.0**	**36.5**	**36.0**	**36.5**	**39.3**	**39.0**	**38.6**
Current revenue	38.0	36.5	35.9	36.4	38.7	38.5	38.1
Tax revenue	32.9	34.2	33.5	34.1	37.0	36.9	36.4
Personal income tax	5.4	4.6	5.1	4.7	5.0	5.0	4.8
Social security contributions	10.8	11.9	11.2	11.1	11.2	10.9	10.5
Corporate income tax	0.6	1.0	1.0	1.0	1.1	1.1	1.1
Retail sales tax / VAT from April 2003 1/	7.1	8.7	7.1	10.1	9.9	9.9	9.9
Excises	4.4	4.5	4.8	4.2	4.7	4.8	4.8
Taxes on international trade	4.3	3.1	4.0	2.9	3.3	3.2	3.2
Other taxes 2/	0.4	0.4	0.3	0.2	1.9	2.1	2.1
Extrabudgetary taxes	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Nontax revenue	5.1	2.4	2.4	2.3	1.6	1.6	1.6
Capital revenue	0.0	0.0	0.1	0.1	0.6	0.5	0.5
Total expenditure and net lending	**42.3**	**40.6**	**38.9**	**39.4**	**40.9**	**40.8**	**40.3**
Current expenditure	38.6	37.3	35.8	35.7	37.0	37.1	36.7
Net wages, salaries and allowances	9.9	10.4	10.4	9.4	9.8	9.8	9.7
Payroll Tax	1.6	1.2	1.7	1.6	1.6	1.6	1.5
Employer contributions	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Purchases of goods and services	5.9	3.9	3.6	4.4	4.9	4.9	4.6
Interest payment	0.1	1.0	1.3	1.0	1.2	1.5	1.5
Subsidies and other current transfers	20.7	20.1	18.2	18.7	19.2	19.1	19.1
Subsidies to enterprises	1.2	2.0	1.1	1.1	0.7	0.6	0.6
Transfers to households	19.5	18.1	17.1	17.7	18.5	18.5	18.5
of which: repayment of FFCDs	0.0	0.3	0.0	0.0	0.5	0.5	0.0
Other non-interest current expenditure	0.5	0.7	0.5	0.5	0.2	0.2	0.2
Capital expenditure	2.0	1.6	2.1	1.6	2.8	2.7	2.6
of which : foreign financed project spending	0.0	0.6	0.4	0.6	1.1	1.1	1.1
General reserves	0.6	1.0	0.7	0.6	0.6	0.6	0.6
Net Lending	1.1	0.7	0.4	1.5	0.6	0.4	0.5
Transfer to the Union Budget	**0.0**	**0.0**	**2.7**	**2.3**	**2.8**	**2.8**	**2.8**
Discrepancy	0.4	0.3	0.0	-0.1	0.0	0.0	0.0
Overall balance before grants	**-4.7**	**-4.3**	**-5.6**	**-5.2**	**-4.4**	**-4.6**	**-4.6**
Overall balance before grants and foreign-financed project loans	**-4.7**	**-3.7**	**-5.2**	**-4.6**	**-3.3**	**-3.4**	**-3.4**
Foreign grants	3.1	2.2	1.4	0.9	0.4	0.5	0.5
Financing	**1.6**	**2.1**	**4.2**	**4.2**	**4.0**	**4.0**	**4.0**
Domestic financing	**1.6**	**-3.5**	**0.6**	**1.8**	**1.0**	**0.8**	**0.8**
Bank financing	0.8	-3.5	0.6	1.1	1.0	0.8	0.8
Nonbank financing	0.8	0.0	0.0	0.7	0.0	0.0	0.0
Net Foreign Financing	**0.0**	**0.6**	**1.9**	**1.4**	**1.9**	**2.2**	**2.2**
Program	0.0	0.0	1.5	0.8	0.8	1.1	1.1
Project	0.0	0.6	0.4	0.6	1.1	1.1	1.1
Privatization receipts	**0.0**	**5.1**	**1.7**	**1.1**	**1.0**	**1.0**	**1.0**
Memorandum item							
Montenegro GDP (Euro million)	1,049	1,250	1,400	1,375	1,475	1,475	1,475

Source: Montenegrin Ministry of Finance and staff projections.
1/ From FY2002 onwards, retail sales tax includes revenues that were redirected to the Army and the Railway.
2/ 2004 includes previously off-budget revenue and spending, most of which represents an excise surtax on petrol products to finance transportation sector project spending.
3/ The revised projections for 2003 and 2004 reflect a carried-over SAC disbursement from Dec 2003 and delayed interest payments to the World Bank paid in January 2004. The increase in program loans relative to the 2004 budget is assumed to decrease net domestic credit to the government by a comparable amount. A fiscal gap of 10.2 million arising mostly from revised revenue projections is closed by 4.5 and 5.7 million in revenue and expenditure measures, respectively.
4/ PIT and social contribution rates reduced in two 5-percent steps on July 1, 2004, and December 1, 2004.

Table 7d. Montenegro: Republican Government Fiscal Operations, 2001–04

(As a percent of GDP)

	2001		2002		2003			2004		
	Budget	Actual	Budget	Actual 1/	Budget	Staff Report	Actual	Budget	Rev. Prog. 4/	Rev. Proj. 5/
A Total revenue and grants (1+2)	**20.9**	**23.3**	**23.9**	**26.7**	**27.4**	**25.8**	**25.7**	**27.7**	**27.5**	**27.7**
1 Total revenue (1.1+1.2)	18.0	21.9	21.6	24.6	25.8	24.4	24.8	27.3	27.0	27.2
1.1 Current revenue (1.1.1+1.1.2)	18.0	21.9	21.6	24.6	25.8	24.4	24.8	27.0	26.8	27.0
1.1.1 Tax revenue (1.1.1.1+1.1.1.2+1.1.1.3+1.1.1.4)	16.3	17.9	16.7	22.9	23.7	22.3	22.9	25.9	25.7	25.9
1.1.1.1 Personal income	5.3	5.4	5.4	5.3	5.4	5.1	4.7	5.0	5.0	4.8
1.1.1.2 Turnover (retail sales) tax / VAT after April 2003 1/	5.3	5.6	5.0	8.6	7.0	7.1	10.0	9.9	9.9	9.9
1.1.1.3 Excises	3.2	3.4	2.7	4.5	6.2	4.8	4.2	4.7	4.7	4.8
1.1.1.4 Taxes on international trade and transactions	0.0	0.0	2.6	3.1	3.7	4.0	2.9	3.3	3.2	3.2
1.1.1.5 Other taxes 2/	1.7	2.6	0.3	0.4	0.2	0.3	0.2	1.9	1.9	2.1
1.1.1.6 Corporate income taxes	0.0	0.0	0.6	1.0	1.1	1.0	1.0	1.1	1.1	1.1
1.1.2 Nontax revenue	1.7	4.0	4.9	1.7	2.1	2.1	1.8	1.1	1.1	1.1
1.2 Capital revenue	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.3	0.2	0.2
2 Grants	2.9	1.4	2.3	2.2	1.7	1.4	0.9	0.4	0.5	0.5
B Total expenditure and net lending (1+2)	**21.6**	**24.3**	**25.8**	**23.0**	**24.6**	**23.1**	**23.2**	**24.8**	**25.1**	**24.2**
1 Total expenditure (1.1+1.2)	21.6	23.7	24.8	22.2	24.0	22.6	21.5	24.2	24.5	23.8
1.1 Current expenditure (1.1.1+1.1.2)	19.9	21.8	23.5	20.7	22.0	20.8	19.9	21.4	21.7	21.2
1.1.1 Interest	0.0	0.1	1.9	1.1	1.8	1.3	1.0	1.2	1.5	1.5
1.1.2 Non-interest (1.1.2.1+1.1.2.2+1.1.2.3+1.1.2.4)	19.8	21.8	21.6	19.6	20.2	19.5	18.9	20.2	20.2	19.7
1.1.2.1 wages and salaries	11.2	10.3	10.8	9.1	10.9	10.8	9.8	10.0	10.0	9.9
Net Wages	5.2	4.8	5.0	5.5	5.0	5.0	5.1	4.8	4.8	4.8
Allowances	1.1	1.0	1.1	1.0	1.1	1.1	0.8	0.9	0.9	0.9
PIT	1.2	1.2	1.2	1.3	1.2	1.2	1.2	1.2	1.2	1.2
Contributions	3.4	3.2	3.3	1.2	3.3	3.3	2.4	3.1	3.1	3.0
1.1.2.2. Goods and Services	3.7	5.3	4.3	3.3	3.1	2.9	3.5	4.3	4.3	4.1
1.1.2.3 Transfers and social benefits to individuals, NGOs 3/	3.0	3.9	3.1	3.9	4.1	3.8	3.5	4.4	4.4	4.4
of which : repayment of FFCDs	0.0	0.0	...	0.3	0.0	0.0	0.0	0.5	0.5	0.5
1.1.2.4 Subsidies to enterprises	1.1	1.2	2.1	2.0	1.2	1.1	1.1	0.7	0.7	0.6
1.1.2.5 Other non-interest expenditure and reserves	0.8	1.1	1.3	1.3	0.9	0.8	1.1	0.8	0.8	0.8
1.2 Capital expenditure	1.7	1.8	1.3	1.5	2.0	1.8	1.6	2.8	2.8	2.5
of which : foreign financed project spending	0.0	0.0	...	0.6	...	0.4	0.6	1.1	1.1	1.1
2 Net lending	0.0	0.6	1.0	0.8	0.6	0.5	1.7	0.6	0.6	0.5
C Net transfer to other levels of government	**0.0**	**0.4**	**0.5**	**5.0**	**6.6**	**6.2**	**5.6**	**6.9**	**7.2**	**7.5**
1 Transfers to the PIO	0.0	0.1	0.0	4.2	3.1	2.9	2.8	3.5	3.7	3.9
2 Transfers to the Health Fund	0.0	0.1	0.2	0.4	0.2	0.2	0.2	0.2	0.4	0.5
3 Transfers to the Employment Fund	0.0	0.2	0.3	0.3	0.4	0.3	0.2	0.3	0.3	0.3
4 Transfers to the Union Budget	0.0	0.0	0.0	0.0	2.9	2.7	2.3	2.8	2.8	2.8
D Discrepancy	0.3	0.2	0.0	1.1	0.0	0.0	0.2	0.0	-0.7	0.0
Overall budget balance before grants (cash)	**-3.9**	**-3.0**	**-4.7**	**-4.5**	**-5.4**	**-5.0**	**-4.2**	**-4.4**	**-4.6**	**-4.6**
Overall balance before grants and foreign-financed project loans	**-3.9**	**-3.0**	...	**-3.9**	...	**-4.5**	**-3.6**	**-3.2**	**-3.4**	**-3.4**
Financing (1+2+3)	**1.0**	**1.6**	**2.4**	**2.3**	**3.8**	**3.5**	**3.3**	**4.0**	**4.0**	**4.0**
1 Domestic financing (net) (1.1+1.2)	**0.0**	**1.6**	**-1.4**	**-2.6**	**0.2**	**0.0**	**1.0**	**1.6**	**1.4**	**1.4**
1.1 Banking system (1.1.1+1.1.2)	0.0	0.8	-1.4	-2.6	0.2	0.0	0.3	1.6	1.4	1.4
1.1.1 Central Bank of Montenegro	0.0	1.0	-1.4	0.3	0.0	-1.0	-0.9	0.0	0.0	0.0
1.1.2 Commercial banks	0.0	-0.2	0.0	-2.8	0.2	1.0	1.2	1.6	1.4	1.4
1.2 Nonbank	0.0	0.8	0.0	0.0	0.0	0.0	0.7	0.0	0.0	0.0
2 Foreign financing (net) (2.1-2.2)	**0.0**	**0.0**	**1.8**	**0.6**	**1.9**	**1.9**	**1.4**	**1.9**	**2.2**	**2.2**
2.1 Disbursements	0.0	0.0	1.8	0.6	1.9	1.9	1.4	1.9	2.2	2.2
2.2 Amortization	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
3 Privatization receipts	**1.0**	**0.0**	**1.9**	**4.3**	**1.7**	**1.7**	**0.9**	**0.4**	**0.4**	**0.4**
Memorandum items:										
Gross wage bill on a commitment basis	11.2	10.3	10.8	11.5	10.9	10.8	9.8	10.0	10.0	9.9
Nominal GDP (Euro million)	1,049	1,049	1,250	1,250	1,400	1,400	1,375	1,475	1,475	1,475

Source: Montenegrin Ministry of Finance.

1/ After 2002 includes sales taxes that were earlier redirected to Pension Fund, Railway and Army; and assumes full payment of payroll tax by the government to itself on behalf of its employees.

2/ 2004 includes previously off-budget revenue and spending, most of which represents an excise surtax on petrol products to finance transportation sector project spending.

3/ From 2003, the reported wage bill excludes wages of employees of the University of Montenegro; these are now included in "Transfers".

4/ The revised projections for 2003 and 2004 reflect a carried-over SAC disbursement from Dec 2003 and delayed interest payments to the World Bank paid in January 2004. The increase in program loans relative to the 2004 budget is assumed to decrease net domestic credit to the government by a comparable amount. A fiscal gap of 10.2 million arising mostly from revised revenue projections is closed by 4.5 and 5.7 million in revenue and expenditure measures, respectively.

5/ PIT and social contribution rates reduced in two 5-percent steps on July 1, 2004, and December 1, 2004.

Table 8. Serbia and Montenegro: Macroeconomic Framework, 2000–05

	2000	2001	2002	2003	2004	2005
				Prel. Est.	Rev. Prog.	
GDP (DIN billion)	382	772	1,007	1,193	1,354	1,504
			(Percent change)			
End-period inflation (RPI)	113.5	39.0	14.2	7.8	8.5	5.0
GDP	5.0	5.5	4.0	3.0	4.4	4.5
			(In percent of nominal GDP)			
Gross domestic savings	-2.7	-7.2	-7.0	-7.0	-4.0	-2.6
Non-government	-4.4	-7.8	-6.9	-6.8	-5.7	-6.1
Government	1.6	0.6	-0.1	-0.2	1.7	3.5
Net factor receipts and transfers from abroad	13.0	16.3	14.2	12.5	11.2	11.6
Non-government	12.3	15.6	14.6	13.9	12.7	13.2
Government	0.7	0.7	-0.3	-1.4	-1.4	-1.6
Gross national savings	10.3	9.1	7.2	5.5	7.3	9.0
Non-government	7.9	7.8	7.6	7.2	7.0	7.0
Government	2.4	1.3	-0.4	-1.7	0.2	1.9
Gross domestic investment 1/	14.2	13.6	16.1	15.7	16.8	17.5
Non-government	12.2	11.7	12.2	13.3	13.7	13.4
Government	3.1	1.6	3.6	2.2	2.9	4.0
Savings-investment balance 1/	-3.9	-4.6	-8.8	-10.2	-9.6	-8.5
Non-government	-4.3	-3.9	-4.6	-6.1	-6.7	-6.3
Government	-0.7	-0.3	-4.0	-3.9	-2.7	-2.1
Foreign savings	3.9	4.6	8.8	10.2	9.6	8.5
Foreign savings including official grants	7.1	9.7	12.8	12.6	11.0	10.0
Net exports of goods and services	-16.9	-20.9	-23.1	-22.7	-20.8	-20.1

Sources: Data provided by the Federal Bureau of Statistics; Ministry of Finance; and IMF staff projections.

1/ Components do not add up to the total as a result of inventory changes.

Table 9. Serbia and Montenegro: Indicators of Capacity to Repay the Fund, 2000–11

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
				Projections								
Fund repurchases and charges 1/												
In millions of SDRs	…	7.9	10.3	12.2	168.4	158.0	42.5	64.8	129.8	187.1	172.5	102.7
In millions of U.S. dollars	…	10.2	13.3	17.1	249.3	233.8	59.1	89.8	179.2	258.3	238.2	141.8
In percent of exports of goods and NFS	…	0.4	0.4	0.4	5.2	4.4	1.0	1.4	2.5	3.3	2.8	1.5
In percent of debt service	…	9.6	7.3	3.9	24.6	19.0	4.9	5.4	8.7	11.5	10.8	6.8
In percent of quota	…	1.7	2.2	2.6	36.0	33.8	9.1	13.8	27.8	40.0	36.9	22.0
In percent of gross official reserves	…	0.9	0.6	0.5	6.9	5.5	1.3	2.0	4.0	5.6	4.7	2.7
Fund credit outstanding												
In millions of SDRs	116.9	216.9	416.9	616.9	621.0	668.8	641.7	591.7	475.0	297.9	131.3	31.3
In millions of U.S. dollars	154.2	280.2	539.9	864.3	919.0	989.8	892.9	820.3	655.7	411.2	181.2	43.1
In percent of quota	25.0	46.4	89.1	131.9	132.8	143.0	137.2	126.5	101.6	63.7	28.1	6.7
In percent of GDP	1.8	2.4	3.4	4.2	3.9	4.2	3.6	3.2	2.4	1.4	0.6	0.1
In percent of gross official reserves	29.9	24.0	23.7	24.3	25.5	23.3	20.1	18.6	14.5	8.8	3.6	0.8
Memorandum items:												
Exports of goods and NFS (millions of US$)	2,547	2,743	3,241	3,970	4,767	5,373	6,001	6,614	7,242	7,932	8,641	9,409
Debt service, after debt relief (millions of US$)	56	107	183	436	1,014	1,228	1,217	1,662	2,060	2,241	2,215	2,071
Quota (millions of SDRs)	468	468	468	468	468	468	468	468	468	468	468	468
Quota (millions of US$)	617	604	606	655	692	692	651	648	646	646	646	646
Gross official reserves (millions of US$)	516	1,169	2,280	3,550	3,600	4,248	4,453	4,418	4,518	4,648	5,093	5,329
GDP (millions of US$)	8,603	11,577	15,681	20,729	23,323	23,550	24,625	25,890	27,811	29,871	32,082	34,500
U.S. dollar per SDR	1.32	1.29	1.29	1.40	1.48	1.48	1.39	1.39	1.38	1.38	1.38	1.38

Sources: SM authorities; and IMF staff estimates.

1/ Arrears to the Fund of SDR 101 million were cleared on December 20, 2000. Projections are based on repurchase expectations to ensure consistency with other tables.

Table 10. Serbia and Montenegro: Stock of External Debt at December 31, 2003 1/
(In millions of U.S. dollars)

Creditor	Total Debt	*Of which:* Arrears 2/ Principal	Interest	Late Interest	Total Arrears
Total Debt	14,303	2,884	1,436	814	5,134
Multilateral institutions	4,968	99	84	76	259
IMF	913	0	0	0	0
IBRD	2,607	0	0	0	0
IDA	282	0	0	0	0
EUROFIMA	167	0	0	0	0
IFC	288	99	84	76	259
EIB	212	0	0	0	0
European Community	331	0	0	0	0
EUROFOND - CEB	35	0	0	0	0
EBRD	131	0	0	0	0
Offical Bilateral Creditors	3,650	232	161	87	479
Paris Club	3,007	0	1	0	1
Other official bilateral creditors	643	232	160	87	478
Commerical Creditors	4,630	1,746	1,082	652	3,479
London Club	2,738	1,141	958	315	2,414
Other commercial creditors: convertible currencies 3/	1,708	446	98	337	881
Other commercial creditors: nonconvertible currencies 3/	184	159	26	0	184
Short-term Debt 3/	1,056	807	109	0	917
Trade credits on oil & gas imports 4/	520	411	109	0	520
Other short-term debt	536	396	0	0	396

Sources: SM authorities, and IMF staff estimates.

1/ Debt figures reflect the effect of the debt rescheduling agreement of November 2001, which envisaged phased NPV reductions in Paris Club debt of 66 percent in total (of which 51 percent came into force upon approval of the current Extended Arrangement in May 2002).
2/ Regular and late interest calculated in accordance with terms of original agreements.
3/ Debt is not owed by government and does not have government guarantees.
4/ Overdue obligations (trade credits) owed to oil and gas enterprises in Russia and China.

Table 11. Serbia and Montenegro: Indicators of External Vulnerability, 1997–2003 1/
(In percent of GDP, unless otherwise indicated)

	1997	1998	1999	2000	2001	2002	2003
Financial indicators							
Public sector debt	…	…	…	119.1	123.2	84.5	76.6
Broad money (percent change, 12-month basis)	23.9	69.4	67.6	61.4	76.6	78.0	28.6
Private sector credit (percent change, 12-month basis)	…	…	128.4	68.6	7.6	49.6	25.1
Weighted interest rates (percent per month, December) 2/	6.3	7.0	3.9	6.8	3.8	2.4	2.1
Retail prices (percent change per annum, end of period)	…	…	49.9	113.5	39	14.2	7.8
External Indicators							
Exports (recorded exports, percent change, 12-month basis in US$)	19.5	24.0	-44.7	14.7	10.4	19.5	19.6
Imports (percent change, 12-month basis in US$)	17.0	1.0	-32.0	14.4	30.4	30.7	25.9
Current account balance, before grants	-7.7	-4.8	-7.5	-7.1	-9.7	-12.8	-12.6
Current account balance after grants and FDI	-3.3	-3.9	-6.4	-3.6	-3.1	-5.2	-3.5
Errors and omissions	-0.6	2.0	4.0	3.1	2.1	2.0	2.9
Gross official reserves (in US$ million)	…	326	293	516	1,169	2,280	3,550
(in months of imports GS of the following year)		1.1	0.9	1.2	2.4	3.2	4.4
Central Bank short-term foreign liabilities (in US$ million) 3/	…	0	0	0	0	100	100
Gross reserves of the banking system (in US$ million)	…	774	659	882	1,809	3,063	4,436
(in months of imports GS of the following year)		2.6	1.9	2.1	3.2	4.2	5.5
Short term foreign liabilities of the commercial banks (in US$ million)	…	…	…	349	59	74	136
Foreign currency liabilities of the commercial banks (in US$ million)	…	…	…	871	775	1,483	2,451
Official reserves/Broad money (M2) (percent)	…	18	30	50	0	74	79
Official reserves/reserve money (percent)	…	59	126	164	0	199	262
Short term external debt by original maturity (in US$ million) 4/	1,048	1,021	987	1,153	1,026	1,020	1,056
Short term external debt by remaining maturity (in US$ million) 4/	1,073	1,038	1,001	1,186	1,069	1,224	1,597
Short term external debt to reserves by original maturity (in percent)	...	313.1	337.0	223.4	87.7	44.7	29.7
Short term external debt to reserves by remaining maturity (in percent)	...	318.3	341.7	229.8	91.4	53.7	45.0
Share of short term external debt to total debt by original maturity (in percent)	10.7	9.7	9.2	10.1	8.6	8.6	7.4
Share of short term external debt to total debts by remaining maturity (in percent)	11.0	9.8	9.3	10.4	8.9	10.3	11.2
Total external debt (in US$ millions)	9,770	10,539	10,744	11,403	11,948	11,839	14,303
Of which : Public and publicly guaranteed debt 5/	8,722	9,518	9,757	10,250	10,922	10,919	13,348
Total external debt (in percent of exports of G&S)	...	267	500	448	436	365	360
External interest payments, cash basis (in percent of exports of G&S)	…	…	…	1.6	2.7	4.3	5.8
External amortization payments, cash basis (in percent of exports of G&S)	…	…	…	0.0	1.2	1.3	5.1
Exchange rate, official (per euro, end of period)	3	12	12	59	61	61.5	68.2
Exchange rate, parallel (per euro, end of period)	5	16	21	30	31	61.5	68.2
REER (annual average, February-December 1994 = 100) 6/	100.4	91.7	66.9	51.4	82.0	91.5	96.4

Sources: SM authorities; and IMF staff estimates.

1/ All stocks are measured end-of-period. Excludes Kosovo, except for external debt.
2/ Weighted average of interest rates on commercial paper, bank bills, and certificates of deposit.
3/ Excluding IMF and liabilities to domestic residents. In 2002, the NBS assumed short-tem external debt of commercial banks of $100 million.
4/ Includes overdue obligations on debt related to imports of oil and gas. Short-term external debt by remaining maturity also includes amortization due in the following year on medium- and long-term debt.
5/ Assuming all long- and medium-term external debt of banks and enterprises is government guaranteed.
6/ Increase denotes appreciation.

Table 12. Serbia and Montenegro: Proposed Schedule of Purchases Under the Extended Arrangement

	Available on or after	Amount of Purchase: In millions of SDRs	Amount of Purchase: In percent of quota 1/	Conditions/Status
1.	May 14, 2002	50.0	10.7	Purchased.
2.	August 15, 2002	50.0	10.7	Purchased.
3.	November 15, 2002	50.0	10.7	Purchased.
4.	February 15, 2003	50.0	10.7	Purchased.
5.	May 15, 2003	50.0	10.7	Purchased.
6	August 15, 2003	50.0	10.7	Purchased.
7.	November 15, 2003	50.0	10.7	Observance of end-September 2003 performance criteria and completion of the third semi-annual review (including financing assurances review).
8.	February 15, 2004	50.0	10.7	Observance of end-December 2003 performance criteria and completion of financing assurances review.
9.	August 15, 2004	62.5	13.4	Observance of end-June 2004 performance criteria and completion of the fourth semi-annual review (including financing assurances review).
10.	November 15, 2004	62.5	13.4	Observance of end-September 2004 performance criteria and completion of the fifth semi-annual review (including financing assurances review).
11.	February 15, 2005	62.5	13.4	Observance of end-December 2004 performance criteria and completion of financing assurances review.
12.	April 30, 2005	62.5	13.4	Observance of end-March 2005 performance criteria and completion of the sixth semi-annual review (including financing assurances review).
	Total	650.0	139.0	

1/ The quota is SDR 467.7 million.

Table 13. Serbia and Montenegro: Millenium Development Goals

	1990	1995	2001	2002	2015 Target
Goal 1: Eradicate extreme poverty and hunger					
Target: Halve between 1990 and 2015 the proportion of people suffering from hunger					
1. Prevalence of child malnutrition (percent under age 5)	...	...	2.0	...	...
Goal 2: Achieve universal primary education					
Target: Ensure by 2015 that children can complete a full course of primary education					
1. Net primary enrollment ratio (percent)	69.4	...	...	...	...
Goal 3: Promote gender equality and empower women					
Target: Eliminate gender disparity in primary and secondary education by 2015					
1. Ratio of girls to boys in primary education	95.8	96.0	...	...	...
2. Proportion of seats held by women in national Parliament	...	...	5.0	7.0	...
Goal 4: Reduce child mortality					
Target: Reduce by two thirds between 1990 and 2015, the under-five mortality rate					
1. Under five mortality rate (per 1,000 births)	26.2	19.4	19	14.8	...
2. Infant mortality rate (per 1,000 births)	22.8	16.8	17.0	12.1	...
3. Immunization, measles (% o children under 12 months)	83.0	86.0	90.0	...	...
Goal 5: Improve maternal health					
Target: Reduce by three quarters between 1990 and 2015 the maternal mortality ratio					
1. Births attended by skilled health care professionals	...	92.6	98.9	...	...
2. Maternal mortality ratio (per 100,000 births)	...	15.0	...	...	...
Goal 6: Combat HIV/AIDS, malaria and other diseases					
Target: Halt by 2015, and begin to reverse the spread of major diseases					
1. Incidence of turberculosis (per 100,000 people)	...	...	44.8	...	...
Goal 7: Ensure future environmental sustainability					
Target: Integrate principles of environmental sustainability into policies and programs					
1. CO2 emissions (metric tons per capita)	12.4	4.6	3.7	...	...
2. Access to improved water source (percent of population)	...	...	98.0	...	...
3. Access to improved sanitation (percent of population)	...	...	100.0	...	...
Goal 8: Develop a global partnership for development					
Targets: Make available new information technologies, affordable essential drugs and implement strategies for productive work for youths.					
1. Fixed line and mobile telephones (per 1,000 people)	...	198.2	415.9	...	...
2. Personal computers (per 1,000 people)	...	14.2	23.4	...	...

SERBIA AND MONTENEGRO: FUND RELATIONS

As of March 31, 2004

I. **Membership Status:** Succeeded to membership of SFRY on December 20, 2000; Article VIII

II. **General Resources Account:**	SDR Million	%Quota
Quota	467.70	100.00
Fund Holdings of Currency	1,057.52	226.11

III. **SDR Department:**	SDR Million	%Allocation
Net cumulative allocation	56.66	100.00
Holdings	13.20	23.29

IV. **Outstanding Purchases and Loans:**	SDR Million	%Quota
Stand-by arrangement	300.00	64.14
Extended arrangements	289.81	61.96

V. **Financial Arrangements:**

Type	Approval Date	Expiration Date	Amount Approved	Amount Drawn
EFF	5/14/02	5/13/05	SDR 650.0 million	SDR 300.0 million
Stand-by	6/11/01	5/31/02	SDR 200.0 million	SDR 200.0 million
Emergency Post-Conflict Assistance	12/20/00		SDR 116.9 million	SDR 116.9 million

VI. **Projected Obligations to Fund:**
Under the Repurchase Expectations Assumptions[1] (In millions of SDR)

	Forthcoming				
	2004	2005	2006	2007	2008
Principal	50.10	139.71	85.42	43.75	50.00
Charges/Interest	10.12	11.71	8.79	7.16	6.21
Total	60.22	151.43	94.21	50.91	56.21

[1] This schedule presents all currently scheduled payments to the IMF, including repayment expectations where applicable and repayment obligations otherwise. The IMF Executive Board can extend repayment expectations (within predetermined limits) upon request by the debtor country if its external payments position is not strong enough to meet the expectations without undue hardship or risk.

VII. Safeguards Assessments:

Under the Fund's safeguards assessment policy, the National Bank of Yugoslavia (now NBS) was subject to a safeguards assessment with respect to the Extended Arrangement approved on May13, 2002, which is scheduled to expire on May 13, 2005. A safeguards assessment of the NBY was completed on November 29, 2001. The assessment concluded that substantial risks may exist in the financial reporting framework, internal audit mechanism, and system of internal controls as reported in IMF Country Report No. 02/105. The proposed remedies by the mission are being implemented.

VIII. **Exchange Arrangement**

Serbia and Montenegro (SM) accepted the obligations under Article VIII as of May 2002. The currency of Serbia is the Serbian dinar. On January 1, 2001, Serbia adopted a managed float system. During 1994–99, the dinar was officially pegged to the DM; for most of the period, multiple exchange rates were in effect. Montenegro has adopted the euro as its sole legal tender.

IX. **Last Article IV Consultation**

The last Article IV consultation was held on May 13, 2002.

X. **Technical Assistance During the Past 12 Months**

Department	**Timing**	**Purpose**
STA	May 2004	Money and financial statistics
MFD	Nov 2003	Banking supervision, domestic payments system, and monetary operations
FAD	Oct 2003	Modernizing revenue administration and preparing for VAT implementation
STA	Sep 2003	Balance of payments statistics
MFD	May 2003	Establishing the infrastructure for a market-based financial system

Technical assistance missions during the past 12 months from FAD, MFD and STA have contributed significantly to tax administration and treasury management; to the creation of a market-based financial system; and to improved statistical data provision, respectively. At this stage of Serbia and Montenegro's reforms, they have primarily focused on institution-building. The FAD mission reviewed the plan for modernizing the tax administration and implementing the VAT, and recommended that (i) the tax policy role of different revenue agencies be more clearly delineated, (ii) taxpayer services and compliance programs be strengthened based on segmenting the taxbase, (iii) preparations for implementing the VAT include raising the turnover threshold, greater reliance on taxpayer self-assessment supported by risk-based field audits and more extensive use of IT resources. The MFD recommendations were key to (i) implementing successfully the pivotal payments system reform at the beginning of 2003, (ii) developing market-based instruments for monetary operations, (iii) improving public sector debt management, (iv) providing a clear focus to future work on enhancing banking supervision practices and (v) outlining positive directions for NBS reorganization. The STA mission provided an action plan to prioritize implementation of its recommendations, including measures to improve coverage, valuation, classification and enhancing the bank reporting system.

XI. **Resident Representative**

Mr. Joshua Charap took up his position as Resident Representative in March 2001.

SERBIA AND MONTENEGRO: IMF-WORLD BANK RELATIONS

Partnership in Serbia and Montenegro's Development Strategy

1. 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 International Bank for Reconstruction and Development (IBRD). FRY membership in the International Development Association (IDA) was confirmed on June 11, 2001. Following constitutional changes, FRY completed its transition to Serbia and Montenegro (SM) on February 4, 2003. The government of SM and its two constituent republics of Serbia and Montenegro have highlighted progress in structural reform and stabilization, and outlined their medium-term development strategies in their respective Poverty Reduction Strategy Papers (PRSP). The Joint Staff Assessment (JSA) of the PRSP was endorsed by the IMF Board on March 2 and by the Bank's Board of Directors on March 16, 2004.

2. In the context of a program supported by a three-year Extended Arrangement (EA) the IMF takes the lead on macroeconomic (fiscal, monetary, and exchange rate) policies aimed at facilitating sustainable growth. In addition to macroeconomic targets, the Fund has established structural performance criteria and benchmarks in areas such as tax administration, payments system reform, banking reform, financial markets, foreign trade policy, and energy tariffs. Working together with bilateral donors, the Fund has also provided technical assistance in the first three areas.

3. As outlined more fully below, the Bank has complemented the Fund's work through its support to structural reforms. In areas of direct interest to the Fund, the Bank leads the policy dialogue in: (i) public expenditure management; (ii) macroeconomically important sectoral reforms (e.g. in the energy sector), (iii) pension, health and social assistance reform; (iv) the restructuring and privatization of enterprises; and (v) legal reforms with a bearing on the business environment, including labor markets. The Bank and Fund have jointly led the policy dialogue in the financial sector, including on the restructuring and privatization of banks, and in foreign trade. The Bank's program of investment lending, representing about 20 percent of planned commitments and covering a range of sectors, is described more fully below.

World Bank Group Strategy

4. The World Bank Group's operations assist the government in achieving its overall goals of: (i) restoring macroeconomic stability and external balance; (ii) stimulating near-term growth and creating the basis for a sustained supply response; (iii) improving social well-being of the most vulnerable and building human capacity; and (iv) improving governance and building effective institutions.

5. The first stage of World Bank assistance commenced even before SM's membership. In view of its urgent needs, and concurrent with the arrears clearance process, the Bank established in May 2001 a Trust Fund for FRY (TFFRY) using US$30 million of IBRD

surplus net income to provide grant financing for selected priority activities. Five grants totaling US$30 million have been approved under the TFFRY and are currently under implementation. These grants, which were important in laying the foundations for the IDA-financed program, included (i) a private sector technical assistance grant for Serbia, (ii) a financial sector technical assistance grant for Serbia, (iii) a social protection grant for Serbia; (iv) an electric power emergency reconstruction grant for Serbia, and (v) an environmental infrastructure grant for Montenegro.

6. The second stage of assistance began on May 8, 2001, when the Bank's Board of Directors endorsed a first Transitional Support Strategy (TSS) for SM.[1] The TSS contained a three-year IDA envelope of up to $540 million for SM on a temporary and exceptional basis, with actual lending to depend upon performance against agreed benchmarks. It was envisaged that up to 80 percent of the program could support policy-based lending. A first year program of lending, economic and sector work and technical assistance was outlined. The Transitional Support Strategy Updates were discussed by the Bank's Board on August 8, 2002 and March 16, 2004. These reviews confirmed the overall approach (including the focus on policy-based lending). A three year Country Assistance Strategy (CAS), developed jointly with the IFC and based on the PRSP, would be finalized at end calendar year 2004.

7. Given the extensive de jure and de facto devolution of responsibility for economic policy to the member state level, the program of adjustment lending is focused at this level. So far, five operations have been approved. In Serbia, a multi-sectoral Structural Adjustment Credit (SAC) (approved in January 2002) was designed to enhance fiscal sustainability through reforms of public expenditure management, the energy sector, social protection, labor markets, and health care. A Social Sector Adjustment Credit (approved in April 2003), supports further reforms in pensions, health and labor, while enhancing the focus on social assistance and poverty monitoring. Parallel Private and Financial Sector Adjustment Credits (PFSAC I and II, approved May 2002 and June 2003) focus on the growth promotion agenda, assisting the government in: (i) strengthening the financial system through the liquidation of troubled banks and an improved policy and regulatory environment; (ii) privatizing and restructuring socially-owned enterprises; and (iii) improving the investment and business climate. Discussions with the Serbian authorities for a second multisectoral SAC during FY05 are under way, with the focus on improving the business environment, further rehabilitating the energy sector, enhancing social protection and fostering stronger public administration. In Montenegro, the multi-sectoral Structural Adjustment Credit approved in August 2002 was completed with a final disbursement in January 2004. It supported reforms critical to fiscal sustainability as well as economic growth in the areas of public expenditure

[1] A plan to clear SM's arrears to the World Bank was approved with the membership packages that provided for the exceptional consolidation of SM's arrears and principal not yet due into a new package of IBRD loans. These Consolidation Loans were approved by the Board on December 13, 2001, and became effective in early-January 2002.

management, pensions, energy, labor markets, and the business environment. Discussions with the Montenegrin authorities are at an advanced preparation stage for a second multi-sectoral SAC for FY05, focusing on key areas to enhance growth potential, including reforms to the financial, energy, pension, health and public administration sectors.

8. The Bank's program of adjustment lending has been underpinned by analytical studies. In June 2001, the Bank, working together with the European Commission and the federal and republican governments, completed an Economic Recovery and Transition Program (ERTP), which was presented to the Donor Conference held the same month.[2] In 2002, the Bank focused on three complementary studies—a Public Expenditure and Institutional Review (PEIR), a Country Financial Accountability Assessment (CFAA), and a Country Procurement Assessment Review (CPAR). Studies of the agricultural (Serbia) and environmental sectors (both republics) were also completed. The Bank is now focusing its analytical work on improving the monitoring and analysis of poverty. Poverty Household Surveys for both republics laid the foundations for a Poverty Assessment, completed in 2003. The Bank is finalizing an Economic Memorandum for Serbia focusing on the agenda for sustained growth and employment creation. An Economic Memorandum for Montenegro will be undertaken in FY05. Initial Diagnostic Notes on Public Administration are being finalized for both republics and notes on the financial sector and privatization program are in progress for Serbia, as is an Investment Climate Assessment for Serbia.

9. In both republics, a program of selective investment lending has been designed to assist the authorities to tackle critical impediments to effective public sector management and private sector development, improve social policy and underpin reforms initiated under the Bank-supported adjustment programs. A Trade and Transport Facility for Southeast Europe and an Export Finance project have been approved which cover both Serbia and Montenegro's needs. In addition, IDA is supporting a Serbian Education project, a Serbian Enterprise and Bank Restructuring Technical Assistance operation, a Serbia Health Reform operation, a Serbia Employment Promotion Learning and Innovation Credit, a Serbia Energy Efficiency Project, a Montenegro Environmental Improvement project and a Montenegro Energy Efficiency Learning and Innovation Credit. For FY04, four investment projects are in the final stages of preparation (Serbia Transport Rehabilitation, Serbia Real Property Registration and Cadastre, and Montenegro Pensions Systems Improvement and Montenegro Health Sector Reform operations). As of end-May 2004,13 IDA credits totaling about $404 million had been approved for SM, with adjustment support comprising the majority.

10. Since SM became a member of IFC in May 2001, 5 projects have been committed, three in the financial markets and two in manufacturing, totaling for about US$42 million. In addition to a robust pipeline in both the financial and real sectors, IFC has developed a technical assistance program for institutional strengthening (insurance sector, leasing,

[2] *Federal Republic of Yugoslavia—Breaking with the Past: The Path to Stability and Growth*, World Bank Report No. 22267-YU.

banking). It has completed or is implementing 15 technical assistance assignments ranging from the energy sector to garments, light engineering, health and education. MIGA has initiated programs in two areas: (i) guarantees for projects in SM (as of 31 May 2003, MIGA has issued guarantees to 2 projects for a total gross exposure of US$17.3 million); and (ii) investment marketing services (MIGA is currently working with the Serbian Investment and Export Promotion Agency (SIEPA) to implement an investment promotion capacity building and outreach program, funded under a World Bank Technical Assistance Grant).

Joint Staff Assessment (JSA) of the Poverty Reduction Strategies

11. Bank and Fund staff collaborated to produce a joint assessment of the authorities' poverty reduction strategies as proposed in the PRSP of each republic. Bank staff took the lead in evaluating the structural measures to underpin poverty reduction, while Fund staff assessed the macroeconomic framework underlying the strategies. The JSA enumerates the strengths of the envisioned poverty reduction strategies, including the focus on harmonization to common EU standards, continuing privatization, improvements in the business environment, and policies to foster employment generation. Staff also found that the reports could usefully have relied on less optimistic assumptions regarding domestic savings, foreign financing inflows and the financing of poverty reduction programs, addressed crime and governance more directly, and provided a sharper sense of prioritization among possible projects. However, staff agreed that the envisioned market-oriented reforms will foster both continuing macroeconomic stability and considerable reduction in poverty looking ahead. As a result, staff recommended that their respective boards support the authorities' poverty-reduction strategies as credible development policies. Bank staff further recommended that the PRSPs represent an adequate basis for continued World Bank support.

Bank-Fund Collaboration in Specific Areas

12. As part of its overall assistance to SM, the Bank combines lending, analytical work and technical assistance to support policy reforms, with a focus on the following areas:

13. **Public expenditure management**. SM's weak systems of public financial management had long contributed to macroeconomic instability, a lack of transparency, and the inefficient use of public resources. In response, the governments of Serbia and Montenegro have prioritized reforms and institution building in this area. The Bank is taking the lead with a multi-pronged assistance program, which the Fund is complementing with policy conditionality and technical assistance. The Bank's program began with the completion in 2002 of the PEIR, CFAA, and CPAR (see above), which in turn helped to define significant public expenditure management components in the first SACs for Serbia and Montenegro. In Serbia, key reforms supported by the Bank included the adoption of the Law on the Budget System (Organic Budget Law), the first steps toward introducing a treasury system, and enhanced inspection, auditing and procurement procedures. In Montenegro, where legal and institutional reforms had reached a more advanced stage, key reforms include the establishment of a more comprehensive multi-year framework for budget preparation, continued implementation of the interim treasury system, and improvements in

the internal audit. Care is being taken to ensure consistency of the PRSP with available budgetary resources.

14. **Energy sector reform**. The combination of low power prices and collection rates, a decade of underinvestment and lack of maintenance, and war-related physical damage, led to power shortages and left SM with loss-making and inefficient electric utilities. As the largest single source of quasi-fiscal pressures, the power sector became an area of particularly close collaboration between the Bank and the Fund. While the Bank has taken the lead in developing the policy agenda, the sector's fiscal impact has also motivated limited but strong conditionality in successive Fund arrangements. The Bank program has combined support for policy reforms with investment loans/grants for critical needs in both Serbia and Montenegro, improved financial management and technical assistance. The SACs for both republics focused on improving the financial position of the republican power utilities through measures to enhance revenues (phased tariff increases and improved collections) or reduce operating costs (e.g. control of the wage bill). Progress in achieving tariff rate targets is being monitored closely both by the Bank and the Fund. In parallel, the electric power emergency reconstruction grant for Serbia under the TFFRY supported urgent repairs, improvements in the financial management of the electric power company, and legal and policy advisory services. The Bank hopes to provide continuing support to the sector in Serbia with the recently approved Energy Efficiency Credit and complementary Global Environmental Fund grant. The Montenegro Energy Sector Learning and Innovation Credit assesses consumer response to the introduction of remote electricity metering and introduce automated billing and demand side management, facilitate the eventual privatization of distribution services and lay the basis for institutional strengthening in the energy sector.

15. **Pension, health and social assistance reform**. The state pension systems of both Serbia and Montenegro account for about one-third of consolidated public spending, and pension spending as a share of GDP is high by regional standards. Chronic arrears on pension payments and large budgetary transfers to the pension funds in both republics were further evidence that reforms were required to improve pension system financial balance and overall medium-term fiscal sustainability. This created a synergy between Bank and Fund programs. The Bank has taken the lead, including initial pension reforms in its adjustment operations in both republics, and providing required technical assistance through the social protection grant under the TFFRY. The key elements of pension reforms were parametric adjustments to retirement ages and indexation rules which would bring immediate fiscal savings relative to the no reform scenario. The Fund has provided supporting fiscal analysis and included related structural benchmarks in its successive arrangements in SM. The SOSAC for Serbia supports the next reforms of the pay-as-you-go system, as well as preparatory steps for a more comprehensive revamping of the pension system. A Pension Systems Administrative Improvements Project is being prepared for Montenegro.

16. In Serbia, the SAC also included initial reforms of the health care system designed to begin restoring fiscal balance in that sector, as a basis for improving its functioning and ability to provide basic health care services for all citizens. To this end, the SAC supported the introduction of modest co-payments, adoption of a more limited essential drugs list, the

addressing of structural inefficiencies in the delivery system, and the laying of foundations for a new policy and legal framework. The SOSAC deepens this reform agenda. The Bank's involvement in the health care sector in Montenegro has to date focused on analytical work, most recently under the PEIR. A Montenegro health sector reform project is in its final stage of preparation.

17. In Serbia, the Bank's work on reforming other components of the social safety net began with conditionality and technical assistance under the social protection grant under the TFFRY. The SAC supported pilot reforms to enhance the equity and coverage of the main program of social assistance (the so-called Material Assistance to Families), to improve the management of donor funds for such programs, and to begin development of a new Law on Employment regulating benefits for unemployed workers. These reforms are now being completed and deepened under the SOSAC. The SAC for Montenegro also supported the enactment of a Law on Labor and Law on Employment.

18. **Restructuring and privatization of enterprises and banks**. Beginning in late 2000 in Serbia, and earlier in Montenegro, SM has been engaged in far-reaching reforms of the enterprise and financial sector. In Serbia, the initial focus in the enterprise sector was on creating a transparent legal and institutional framework for privatization to attract strategic investors. The agenda in the banking sector focused on the need to address the deep insolvency of the banking sector in a permanent and fiscally responsible fashion. The Bank and the Fund have worked closely together to support the needed policy reforms, with the Bank taking the lead on the enterprise sector and sharing leadership in the banking sector. The Bank program has combined sectoral adjustment credits focused on these themes with parallel projects to provide technical assistance. The Bank has worked closely with the Fund to formulate the benchmarks in PFSAC I and II which complement and reinforce the elements of the EA related to financial sector strengthening. Fund conditionality under the EA has focused on facilitating a brisk pace for privatization, ensuring that all privatization proceeds flow transparently through the budget, and putting in place control mechanisms in banks prior to their privatization. Under the TFFRY, the Bank provided early support through private and financial sector technical assistance grants. This work will be continued under the recently approved Privatization and Restructuring of Banks and Enterprises Technical Assistance Project. For reasons of selectivity and given the strong role of other donors, the Bank did not undertake a major involvement in these areas in Montenegro until early 2004. The proposed second SAC for Montenegro would support selective reforms in the financial sector including: (i) the resolution of non-performing assets carved out of the banking sector; (ii) bank privatization; and (iii) strengthening supervisory enforcement of the anti-money laundering regime.

19. **Legal reforms with a bearing on the business environment**. The Bank has taken the lead on business environment and general private sector development. The SAC for Montenegro supports the adoption and initial implementation of the enterprise law, bankruptcy law, and law on secured transactions. The PFSAC for Serbia supported enactment of laws on foreign direct investment and an SME agency, amendments to federal and republican enterprise laws, and preparation of a law on secured transactions. The PFSAC

II followed up by supporting the enactment of laws on concessions, leasing, and preparation of the draft bankruptcy law. In addition, the SACs in both republics emphasized reforms of the legal framework for the labor market, promoting employment creation through greater flexibility, and promoting the financial sustainability and effectiveness of unemployment benefit programs. This complements Fund conditionalities related to securities and accounting legislation, and rationalizing employment clauses in social programs associated with privatization and enterprise restructuring. In FY02, the Bank prepared an initial diagnostic study of Serbia's legal and judicial framework; a small grant supports the improvements in court administration.

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SERBIA AND MONTENEGRO: STATISTICAL ISSUES

1. Serbia and Montenegro's (SM) statistical database uses definitions that 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 the country was isolated from international developments. The authorities have, therefore, requested that the Fund send a mission to prepare the data module of the Report on the Observance of Standards and Codes (ROSC), which would include a comprehensive data quality assessment, as a basis for further technical assistance.

2. A multisector statistics mission visited Belgrade and Podgorica during July 10–31, 2002. The mission found that there was a critical need for Serbia and Montenegro to improve the quality of existing macroeconomic statistics by developing comprehensive data sources and by implementing sound statistical techniques. To streamline data compilation, federal statistics could be derived from information compiled on the two member states, without undertaking separate data collections, as is currently the case. To strengthen SM's statistical infrastructure, there is a need for relevant official agencies to work together in setting priorities, developing action plans, and coordinating statistical initiatives in a systematic manner. Except for monetary statistics for Serbia compiled by the National Bank of Serbia (NBS) as discussed in Section D below, SM does not report data to STA and does not have a page in *International Financial Statistics.*

A. Real Sector

3. Real sector statistics are compiled and published by the Federal Statistics Office (FSO), the Statistics Institute of Serbia (SIS), and the Statistics Institute of Montenegro (SIM). The FSO has been compiling national accounts statistics for the FRY, Serbia, and Montenegro since 1997. Current price estimates of GDP by activity and by expenditure approach are available for 1997–2001. In addition, a full sequence of accounts (generation of income account, allocation of primary income account, secondary distribution of income account, use of income account, and capital account) for the total economy and by institutional sectors is also available for 1997–2001. Generally, the methodology follows the *System of National Accounts (1993 SNA),* but there are problems with the scope of the accounts and the basis for recording that are not broadly consistent with the international standards. Also, the data sources are in need of improvement, given the closure, from January 8, 2003, of the Clearing and Payments Service of Yugoslavia (ZOP), which used to collect information from annual balance sheets and profit/loss statements from all legal entities. This was a key input to the national accounts. The statistics techniques used for the national accounts compilation need further improvement. A major problem is the lack of estimates for the informal activities. The coverage of labor force statistics is similarly impaired by incomplete sampling of informal sector activities. Statistical agencies are aware that improvements are needed, particularly in source data. These issues are being addressed in a master plan for the improvement of economic statistics, which is being developed with the assistance of EUROSTAT.

4. The FSO and SIS compile and disseminate, respectively for the union and Serbia, retail price indices (RPI), cost of living indices (COLI), producer price indices (PPI), and unit-value price indices for imports and exports. In Montenegro, the SIM compiles a RPI while the Institute for Strategic Studies and Prognoses, a nonprofit institution, also publishes its own series based on surveys of household consumption. While the frequency and methodology of observation appear adequate, weighting, data storage, and dissemination could be improved.

B. Balance of Payments

5. Balance of payments statistics are currently compiled by the NBS and the Central Bank of Montenegro (CBM). Principal data sources are customs data on merchandise trade as processed by the FSO and information of foreign exchange transactions provided by banks and exchange bureaus. These are complemented by data from the Ministry of International Economic Relations on external grants and loans. The NBS keeps appropriately detailed records of external debt held by commercial banks, the government and itself. While the data compilation procedures appear appropriate, some components of the balance of payments suffer from substantial under recording owing to the large proportion of foreign exchange transactions carried outside official channels. Since 2001, the NBS has expended commendable efforts to improve its estimation of actual flows based on existing data. There has been some improvements since a new reporting system was implemented in October 2002 for commercial banks, although better coverage and classification of transactions remain key issues. In addition, the NBS could improve coverage, valuation and classification by adjusting trade data for transactions that are not explicitly declared (such as repairs, shuttle trade and grants in kind), removing exchange-rate changes from certain financial transactions, including arrears below the line, and assuring consistency of reserve assets with the monetary statistics.

6. However, the union's balance of payments statement is incomplete because not all information covers both constituent states and the statement shows large net errors and omissions. The NBS has begun compiling a balance of payments statement for Serbia by using existing information from the Union's statement, adjusted for imports and exports of Montenegro and financial flows pertaining to transactions between the two constituent states covered under the financial account of the union's statement. The CBM has begun compiling a similar statement for Montenegro. Close coordination between the NBS and the CBM will be needed to compile balance of payments data for the Union.

C. Government Finance

7. Fiscal statistics for Serbia are compiled by the Serbian Ministry of Finance and for Montenegro by the Montenegro Ministry of Finance. Principal data sources are the budget execution reports of the spending ministries and first-level budget units and—until end-2002—ZOP reports. Revenue data are more timely and reliable than expenditure data, which are compiled with longer delays, although the implementation of the Treasury in both member states has brought improvements.

8. Data on the general government are not compiled, but, several initiatives will permit eventual development of these statistics. These include: (1) new budget laws that provide ministries of finance with the legislative authority for budget execution, borrowing, issuing of guarantees, debt management, and budget accounting and reporting for all levels of government in the republics; (2) the establishment of a Treasury in Montenegro and in Serbia, which will facilitate the collection of sound source data for government finance statistics; and (3) the application of classifications set forth in the government Finance Statistics Manual 2001(GFSM 2001) by the Serbian and Montenegrin Ministries of Finance for producing data on central government operations.

9. During 2001, the government in Serbia made an effort to bring the existing budget reporting system in line with GFS methodology, but full compliance will require, *inter alia,* full implementation of the new chart of accounts (generally consistent with the classifications of the *GFSM 2001*). Data on expenditure arrears are less reliable due to the lack of basic treasury functions in the existing system of expenditure management.

10. Fiscal data for the central government of Montenegro are based on the new GFS classification. Data for the social security funds are reported directly by the funds and are available only with delays and are not based on GFS classification. A new chart of accounts was introduced in Montenegro in 2001 and needs to be fully implemented at the local level. No data are available for local governments.

11. The multisector mission recommended that (1) data on member states be consolidated to produce information for the union in accordance with international guidelines; (2) mechanisms be developed quickly to ensure the availability of source data for the compilation of government finance statistics following the discontinuation of data provision by the Clearing and Payments Service of Yugoslavia (ZOP) from January 8, 2003; (3) new charts of accounts be adopted at all government levels; (4) the classification of government debt be improved; and (5) government finance statistics be compiled and disseminated to the public and reported to STA for publication in the International Financial Statistics (IFS) and the government Finance Statistics Yearbook.

D. Monetary Accounts

12. Monetary and financial statistics are compiled by the NBS and the CBM following broadly the methodology set forth in the *Monetary and Financial Statistics Manual.* The July 2002 multisector statistics mission found that the authorities had made good progress in implementing the recommendations of the 2001 and 2002 STA missions. Nevertheless problems persist related to inadequate disaggregation of the resident sector, especially the government sector, and the lack of clearly defined criteria for distinguishing residents and nonresidents in monetary statistics. Although there is a methodological break for data prior to January 2002, the chart of accounts used since January 2002 will facilitate the production of consistent time series in the future. The NBS and CBM plan to introduce changes to their charts of accounts to provide additional details for the government sector, thereby increasing the accuracy and reliability of the data. During March 2003, STA provided extensive

comments to the NBS authorities on their draft new chart of accounts for the commercial banks. With reference to periodicity and timeliness of data for the financial sector, both the NBS and the CBM meet the GDDS recommendations.

13. For the first time in over a decade, in November 2002, the NBS began reporting to STA monetary statistics for the Republic of Serbia. The data included monthly data for January 2002–October 2002, annual data for 1998–2000 and quarterly data for 2001 on analytical accounts of the NBS, other depository corporations, and the banking system, as well as data on interest rates, compiled based on the recommendations made by STA missions on monetary and financial statistics in 2001 and 2002. In March 2003, the NBS sent to STA monetary statistics for December 2002.

Serbia and Montenegro: Core Statistical Indicators
(As of May 15, 2004)

	Exchange rates	International Reserves	Central Bank Balance Sheet	Reserve Money	Broad Money	Interest Rates	Retail Price Index	Exports/ Imports	Current Account Balance	Government Balance	Gross Domestic Product	External Debt/ Debt Service
Date of Latest Observation	May 13, 2004	May 13, 2004	May 13, 2004	May 13, 2004	May 13, 2004	May 13, 2004	Apr 2004	Jan-Feb 2004	Dec 2003	Jan-Mar, 2004	2001	Dec 2003
Date Received	May 13, 2004	May 13, 2004	May 13, 2004	May 13, 2004	May 13, 2004	May 13, 2004	Apr 30, 2004	Apr 30, 2004	Mar 2004	Apr 30, 2004	Sep. 2003	March 16 2003
Frequency of Data	Daily	Daily	Monthly	Daily	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Annually	Annually
Frequency of Reporting	Daily	Daily	Monthly	Weekly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Annually	Annually
Source of Update	NBS	NBS	NBS	NBS	NBS	NBS	SBS	SBS	NBS	Ministries of Finance of Serbia and Montenegro	SBS	NBS
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	NBS
Confidentiality	Public	Confidential	Confidential	Confidential	Public	Public	Public	Public	Public	Public	Public	Confidential
Frequency of Publication	Daily	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Annually	Annually	Annually

Serbia and Montenegro: External Debt Sustainability Analysis

This note updates the debt sustainability analysis in IMF Countr Report No 03/296.

A. Medium-Term Balance of Payments projections

The baseline scenario assumes that: (a) exports will grow at an annual average of 15 percent in the first three years and 10 percent in the following five years in dollar terms (about 11 percent and 10 percent in euro terms); (b) imports will grow at an average rate slightly higher than nominal GDP in the next eight years (around 5.5 percent in euro terms);[1] (c) the FDI inflows in 2003 were unusually high on account of the success in the privatization program; the privatization process is expected to continue in the next two years, albeit on a smaller scale. Other types of FDI, including greenfield investment and equity investment and reinvestment on existing companies, will rise steadily, reflecting progress in privatization and improving business environment; (d) commercial borrowing will increase steadily as the business environment improves; (e) official borrowing will increase moderately, with declining program support being offset by increasing project support; (f) there will be no IMF support after the current arrangement; (g) payments to London Club creditors and non-Paris Club official creditors will start in late 2004 following agreements with these creditors on terms comparable to those granted by the Paris Club; (h) gross international reserves will remain at the equivalent of around 4.2 months of imports of goods and services.

Under the baseline scenario, the debt ratios improve over the next 10 years, although the improvement is more modest in the first half of the period. The debt-to-GDP ratio will average around 54 percent in the first 3 years and around 42 percent in the next five years. Debt service ratios, on the other hand, will increase until 2009 and decline gradually afterwards, partly reflecting the increased debt service after the end of the grace period offered by the Paris Club and other bilateral creditors. The rise of debt service ratios in the

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[1] The assumptions on export and import growth rates take into consideration the experience of other transition economies and the performance of exports and imports of SM since 2000. The rapid growth of imports in 2001-03 has stemmed from the large investment and consumption needs after a decade of sanctions and conflicts. In conjunction with policies to rein in domestic demand, import volume growth slowed in 2003 (to 7½ from 23 percent in 2002) and is projected to decelerate further in the projection period. In particular, envisaged policy adjustments in 2004 would contain the import volume at approximately its 2003 level. The share of investment goods in total imports rose substantially since 2000. Meanwhile, exports are expected to show sustained growth in the projection period, reflecting an economic recovery in SM's main trading partners, as well as the impact of the structural reforms and the domestic and substantial foreign investments in recent years. Under these assumptions, the average export and import growth rates amount to about 12 and 11 percent, respectively, in euro terms during 2000-2011, in line with the experience of other European transition economies in the past decade.

latter half of the projection period argues for a steady buildup of official reserves in early years to guard against possible risks, while keeping on schedule with the country's external obligations. Both the external debt and debt service ratios, especially those to exports, increased somewhat compared to the results in IMF Country Report No. 03/296. The increase in the ratios to GDP is mostly related to the revision of nominal GDP figures and exchange rate valuation effects, while the increase in the ratios to exports mainly reflects the lower than expected total exports in 2003 and some downward adjustment of export growth in the near term. Moreover, the higher-than-previously expected commercial borrowing by newly privatized companies—mostly from their parent companies abroad—has also contributed to the higher debt service.

B. Stress testing applying the debt sustainability framework.

Standard Stress Tests

As explained in IMF Country Report No. 03/151, the standard framework of the debt sustainability analysis is modified in the case of Serbia and Montenegro owing to the uncertainties related to the historical data. In particular, the 1996-2001 data for 4 countries in the region, namely Albania, Bulgaria, Croatia, and Romania, were used to derive the standard deviation. The historical averages are based on the outturns of 2002 and 2003 following the standard approach.

If real GDP growth, nominal interest rate, dollar deflator, non-interest current account, and non-debt inflows are set as the estimates of the 2002 outturn, the external debt ratios would decline much faster than in the baseline case after the first year, owing to the more favorable GDP deflators and nominal interest rate in 2002 and 2003 than in the outer years.

Applying shocks to the parameters, the stress tests indicate that higher debt burden stemming from shocks to the external current account deficit and/or a significant economic downturn would increase the debt ratios substantially, before the ratios improve slightly following the end of the shocks. On the other hand, shocks to the interest rate from the historical average do not have a significant impact on the debt ratios, reflecting the fact that the interest rate in 2002 and 2003 was relatively low, partly associated with the delayed start of debt service to the Paris Club creditors, and stress tests for the interest rate do not cause major deviations form the baseline projections because of the starting point. Similarly, as the dollar deflator in 2002 and 2003 was relatively high partly owing to dollar depreciation, and is expected to decline substantially in the projection period, the scenario with shocks to the deflator from its historical average actually generates improved debt ratios relative to the baseline. The combination of smaller shocks of all the above variables would also yield higher debt ratios than the baseline. Finally, a large one-time nominal deprecation would substantially worsen the debt ratios.

Tailored Stress Tests

In the first test, it is assumed that imports continue to grow strongly in 2004 on the back of strong domestic demand fueled by fiscal policy as implied by the 2004 budget (i.e., a fiscal deficit higher than envisaged under the program by about 2 percentage points of GDP) and exchange rate policy unchanged from its 2003 stance, while export recovery is more modest than in the baseline owing to continued delays in structural reforms and a lack of improvement in the country's external competitiveness. The policies are tightened in subsequent years at the rate envisaged in the baseline, though they remain looser than in the baseline. Even if the higher current account deficits in 2004 and subsequent years can be financed by external borrowing—which could be difficult and raise concerns of financial instability even in the short-term—a rise of the debt/GDP ratio to almost 65 percent would significantly increase the country's external vulnerability. This scenario illustrates the importance for prudent policies to contain domestic demand and enhance export performance, given the fragile external position.

In the second test, it is assumed that FDI inflows will be half of that projected in 2004 and 2005 under the baseline, possibly owing to rising political uncertainties and delayed structural reforms, which would deter foreign investments. As a result, real growth and exports would be negatively affected in subsequent years. While the debt ratios change only marginally in the first two years—as the reduced foreign investments are likely accompanied by smaller demand for imports—the worsening of the debt ratios is more pronounced in outer years, given the lower GDP and larger borrowing needs due to smaller exports.

Table 1. Serbia and Montenegro: External Debt Sustainability Framework, 2001–08
(In percent of GDP, unless otherwise indicated)

	Actual			Projections				
	2001	2002	2003	2004	2005	2006	2007	2008
				I. Baseline Medium-Term Projections				
External debt	103.2	75.5	69.0	**55.1**	**54.1**	**53.9**	**50.1**	**45.9**
Change in external debt	-29.3	-27.7	-6.5	-13.9	-0.9	-0.2	-3.8	-4.2
Identified external debt-creating flows (4+8+11)	-25.8	-17.8	-12.5	0.3	4.5	3.5	2.5	0.6
Current account deficit, excluding interest payments	9.0	11.9	11.5	9.0	7.7	6.3	5.6	4.7
Deficit in balance of goods and services	-20.9	-23.1	-22.7	-20.8	-20.1	-19.4	-18.8	-17.9
Exports	23.7	20.7	19.2	20.4	22.8	24.4	25.6	26.1
Imports	-44.6	-43.7	-41.8	-41.3	-43.0	-43.8	-44.4	-43.9
Net non-debt creating capital inflows (negative)	-1.4	-3.6	-6.7	-3.1	-5.0	-2.8	-3.1	-3.2
Net foreign direct investment, equity	1.4	3.6	6.7	3.1	5.0	2.8	3.1	3.2
Net portfolio investment,equity	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Automatic debt dynamics 1/	-33.4	-26.1	-17.3	-5.6	1.8	0.1	0.0	-0.9
Contribution from nominal interest rate	0.6	0.9	1.1	2.0	2.3	2.4	2.6	2.6
Contribution from real GDP growth	-5.4	-3.0	-1.7	-2.7	-2.4	-2.4	-2.6	-2.3
Contribution from price and exchange rate changes 2/	-28.6	-24.0	-16.7	-5.0	1.9	0.0	0.0	-1.1
Residual, incl. change in gross foreign assets (2-3)	-3.5	-9.9	6.0	-14.3	-5.4	-3.8	-6.3	-4.8
External debt-to-exports ratio (in percent)	435.6	365.3	360.3	269.4	237.3	221.2	196.0	176.2
Gross external financing need (in billions of US dollars) 3/	2337.8	3118.8	4043.0	4378.2	4606.0	4495.0	4741.7	5167.5
in percent of GDP	20.2	19.9	19.5	18.8	19.6	18.3	18.3	18.6
Key Macroeconomic and External Assumptions								
Nominal GDP (US dollars)	11577.3	15681.0	20729.1	23322.5	23550.3	24624.8	25864.7	27784.3
Real GDP growth (in percent)	5.5	4.0	3.0	4.4	4.5	4.6	5.0	5.0
Exchange rate appreciation (US dollar value of local currency, change in percent)	-33.5	3.8	11.6	-0.9	-9.1	-4.7	-3.4	-1.0
GDP deflator (change in domestic currency)	91.7	25.5	15.0	8.7	6.4	4.8	3.5	3.3
GDP deflator in US dollars (change in percent)	27.6	30.3	28.3	7.8	-3.3	-0.1	0.0	2.3
Nominal external interest rate (in percent)	0.6	1.2	2.0	3.3	4.2	4.7	5.0	5.5
Growth of exports (US dollar terms, in percent)	7.7	18.2	22.5	20.1	12.7	11.7	10.2	9.5
Growth of imports (US dollar terms, in percent)	28.9	32.9	26.5	10.9	5.1	6.5	6.5	6.3
				II. Stress Tests for External Debt Ratio				
Standard Stress Test								
1. Real GDP growth, nominal interest rate, dollar deflator, non-interest current account, and non-debt inflows are at historical average			**69.0**	**44.9**	**35.4**	**29.7**	**22.9**	**19.2**
2. Nominal interest rate is at historical average plus two standard deviations in 2004 and 2005			**69.0**	**55.0**	**53.6**	**53.3**	**49.6**	**45.4**
3. Real GDP growth is at historical average minus two standard deviations in 2004 and 2005			**69.0**	**63.0**	**70.4**	**70.2**	**66.4**	**61.9**
4. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2004 and 2005			**69.0**	**55.5**	**49.0**	**48.7**	**44.9**	**40.8**
5. Non-interest current balance account is at historical average minus two standard deviations in 2004 and 2005			**69.0**	**64.0**	**73.7**	**73.5**	**69.7**	**65.1**
6. Combination of 2-5 using one standard deviation shocks			**69.0**	**58.6**	**56.3**	**56.0**	**52.2**	**48.0**
7. One time 30 percent nominal depreciation in 2004			**69.0**	**81.5**	**81.4**	**81.2**	**77.4**	**72.7**
Statistics of the key variables used for stress testing	Standard 4/ Deviation				Average 2003-08			
Current account deficit, excluding interest payments	3.1				7.5			
Net non-debt creating capital inflows	1.8				4.0			
Nominal external interest rate (in percent) 5/	0.6				4.1			
Real GDP growth (in percent)	5.3				4.4			
GDP deflator in US dollars (change in percent)	11.1				5.8			
Tailored Stress Test								
Looser macroeconomic policies which would increase 2004 current account deficit significantly relative to the baseline, and policy adjustments in subsequent years would bring down the deficit gradually.			**69.0**	**58.3**	**60.9**	**64.1**	**64.0**	**63.1**
Lower FDI in 2004 and 2005, followed by reduced exports and real growth in subsequent years			**69.0**	**55.4**	**55.0**	**58.0**	**56.9**	**54.8**

1/ Derived as [r - g - ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.
2/ The contribution from price and exchange rate changes is defined as [-ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) times previous period debt stock. ρ increases with an appreciating domestic currency (ε > 0) and rising inflation (based on GDP deflator).
3/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.
4/ The average of standard deviation of Albania, Bulgaria, Croatia, and Romania between 1996 and 2001
5/ Modified the standard framework by adjusting downwards the end-2001 debt stock by the amount of bilateral debt to be reduced. This would give a more reasonable basis for projection forward.

Table 2. Serbia and Montenegro: Medium-Term External Sustainability, 2000–11

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Average 2004-06	Average 2007-11
	(In millions of U.S. dollars, unless indicated otherwise)													
Export growth (US$ terms, in percent)	14.7	4.2	20.4	20.9	19.4	13.0	13.0	11.0	10.3	10.3	9.5	9.3	15.1	10.1
Export growth (euro terms, in percent)	32.5	7.5	14.2	1.0	8.0	13.0	13.0	11.0	10.3	10.3	9.5	9.3	11.3	10.1
Import growth (US$ terms, in percent)	12.6	30.4	30.7	25.9	10.7	5.0	6.5	6.5	6.3	6.3	6.3	6.3	7.4	6.3
Import growth (euro terms, in percent)	30.0	34.5	23.9	5.2	0.1	5.0	6.5	6.5	6.3	6.3	6.3	6.3	3.9	6.3
Current account balance, before grants	-610	-1,119	-2,007	-2,614	-2,577	-2,356	-2,143	-2,115	-2,030	-1,896	-1,745	-1,546	…	…
percent of GDP	-7.1	-9.7	-12.8	-12.6	-11.0	-10.0	-8.7	-8.2	-7.3	-6.3	-5.4	-4.5	-9.9	-6.3
Current account balance, after grants	-339	-528	-1,383	-2,121	-2,239	-2,005	-1,850	-1,881	-1,796	-1,662	-1,511	-1,312	…	…
percent of GDP	-3.9	-4.6	-8.8	-10.2	-9.6	-8.5	-7.5	-7.3	-6.5	-5.6	-4.7	-3.8	-8.5	-5.6
Gross official reserves	516	1,169	2,280	3,550	3,600	4,248	4,453	4,418	4,518	4,648	5,093	5,329	…	…
in months of imports of goods and services	1.2	2.4	3.2	4.4	4.3	4.7	4.7	4.3	4.2	4.0	4.2		4.6	4.2
External debt 1/	11,403	11,948	11,839	14,303	12,843	12,750	13,272	12,961	12,759	12,388	12,056	11,860	…	…
As percent of exports of goods and services	448	436	365	360	269	237	221	196	176	156	140	126	242.6	158.8
As percent of GDP	133	103	75	69	55	54	54	50	46	41	38	34	54.4	41.9
As percent of government revenue	361	265	176	162	126	128	130	124	114	103	93	85	128.1	103.5
External debt service 2/	56	107	183	436	1,014	1,228	1,217	1,662	2,060	2,241	2,215	2,071	…	…
As percent of exports of goods and services	2.2	3.9	5.7	11.0	21.3	22.9	20.3	25.1	28.4	28.3	25.6	22.0	21.5	25.9
As percent of GDP	0.6	0.9	1.2	2.1	4.3	5.2	4.9	6.4	7.4	7.5	6.9	6.0	4.8	6.8
As percent of government revenue	1.8	2.4	2.7	4.9	10.0	12.3	11.9	15.9	18.3	18.6	17.0	14.8	11.4	16.9

Sources: SM authorities, and IMF staff estimates.

1/ Incorporates the phased 66 percent debt reduction offered by the Paris Club, with comparable action provided by other official bilateral and commercial creditors.

2/ Besides the phased 66 percent debt reduction offered by the Paris Club, assumes a 60 percent capitalization of moratorium interest for the 2002-2005 period (as per the Paris Club agreement). Debt service projections for other official bilateral and commercial creditors are based on the assumption of comparable treatment.

Serbia and Montenegro: Public Sector Debt Sustainability Analysis

1. This Appendix updates the public sector debt sustainability analysis in IMF Country Report No 03/296, 7/14/03. Under the baseline scenario, SM's debt-to-GDP ratio would decline steadily from 79 percent of GDP in 2003 to 48.2 percent of GDP in 2008 (Table 16). The debt-to-revenue ratio would decline by 66.2 percentage points over the same period, from 184.4 percent in 2003. The baseline scenario is broadly unchanged from the one presented in IMF Country Report No 03/296, although the debt-to-GDP ratio is higher in 2004 by 4.2 percentage points of GDP owing mainly to weaker GDP growth and valuation effect; as of 2006, the ratios return to the same broad magnitude. As in the last DSA, it is assumed that London Club debt rescheduling will be reached in 2004. The baseline scenario assumes a gradual fiscal adjustment during 2004–2008. Current primary spending would gradually decline as a share of GDP, while allowing for a small increase in real terms over time. This decline reflects the consequence of structural reform in public enterprises and the social security system, as well as a general reduction in the size of the government. The primary deficit gradually falls from 3 percent of GDP in 2003 to zero in 2006, before turning into a surplus of 0.9 percent in 2008, as the projected decline in primary expenditures would outpace the projected fall in revenue-to-GDP ratio. Privatization receipts are projected to be declining, and relatively modest, in the coming years (especially when compared to 2003).

2. Using the standardized methodology set out in Assessing Sustainability (www.imf.org), but with modifications due to data constraints, stress tests were conducted. Because data prior to 2000 are either incomplete or unavailable, and because SM underwent a series of structural breaks, it was not possible to use historical averages or standard deviations. As a result, and as explained in Appendix IV, the 2002–03 outturns were used to replace historical averages, and the 1997–2000 data for 4 countries in the region, namely Albania, Bulgaria, Croatia and Romania, were used to derive the standard deviation.

3. In the first test, real GDP growth rate, real interest rate, and the primary balance remain at the 2003 level. This scenario results in a faster reduction in the debt-to-GDP ratio, which would decline by 37.1 percentage points of GDP by 2008. This is due mainly to nominal and real interest effects which were more conservative under the baseline scenario. This also indicates that the baseline scenario is rather conservative.

4. Most stress tests, namely (i) higher real interest rates in 2004–2005, (ii) lower GDP growth, (iii) lower primary balance; (iv) a combination of these three using a one standard deviation shock; and (v) a 10 percent increase in other debt-creating flows in 2004 would not result in an increase in the debt-to-GDP ratio from its 2003 level, but would make the debt-to GDP reduction slower than under the baseline scenario.

5. One test only, the real depreciation of 30 percent in 2004, would increase the debt-to-GDP ratio from its 2003 level in the depreciation year; the ratio would be declining thereafter through the projection period, but would still be higher than its starting level in 2008.

Table 1. Serbia and Montenegro: Public Sector Debt Sustainability Framework, 2002–08

(In percent of GDP, unless otherwise indicated)

	2002	Prel. 2003	Projections 2004	2005	2006	2007	2008
			I. Baseline Medium-Term Projections				
1 Public sector debt 1/	85.4	**79.0**	**65.0**	**59.5**	**55.9**	**52.0**	**48.2**
o/w foreign-currency denominated	78.5	71.3	57.5	53.3	51.1	47.5	44.9
2 Change in public sector debt	-37.8	-6.4	-13.9	-5.6	-3.6	-3.9	-3.8
3 Identified debt-creating flows (4+7+12)	-39.1	-11.7	-5.2	-2.7	-2.2	-2.3	-3.4
4 Primary deficit	2.4	3.0	2.0	0.2	0.0	-0.6	-0.9
5 Revenue and grants	43.9	42.8	43.9	42.9	41.8	40.9	40.8
6 Primary (noninterest) expenditure	46.3	45.8	45.9	43.1	41.8	40.3	39.9
7 Automatic debt dynamics 2/	-39.4	-10.4	-6.6	-1.9	-1.4	-1.1	-2.0
8 Contribution from interest rate/growth differential 3/	-27.8	-12.3	-8.2	-4.9	-3.6	-2.8	-2.4
9 Of which contribution from real interest rate	-24.1	-10.1	-5.2	-2.3	-1.1	-0.2	0.0
10 Of which contribution from real GDP growth	-3.8	-2.2	-3.1	-2.6	-2.5	-2.6	-2.4
11 Contribution from exchange rate depreciation 4/	-11.5	1.9	1.7	3.0	2.2	1.7	0.5
12 Other identified debt-creating flows	-2.2	-4.3	-0.7	-1.0	-0.8	-0.6	-0.6
13 Privatization receipts (negative)	-2.2	-4.3	-0.7	-1.0	-0.8	-0.6	-0.6
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0
15 Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
16 Residual, including asset changes (2-3)	1.3	5.3	-8.7	-2.9	-1.4	-1.6	-0.4
Public sector debt-to-revenue ratio 1/	194.6	184.4	148.3	138.8	133.9	127.2	118.2
Gross financing need 5/	3.5	4.1	3.3	2.2	2.1	1.7	1.4
in billions of U.S. dollars	0.5	0.9	0.8	0.5	0.5	0.4	0.4
Key Macroeconomic and Fiscal Assumptions							
Real GDP growth (in percent)	4.0	3.0	4.4	4.5	4.6	5.0	5.0
Average nominal interest rate on public debt (in percent) 6/	1.0	1.4	1.6	2.8	2.9	3.2	3.4
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-24.5	-13.6	-7.1	-3.6	-1.9	-0.3	0.1
Nominal appreciation (increase in US dollar value of local currency, in percent)	15.2	-2.7	-2.6	-5.4	-4.2	-3.4	-1.0
Inflation rate (GDP deflator, in percent)	25.5	15.0	8.7	6.4	4.8	3.5	3.3
Growth of real primary spending (deflated by GDP deflator, in percent)	22.0	1.9	4.6	-2.0	1.5	1.4	4.0
			II. Stress Tests for Public Debt Ratio				
1. Real GDP growth, real interest rate, and primary balance are at 2003 preliminary in 2004-2008		**79.0**	**63.5**	**56.6**	**51.4**	**46.3**	**42.1**
2. Real interest rate is at historical average plus two standard deviations in 2004 and 2005		**79.0**	**72.9**	**69.6**	**65.8**	**61.7**	**57.5**
3. Real GDP growth is at historical average minus two standard deviations in 2004 and 2005		**79.0**	**73.0**	**74.8**	**70.7**	**66.3**	**61.6**
4. Primary balance is at historical average minus two standard deviations in 2004 and 2005		**79.0**	**69.6**	**70.3**	**66.4**	**62.4**	**58.1**
5. Combination of 2-4 using one standard deviation shocks		**79.0**	**74.4**	**77.0**	**67.8**	**58.6**	**49.4**
6. One time 30 percent real depreciation in 2004 7/		**79.0**	**103.5**	**96.9**	**92.4**	**87.8**	**82.6**
7. 10 percent of GDP increase in other debt-creating flows in 2004		**79.0**	**75.1**	**69.2**	**65.4**	**61.3**	**57.1**

Variables used for stress tests	Standard Deviation 8/	2003 Prel.	Average 2004-08
Primary deficit	1.8	3.0	0.2
Real GDP growth (in percent)	4.4	3.0	4.7
Nominal interest rate (in percent) 6/	11.1	3.1 9/	2.8
Real interest rate (in percent)	7.9	-11.9 9/	-2.5
Inflation rate (GDP deflator, in percent)	6.7	15.0	5.3
Revenue to GDP ratio	2.6	42.8	42.0

1/ Consolidated government of Serbia and Montenegro. Covers gross external debt, and net domestic debt.

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

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as r - π (1+g) and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.

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

6/ Derived as nominal interest expenditure divided by previous period debt stock.

7/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

8/ Using average data for Albania, Bulgaria, Croatia, Romania, 1997-2001, subject to availability.

9/ Calculated excluding debt written off and domestic arrears stock.

May 21, 2004

Ms. Anne Krueger
Acting Managing Director
International Monetary Fund
Washington DC 20431

Dear Ms. Krueger:

Firm implementation of our medium-term economic program supported by the Fund under the Extended Arrangement (EA) has permitted good progress in stabilization and reform. To ensure continued progress, we have updated our economic and policy targets for 2004–05, as described in detail in the attached Memorandum on Economic and Financial Policies, to reflect the latest developments. On this basis, we request: (a) completion of the third review (including the sixth and seventh financing reviews) under the EA, (b) a waiver for the non-observance of the end-December, 2003 performance criterion on net bank credit to the government, (c) two purchases of SDR 50 million each corresponding to the end-September and end-December 2003 test dates, and (d) a reapportionment of the last five purchases originally envisaged under the arrangement into four equal purchases to be phased over the remainder of the arrangement..

We believe that the policies and measures described in the attached memorandum are sufficient to achieve our program objectives, but we stand ready to take timely additional measures and seek new understandings with the Fund, as necessary, to keep the program on track. We will remain in close consultation with the Fund on the adoption of these measures, and in advance of any revisions to the policies contained in the attached MEFP in accordance with the Fund's policies on such consultations. We will provide all information to the Fund that it requests to assess the implementation of the program. The program will continue to be reviewed by the Fund, with the discussions for the fourth review, in combination with the Article IV consultation, expected in September 2004. The fourth review will concentrate on the implementation of fiscal, monetary and exchange rate policy, progress in enterprise and bank reform (including issues related to connected lending) and the broad macroeconomic and policy parameters of the 2005 program, while the fifth review will focus on the annual budget and financial program for 2005. Moreover, each purchase under the arrangement will continue to be subject to a review of the financing of the program.

Yours sincerely,

Predrag Ivanović /s/
Minister of Foreign Economic Relations
Serbia and Montenegro

Miroljub Labus /s/
Deputy Prime Minister
Republic of Serbia

Miroslav Ivanišević /s/
Deputy Prime Minister
Republic of Montenegro

Mladjan Dinkić /s/
Minister of Finance
Republic of Serbia

Radovan Jelašić /s/
Governor
National Bank of Serbia

Igor Luksić /s/
Minister of Finance
Republic of Montenegro

Ljubisa Krgović /s/
Chairman
Central Bank of Montenegro

SERBIA AND MONTENEGRO

MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

May 21, 2004

I. Introduction

1. This memorandum updates and supplements the Memorandum of Economic and Financial Policies (MEFP) attached to the Letter of Intent of July 11, 2003. It reports on recent developments under the program supported by the Extended Arrangement (EA) approved in May 2002 and updates the economic objectives and policy agenda for the remainder of 2004. Annexes A and B, attached to this memorandum, contain the quantitative performance criteria and indicative targets, while Annexes C and D list the structural performance criteria and benchmarks as well as prior actions. Annex E (Technical Memorandum of Understanding, TMU) defines the performance criteria and indicative targets and describes the reporting arrangements.

2. **Although political developments impacted adversely on the pace of reforms, further progress has been made toward integration with Europe over the past year.** The two states of the Union of Serbia and Montenegro have moved toward harmonizing their customs, trade and indirect tax regimes as a step toward a Stability and Association Agreement with the EU. Continued progress has also been made in stabilizing and restructuring the economy as described below. Meanwhile, following Serbian parliamentary elections in December 2003, a new government took office in March and began work to reinvigorate reforms and foster sustainable growth.

3. **Economic performance has remained generally favorable but the current account deficit remains large.** Twelve-month inflation was almost halved from a year earlier to 7.8 percent at end-2003—below the 9–11 percent target—notwithstanding currency depreciation. Real GDP growth in 2003 is estimated at about 3 percent—lower than the targeted 3½–4½ percent owing in part to the effects of drought on agricultural output. Gross industrial output declined by 2.7 percent, but this reflected the contraction of inefficient production and incomplete coverage of the most dynamic enterprises, with value added in industry performing better. The current account deficit (before grants)—at almost 12½ percent of GDP in 2003—exceeded the program target by about 1½ percentage points of GDP. A large fiscal deficit, rapidly rising euro wages, and continued albeit lower credit growth contributed to the 7½ percent import volume growth in 2003, while restructuring-induced losses in the export base and weak foreign demand dampened export volume growth to 3 percent, leaving export levels low by historical standards. Private remittances were buoyant at 11.2 percent of GDP. About ¾ of the 2003 current account deficit was financed by FDI (which reached 6¾ percent of GDP) and foreign grants. A surge in privatization proceeds helped raise official gross reserves by $1.3 billion in 2003 to $3.6 billion (4.4 months of 2004 imports) at end-year, although subsequent pressures on the foreign

exchange market – triggered mainly by budgetary overspending in December – reduced official reserves to $3.3 billion by end-March.

4. **Macroeconomic policies have remained broadly on track (Annex A).** End-December 2003 performance criteria on credit and external sector targets were met, but the ceiling on net bank credit to the general government was exceeded by 0.4 percent of GDP. As regards indicative targets, the ceilings on banking system NDA and on the transfer of central government bank deposits to the central bank were met, but the ceiling on the wage bill of public enterprises (adjusted for spin-offs) was exceeded by a small margin and the zero limit on net new expenditure arrears was breached by the equivalent of 0.1 percent of GDP (on account of the social funds).

5. **Fiscal developments have been broadly in line with the program, except for an expenditure slippage in December**. The fiscal deficit excluding foreign-loan financed projects (FLFPs) amounted to 3.7 percent of GDP, 0.4 percent above the program target. This reflected election-related spending as well as "expenditure-smoothing" in late December before the onset of tight temporary financing arrangements for 2004 Q1. Revenue was in line with the program, with strong PIT and CIT receipts offsetting weaker-than–projected retail sales taxes and social contributions. The overall fiscal deficit, including FLFPs amounted to 4.2 percent of GDP. Temporary budget rules restricted spending in the first quarter of 2004 in Serbia while revenue performance was approximately as budgeted, leading to a broadly balanced general government position in 2004 Q1.

6. **Privatization exceeded expectations, but other structural reforms were delayed.** Serbian cash privatization receipts reached €729 million (4 percent of GDP) in 2003, more than twice the budget assumption. Other key structural reforms included the introduction of a new Serbian payments system, pension reform, and trade regime harmonization within the union. However, political developments since late 2003 delayed enterprise, bank and fiscal reforms (Annex C). Under a revised timetable, the resolution plan of the largest Serbian bank will be finalized by mid-May, 2004; the tender for the sale of the first bank to be privatized will also be launched by end-May, with two others to follow before end-2004; and, following a further step in early 2004, the debt-equity swap in banks associated with Paris and London Club related debt will be completed by end-June 2004.

7. **Negotiations with foreign creditors will continue.** Despite progress in discussions with London Club creditors—including the submission by the outgoing authorities of a detailed debt restructuring proposal to creditors on Paris Club terms—political developments precluded an agreement. The new government will: resume London Club discussions in June 2004, thereby demonstrating SM's continued good-faith efforts in the negotiations; sign the remaining Paris Club bilaterals in the coming months; and, complete the restructuring of other debt, including short-term debt to Russia and China.

II. Economic Objectives and Policies

8. **The economic objectives for 2004 have been updated within a medium-term framework to take into account recent developments** (Table). They are consistent with the achievement of sustainable growth, low inflation, and a viable external position over the medium term:

- **Real GDP** is projected to grow by 4-5 percent in 2004 supported by the recovery in agriculture this year, and reach 5 percent in subsequent years owing to further progress in privatization, large cumulative FDI inflows since early 2002, and declining restructuring-related output losses.

- **Inflation** is targeted to be contained at 8-9 percent through end-2004 and to converge toward EU levels over the medium term.

- The external **current account deficit** (before grants) is projected to narrow by 1½ percentage points to 11 percent of GDP in 2004 in line with progress toward external sustainability and consistent with expected financing; and to decline steadily thereafter based on a recovery of exports toward historical levels—reflecting improving domestic supply conditions and an upturn in foreign demand—and a containment of imports through prudent policies.

- **FDI and grants** will cover almost half of the 2004 deficit (based on cautious official privatization estimates), with official borrowing and other capital inflows covering the remainder. As the business climate improves over the medium term, FDI inflows will play an increasing role in financing the current account deficit, allowing a gradual decline in reliance on foreign assistance.

- Following a large over performance this year, import coverage of **foreign reserves** will remain broadly unchanged from end-2003, with a view to guarding against possible risks and preparing for the projected rise in external debt service in a few years following the expiry of grace periods under debt restructuring agreements.

9. **Macroeconomic policies will be geared to support growth while narrowing the external current account deficit.** Specifically, (a) the overall fiscal deficit (including FLFPs) will be reduced by 0.7 percentage points to 3.1 percent of GDP; (b) cost competitiveness and profitability in the traded goods sector will be enhanced in part through wage restraint in the state sector; and (c) dinar money growth will be kept broadly in line with targeted nominal GDP growth.

10. **To safeguard medium-term objectives, structural reforms in the enterprise and banking sectors will be invigorated.** With the pipeline of readily privatizable socially-owned enterprises drying up, focus will shift toward the accelerated restructuring of public utilities and insolvent socially-owned enterprises to facilitate their rapid privatization. Further structural reforms will include public expenditure and tax reform, bank restructuring and

privatization, and the early passage and effective implementation of laws on bankruptcy and energy to harden enterprise budget constraints.

Text Table 1. Serbia and Montenegro: Key Macroeconomic Objectives and Policies, 2002–05

	2002	2003		2004		2005
	Actual	Staff Report	Prel Act.	Staff Report	Rev. Prog.	Rev. Prog.
			(Percentage change)			
Real GDP Growth	4.0	3½–4½	3.0	4.0	4 - 5	4 - 5
Inflation (end period)	14.2	9–11	7.8	7.0	8 - 9	5.0
Of which : Montenegro	9.4	9.0	8.0	5.0	4.0	3.5
Current account deficit (before grants)			(In billions of US$)			
In percent of GDP	12.8	10.8	12.6	10.2	11.0	10.0
Gross official reserves	2.3	2.9	3.6	3.2	3.6	4.2
In months of projected imports	3.1	3.7	4.4	3.8	4.3	4.7
			(In percent of GDP)			
Fiscal deficit	4.5	4.5	4.2	4.3	3.4	2.4
Government credit from the banking system	-0.5	0.0	-1.4	0.5	0.9	-0.6
Public debt	84.5	70.0	79.0	60.8	65.0	59.5
NFA growth	52.4	6.9	52.9	…	-8.3	…
NDA growth	-4.2	4.3	-42.8	…	15.5	…
Reserve money growth	48.1	11.3	10.1	…	7.3	…

Sources: SM authorities; and IMF staff estimates.

11. **The PRSP process will continue to guide the development agenda and social policies.** After consultations with and contributions by civil society, full PRSPs were adopted by the Serbian and by the Montenegrin governments in late 2003. Social spending will be protected to provide a safety net for those affected adversely by reforms, while its efficiency will be enhanced through the improved targeting of benefits.

A. Fiscal Policy

12. **Fiscal policy will underpin the stabilization effort in 2004.** The overall SM fiscal deficit will be lowered to 3.4 percent of GDP, of which 3.1 percent would be incurred by Serbia and the remainder by Montenegro (equivalent to 4.6 percent of its own GDP). Excluding foreign-loan financed projects (expected to rise by ½ percentage points of GDP), the deficit is projected to fall by 1.2 percentage points to 2.5 percent of GDP. Reflecting prudently budgeted privatization receipts (0.7 percent of GDP), the fiscal program in 2004 will be financed mainly domestically (0.9 percent of GDP) including a drawdown of privatization receipts from previous years, and by foreign assistance (1.8 percent of GDP). Excess privatization proceeds, after covering a shortfall in foreign assistance, will be used to reduce net government indebtedness and—if consistent with achieving program objectives and in consultation with the Fund in the context of program reviews—to cover investment and restructuring costs.

Serbia

13. **The consolidated Serbian fiscal deficit will be limited to 2.3 percent of GDP (3.1 percent including FLFPs) to put the fiscal and current account deficits on sustainable paths.** [1] In line with the new government's objectives to promote growth, create jobs, boost agricultural production, and maintain macroeconomic stability, the 2004 fiscal program will reduce the labor tax burden, increase capital expenditures, notably for road construction, channel assistance to the agriculture sector, and help accelerate enterprise restructuring and bank reform. These programs will be financed though higher taxes on consumption and cuts in recurrent expenditures, especially for goods and services. To avoid the accumulation of new arrears, the republican budget will provide adequate transfers to the social funds. Since the 2004 budget adopted by parliament last March provides for a deficit of 3.3 percent of GDP (excluding FLFPs), additional measures have been adopted or will be in place before Board consideration of the third review, as described below, to ensure achievement of the program's fiscal deficit target.

14. **The tax policy package will raise budgetary revenues.** In line with the 2004 fiscal program, consolidated revenue is projected to increase by 0.7 percentage points to 40.5 percent of GDP. First, several new measures were adopted in April, including: (i) amending the Excise Law, effective May 2004, with a total positive revenue effect of around (CSD 5.2 billion), including gains from additional retail sales tax receipts;[2] (ii) increasing the Tax on Use, Keeping and Carrying of Goods (tax on motor vehicles, vessels, and aircrafts) (CSD 0.7 billion); and (iii) securing an agreement with the Board of NIS (state-owned oil refinery enterprise) to make a cash dividend transfer of CSD 5 billion to the budget. Second, as prior actions for the Board discussion, in May the contribution rate to the Employee Pension Fund will be increased by 1.4 percentage points to 22 percent (CSD 3 billion) and excise on diesel will be raised by 3 dinars/liter (CSD 3.5 billion). These measures will more than compensate for the elimination of the wage-bill tax (3.5 percentage points, accruing fully to local governments) starting July 1, with an estimated cost, already included in the 2004 budget, of CSD 7½ billion this year (1.1 percent of GDP on an annualized basis). The republican budget will compensate local budgets by transferring a higher share (30 percent rather than 5 percent) of the personal income tax (PIT) with an amendment of the Law on Local Public Finance

[1] Equivalent to a deficit of 2.5 percent (3.4 percent including FLFPs) of Serbia's GDP.

[2] Specifically, excise increases on gasoline (3 dinars/liter) would raise CSD 2.8 billion (including sales tax); on cigarettes (between 1–2 dinars/pack), CSD 1.2 billion; and on alcoholic and soft drinks, CSD 1.3 billion. Concurrently, already included in the 2004 budget, coffee excises will be changed from specific to ad valorem (revenue gain CSD 0.3 billion), and excises on oil products will be eliminated, specifically, on lubricants (revenue loss CSD 0.6 billion), oil derivatives (CSD 0.9 billion), and ethyl alcohol (CSD 0.3 billion).

15. **The expenditure share in GDP at the general government level is projected to remain broadly at its 2003 level of 44 percent.** In line with the new government's objectives, the 2004 budget has increased allocations for road building, agricultural support (subsidies and a new bank-administered investment lending program), and enterprise and bank restructuring. The general government wage bill will rise somewhat in relation to GDP, reflecting mainly wage increases at the union level in late 2003, but spending on goods and services will be curtailed.

16. **Expenditure cuts and reallocations in the 2004 budget will facilitate the realization of the deficit target while avoiding new arrears.** Transfers to the social funds will be increased by about CSD 7 billion—CSD 3 billion for the Employee Pension Fund (EPF), CSD 2.5 billion for the Farmer's Pension Fund, and CSD 1.5 billion for the Labor Market Fund—to ensure timely payment of entitlements. Expenditure cuts relative to the 2004 budget, to be implemented in line with the organic budget law, include transportation (CSD 0.5 billion), the development fund and others (CSD 2 billion), subsidies to agriculture (CSD 1.5 billion), and bank restructuring (CSD 1.2 billion). These cuts will be complemented by reductions in (i) net lending to agriculture (CSD 0.5 billion); (ii) the general reserve (CSD 2 billion); (iii) projects for the Road Directorate (CSD 1 billion); (iv) Health Fund transfers (CSD 0.5 billion); and (v) goods and services (CSD 0.5 billion). To help ensure that the finances of the social funds are placed on a sustainable path, the government has started an audit of the EPF, which could generate savings in the medium term.

Fiscal reform

17. **The government will present to Parliament a major tax reform package for implementation in 2005.** Eliminating the wage bill tax was a first step in the new government's plan to improve the tax system. By mid-year, the parliament is expected to adopt a value-added tax (broad-based with no more than two rates) to replace the cascading retail sales tax (RST) with effect from January 1, 2005. In addition, the financial transaction tax on all transactions will be eliminated (taxes on secondary market transactions in securities were abolished recently). Finally, local property taxes will be placed on a progressive scale, raising revenues for local governments.

18. **The strengthening of revenue administration will continue.** An excise and retail sales tax enforcement program was revitalized recently, and a program of unannounced field audits targeting selected enterprises/activities traditionally associated with high tax evasion is being implemented. The newly adopted Customs Law will facilitate tighter control and the enforcement of duties collection, while the standardization of the business identification number will help reduce tax fraud and evasion. Following the VAT law adoption, the Ministry of Finance will immediately begin intensive training for tax officials, promote VAT registration, and increase taxpayer education. VAT administration will be centralized in the four regional offices and in 24 A-type branch offices with strong taxpayer services; VAT audit and refund audit programs will also be put in place. In the coming months, new

legislation will harmonize the bases of the social security contributions and the personal income tax; and eliminate remaining nuisance taxes.

19. **Treasury operations will be further strengthened.** All remaining direct budget users (Serbian Parliament, President of the Republic, the Ministry of Interior, Agency for Security and Intelligence Service, Tax Administration, Public Payment Agency, Road Directorate, Geodesic Agency, and Tobacco Agency) will be brought into the Treasury Single Account (TSA) by end-2004 following a further expansion of the treasury's implementation capacity. In the interim, the treasury will ensure the daily transfer of cash balances of these sub-accounts to the TSA to minimize idle cash balances. Second, with FAD technical assistance, the Ministry of Finance will examine the role of the PPA and decide how to ensure centralized monitoring and control over all budgetary payments. In the medium term, all sub-accounts of indirect budget users will be closed, with their financial operations being brought under the TSA.

Montenegro

20. **Fiscal adjustment continues in Montenegro.** Following revisions in March-April, the 2004 general government deficit (before grants) is targeted at €67.1 million, representing a fiscal adjustment relative to 2003 by 0.6 percentage points to 4.6 percent of Montenegrin GDP (or by 1.2 percentage points to 3.4 percent of GDP excluding foreign loan-financed projects). In light of a projected shortfall in budget revenue, achievement of this target will require corrective measures of €10.2 million. Accordingly, as prior actions for the Board consideration of the third review, (a) new legislation in May raised cigarette excises and introduced new taxes on motor vehicles, insurance and gambling (with an expected yield of €4.5 million) and (b) the government adopted a decision to cut spending commitments on agricultural subsidies, net lending and public investment by €5.7 million. Over the medium term, the government is committed to continue lowering the deficit to ensure fiscal and external sustainability.

21. **The government is implementing a tax reform package to reduce the currently high and distortionary payroll taxes that discourage job creation.** The government, in consultation with the IMF and World Bank and in the context of a Supplementary Budget for 2004, envisages a phased lowering in social contribution and PIT rates, with a first 5 percentage point reduction effective July 1, 2004, and a subsequent reduction of equal size effective on December 1, 2004. The resulting revenue loss would be partly offset by a marked reduction in budgetary employment involving at least 4,200 government sector redundancies by end-2004, which is projected to generate savings in 2005 of €15 million. When preparing the revised 2004 and the 2005 budgets, the government, in consultation with the IMF and the World Bank staff, will adopt sufficient fiscal measures effective at the time of the first reduction in social contribution and PIT rates to ensure that the program's deficit targets in 2004 and beyond are achieved. In particular, the government will review revenue developments, and, if necessary to achieve the program's deficit target, adopt a one percentage-point increase in the VAT. Meanwhile, the government will refrain from extending new exemptions or differential VAT rates to any sector.

22. **The government will also adopt key reforms in cash management, health sector financing and revenue administration.** To improve cash management, central government deposits will be shifted gradually from commercial bank accounts to the Treasury Single Account held at the CBM by end-2004, except for balances held at the largest bank undergoing restructuring, where the amount of central government deposits would be halved by end-2004 and reduced to zero by end-2005. In the health sector, the government will work closely with the World Bank to ensure early implementation of an equitable system of co-payments for health care services to raise efficiency in the use of public resources. Finally, revenue administration will be enhanced with a stronger focus on collecting tax arrears and enforcing stricter compliance with current obligations. The government will avoid restructuring the tax debt in a manner that would undermine its tax collection over the medium term.

B. Monetary and Exchange Rate Policies

23. **The 2004 monetary program is consistent with targeted inflation on the assumption of a slight increase in dinar broad money velocity.** Reserve money is programmed to rise by 7½ percent, reflecting an expected reduction in banks' excess dinar reserves. With NFA broadly unchanged, reserve money growth would be driven by NDA. Dinar broad money and credit to the economy are projected to rise by 11½ percent. In accordance with the central bank law, the NBS will not extend credits to the government, except in limited amounts and for short periods.

24. **The development of market-based instruments remains a key task.** To expand its monetary instruments, facilitate the development of a money market, and manage bank liquidity, the NBS will introduce repo operations. To this end, the NBS and the Ministry of Finance will restructure the government's debt to the NBS and enhance NBS-Treasury coordination, in the context of new by-laws on the NBS' organizational structure. In addition, taxes on interbank security transactions will be phased out. To enhance public resources management and avoid implicit subsidies to banks, all republican government deposits will be transferred to the NBS by end-June 2004, and all NBS deposits in commercial banks will steadily decline and will be fully withdrawn by end-February 2005, while imposing market-based interest rates on remaining deposits in the interim. To make NBS monetary operations more effective, the fiscal-monetary committee will prepare a monthly operation plan for 2004 taking into account budget financing needs, the schedule of T-bill issuance, and treasury debt repayments.

25. **Exchange rate policy in Serbia will continue to strike a balance between safeguarding the external position and containing inflation.** The NBS will maintain a flexible exchange rate policy taking into account conditions in the interbank market and developments in trade, prices, and domestic costs, with a view to supporting external competitiveness, while continuing to provide a nominal anchor for price expectations.

C. Bank Reform

26. **Bank restructuring and privatization will continue.** A resolution plan for the largest bank, to be prepared in consultation with IMF and World Bank staff, will be adopted by the Board of the Bank Rehabilitation Agency (BRA) by mid-May 2004 as a prior action for Board consideration of the third review under the Extended Arrangement (Table D). The plan will provide a cost estimate for the chosen resolution option and involve: (i) no recapitalization or new liquidity support from the NBS, general government, or state-owned enterprises, prior to privatization; (ii) consolidation prior to recapitalization, including incentives and penalties for bank management to achieve downsizing targets; (iii) a reduction in operating costs in 2004 of at least 10 percent compared with 2003, along with clear incentives and penalties linked to management performance; (iv) no net new lending or launch of new business activities; and (iv) no significant capital investment. By end-June 2004, the government will adopt and publish a comprehensive strategy and timetable to divest the state's equity stakes in 16 banks based, inter alia, on diagnostic audit reports, annual audits, and supervisory reports. A tender notice offering a controlling stake in Jubanka will be published by end-June 2004. The tenders of state-owned stakes in Continental Banka and Novasadska Banka will be launched by end-September 2004. The tenders will seek to maximize the present value of the State's equity, notably through either ensuring that the new owners will retain responsibility for managing existing bank assets, or carving out and auctioning selected impaired assets. At the same time, the government will prudently evaluate and strictly limit the provision of indemnities or put options and warranties to new owners. As regards Niška Banka, a privatization advisor is expected to be appointed by end-July, and a tender for its sale issued by end-December, 2004.

27. **The operations of the Serbian Bank Rehabilitation Agency (BRA) will be strengthened.** A government decision will clarify the mandate of the BRA in managing and divesting the government's shareholdings in all banks. Concurrently, the BRA will strengthen its reporting requirements, control mechanisms, and governance in nationalized banks to preserve their value prior to resolution. The BRA will resolve the remaining bank under its administration, Pirotska Banka, by end-June 2004. By the same date, it will also complete the conversion into state equity of the bulk of London Club obligations (e.g., principal and interest accruing through end-May 2004), in compliance with the PLC law in a manner that maximizes the value of the State's equity.

28. **Strengthening financial sector supervision and regulation remains a top priority in Serbia.** After a delay due to management changes, the NBS resumed the implementation of the Supervisory Development Plan. Monthly liquidity indicators on banks were developed and a CAEL (capital, assets, earnings, and liquidity) system has been put in place. The large-debt registry was enhanced to include information on rating, provisions, and industry. As of early 2004, 5 banks have undergone full-scope on-site examinations, while on-site examinations of another 5 non-bank financial institutions have led to the closure of 3 such institutions. An early warning system will be broadened and the full CAMEL rating system will be finalized by mid-2004 with a view to developing a risk-based NBS examination schedule. Work is also underway to identify banks' ownership structure so as to enforce

regulations on lending to connected parties. The official translation of IAS standards and the corresponding chart of accounts have been published, enabling financial institutions to prepare and publish IAS-conform financial statements for 2003 and to fully implement IAS from 2004; the same schedule, delayed by a year, will apply to non-financial institutions. Building on this progress, the NBS will intensify the enforcement of asset classification and provisioning through risk-based on-site and off-site supervision. In addition, the government will implement a more robust, pro-active framework for the supervision of non-bank financial institutions—involving comprehensive audits and the consistent enforcement of minimum capital requirements for insurance companies—following the enactment of a new law on insurance expected by end-June 2004.

29. **Bank reform in Montenegro will continue to focus on privatization, asset resolution, and government deposit management, with banking supervision remaining vigilant.** An international tender will be launched by end-2004 to sell the government's holdings in Podgoricka Banka, aiming to maximize cash privatization proceeds. Building on progress so far, a strategy to divest all state holdings from the banking system will be prepared by end-2004. Meanwhile, the state will cease to increase its stake in the banking system both directly and indirectly, through capitalizing banks by state-owned enterprises. While the CBM had made good progress in banking supervision—including implementing most of the Basel Core Principles, working towards consolidated risk-based supervision, and tightly enforcing prudential regulations—it will continue to be vigilant in light of the rapid credit expansion in 2003. A recently established Financial Investigation Unit has taken the lead responsibility for implementing the Anti-Money Laundering law, and, in cooperation with the CBM and the MOF, for continuing to identify remaining illegally operating offshore banks and recommend actions to close them if any are identified. To safeguard public resources and instill financial discipline, the Ministry of Finance intends to classify assets carved out from the banking system according to collectibility in the coming months. On this basis, by end-September 2004 the government will contract out—through an international tender procedure—the collection of assets deemed most collectible; and adopt a clear policy by year-end regarding the early resolution of the remainder. A draft Law on Insurance will be submitted to Parliament by end-June 2004, requiring insurance companies to be supervised by an independent authority in line with international best practice. Building on notable progress to date and forthcoming technical assistance, enhanced balance sheets for the central bank and for deposit money banks will be developed to improve the monitoring of banking and fiscal developments.

D. Enterprise Sector

State enterprises

30. **The Serbian government will continue restructuring public utilities based on strategic plans.** The forthcoming new Company Law will considerably simplify the spin-off and subsequent privatization of non-core activities. To ensure continued financial viability of EPS (electricity company), the average electricity price will be raised by at least 10 percent effective July 1, 2004 (PC-monitored)—part of the increase will be in the form of a change in

the block tariff structure, namely a reduction in the first block tariff structure from 600 kWh to 300 kWh per month. EPS will reduce its core employment (relative to end-September 2003) by 3,400 by end-2004 in line with its business plan; service all its debt to the government in full except for the Kosovo-related debt; and, as in 2003, not receive any budgetary subsidy in 2004. To facilitate energy sector restructuring, the government will submit the draft Energy Law to Parliament by end-May. To enhance the collection rate and strengthen enterprise budget constraints, utilities will enforce penalties on late payments, cut off supplies to nonstrategic users with large arrears, or initiate their bankruptcy. Preparations will also continue to implement an operational regulatory framework for natural monopolies by end-December, 2004. Finally, the government will adopt a revised railway transport strategy based on profitability benchmarks involving substantial reductions in core employment, the closure of nonprofitable lines, and opening competition with alternative service providers on an equal footing to enable a reduction in government support to ZTP, which claims massive budgetary subsidies.

31. **Wage bills in state enterprises will continue to be controlled to contain inflation pressures and encourage labor shedding.** The wage bills in monitored state enterprises in 2004 will be allowed to grow by 8 percent on an annual average basis in line with the inflation target. Serbia's Ministry of Finance and Economy will monitor closely wage bill developments and ensure that the program's wage bill targets are met. In the list of monitored enterprises, Srbija Telekom will replace Srbija Voda to better reflect the macroeconomic importance of monitored enterprises in 2004. In the event of spin-offs as a result of future restructuring, the monitored wage-bill envelope will be adjusted downward for the wage-bills of the spun-off units.

Socially-owned enterprises

32. **The pace of privatizing socially-owned enterprises is expected to slow, reflecting the lesser quality of the enterprises remaining in the pipeline.** About 10 large socially-owned enterprises will be offered for sale through tenders, and 300 small and medium-sized ones through auctions during March-December 2004. Following a setback stemming from legal complications during the first quarter of 2004 in the sale of residual state-owned shares in socially-owned enterprises, share sales will resume from June 2004. A large transaction involving a state-owned company in the telecom sector will be prepared during the year, with the sale expected to be completed in 2005. The government will ensure that all asset sales are carried out in accordance with international best practice, including the competitive hiring of investment advisors and transparent international tenders. In addition, at least 2 large conglomerates undergoing restructuring, or core parts thereof, should be offered for sale by end-September, and 2 more by end-December 2004. The success rate in both auctions and tenders is expected to decline, reflecting the lower average quality of enterprises offered for sale (first attempts at selling many of these firms failed). In total, cash receipts from enterprise privatization are expected to amount to some €150 million in 2004. This compares with privatization receipts of about €230 million assumed in the budget, which includes receipts from expected bank sales. To ensure fiscal transparency, all privatization proceeds will be channeled through the budget and spending will follow normal budgetary procedures.

33. **Rapid restructuring and privatization of remaining large socially-owned enterprises remains critical for enhancing the supply response and strengthening the external position.** In this regard, the indebtedness of insolvent enterprises has become a critical impediment to the privatization process, which needs to be addressed without creating moral hazard. To this end, further write-offs of arrears on taxes, contributions or other enterprise liabilities to the government, public utilities or state-owned banks will be conditional on privatization or irreversible bankruptcy. With World Bank assistance, the extensive network of claims and liabilities will be tackled through coordinated agreements of state creditors (government and state-owned enterprises and banks) on haircuts; experience to date shows that private creditors are willing to accept similar haircuts in return for prompt payment. Recent progress in this area included the government decree enabling the Privatization Agency and the BRA to negotiate with creditors on the state's behalf, and the establishment of an inter-ministerial negotiating group with the right to propose haircuts on public utilities' claims on enterprises to be privatized. This approach will be prudently, transparently, and expeditiously implemented for socially-owned enterprises under restructuring.

34. **An effective bankruptcy process is critical for strengthening enterprises' financial discipline.** The bankruptcy process will become operational by end-November 2004, following Parliamentary adoption of the new bankruptcy law and related legislation (including on the establishment of an agency to license and regulate bankruptcy trustees) by end-June 2004 (performance criterion-monitored), and the establishment of supporting institutions by end-November 2004 (structural benchmark-monitored). In collaboration with the World Bank, intensive work—including training courses—will continue to address existing limitations in the judiciary and in the availability of qualified trustees. The bankruptcy process for all enterprises will be under the authority and supervision of the courts, with trustees preparing each case for judges to rule on a handful of remaining key issues, such as unresolved creditor seniority, and the timing of asset sales or closure. The implementation of bankruptcy proceedings for socially-owned enterprises will also be facilitated by creating a specialized bankruptcy trustee agency for these enterprises.

35. **Privatization in Montenegro is proceeding.** The large aluminum company (KAP) and a steel company are in the process of privatization. For the former, a financial advisor has been hired and an international tender will be announced by end-June. In addition, Montenegro Telecom is expected to be offered for sale later this year. Privatization proceeds have been conservatively budgeted at €15 million.

E. Foreign Trade System

36. **The foreign trade system is being harmonized internally and liberalized through regional agreements.** Agreement on a timetable to harmonize the trade, customs, and indirect tax regimes of the two republics was adopted in August 2003, with 93 percent of harmonized tariff rates applied immediately, and the remaining 7 percent—with the exception of 56 agriculture products, for which harmonization will take up to 5 years—applied in 18–24 months. The special import fees for agricultural products will also be

harmonized in 5 years. All export and import quotas have been eliminated, and the two republics intend to harmonize customs and trade laws and their implementation. Discussions on bilateral Free Trade Agreements with neighboring countries within the initiative of Stability Pact—aimed at facilitating trade through harmonized rules and standards, and simplified customs procedures—have progressed well. A Free Trade Agreement with Bosnia and Herzegovina is already in force, while the agreements with Bulgaria, Croatia and Romania have been ratified. It is envisaged that the first meeting of the Task Force of Serbia and Montenegro for the WTO accession will take place in the second half of 2004. Customs operation is expected to be further strengthened, including at the Union level. To avoid backtracking on reforms and maintain a competitive market environment, both Serbia and Montenegro will refrain from introducing or intensifying import restrictions.

III. Program Monitoring

37. Macroeconomic policy performance under the EA will continue to be monitored on the basis of quarterly quantitative performance criteria and indicative targets (Annex B). Progress in structural reform will be monitored through structural performance criteria and benchmarks on key policy measures (Annex D). Quarterly performance criteria are proposed for end-June, end-September, and end-December, 2004. Parliamentary (or when sufficient, government) approval of selected fiscal measures for Serbia and for Montenegro, as well as the adoption of a resolution plan for the largest domestic bank in Serbia in line with policies described in this memorandum, will constitute prior actions for Board consideration of the third review under the Extended Arrangement (Annex D).

Serbia and Montenegro: Quantitative Performance Criteria and Indicative Limits for 2003 Under the 2002–05 Extended Arrangement 1/
(In millions of dinars, unless otherwise noted; end of period)

	2002	2003						
	Dec. Est.	June	Sep.			Dec.		
	End-02		Staff Report 14/	W/adjustor		Staff Report 14/	w/adjustor	Prel
	Ex. Rates							
A. Quantitative performance criteria								
Floor on the net foreign assets of the NBS 2/ 3/	1,056	879	970	870	1,519	1,098	998	1,502
Ceiling on net domestic assets of the NBS 2/ 4/	1,971	6,316	4,759	-6,525	-13,684	-33	-17,817	-28,527
Ceiling on net credit of the banking system to the consolidated general government 2/ 5/ 6/	-15,146	-11,784	-13,023	-34,977	-40,246	-13,779	-31,563	-27,251
Ceiling on contracting or guaranteeing by the public sector of new nonconcessional external debt with original maturity of more than one year 3/ 7/	0	0	0	…	0	0	…	0
Ceiling on new external debt contracted or guaranteed by the public sector with an original maturity of up to and including one year 3/ 8/	0	0	0	…	0	0	…	0
Ceiling on new guarantees and the assumption of bank or enterprise debt by the public sector 9/	0	0	0	…	0	0	…	0
Ceiling on outstanding external debt service arrears 3/ 10/	0	0	0	…	0	0	…	0
B. Indicative targets								
Ceiling on net credit of the banking system to								
consolidated general government of Serbia 2/ 5/ 11/	-12,595	-9,140	-10,274	-32,843	-38,028	-11,774	-30,163	-26,025
consolidated general government of Montenegro 2/ 5/ 11/	-2,551	-2,644	-2,749	-2,134	-2,218	-2,005	-1,390	-1,226
Ceiling on net domestic assets of the banking system 2/ 12/	49,970	68,437	71,343	…	48,235	69,856	…	64,887
Ceiling on Serbian central government dinar deposits in commercial banks	10,498	10,436	9,188	…	8,513	6,187	…	4,813
Ceiling on change in the arrears of								
the federal government	0	0	0	…	0	0	…	0
the consolidated general government in Serbia	0	7,200	0	…	9,400	0	…	1,200
the consolidated general government in Montenegro	0	...	0	…	...	0	…	
Ceiling on the wage bill of the 7 largest public enterprises, cumulative from beginning of year 13/	22,398	12,243	18,684	18,171	18,252	25,399	24,525	24,867

1/ Quantitative performance criteria and indicative targets are defined in Annex D attached to the Letter of Intent of July 14, 2003 and evaluated at end-December 2002 exchange rates for program purposes.
2/ These performance criteria will be adjusted by the amount that revised estimates differ from the preliminary estimates of the end-2002 outcome.
3/ In millions of U.S. dollars. The net foreign assets floor will be adjusted downward by the shortfall relative to the programed level of net external budgetary financing with a maximum adjustment of US$100 million.
4/ Monitored on the basis of monthly averages as defined in Annex D. Subject to the same adjustment for excess or shortfall in combined budgetary external financing and privatization proceeds for the consolidated Serbian government as defined in 5/ except that the limit for upward adjustment is dinar 2500 million.
5/ 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 currency deposits), starting from January 1, 2003, and upward for any decrease. In addition, in the event of a shortfall in the sum of net foreign budgetary financing and privatization proceeds, the ceilings will be adjusted upward by 75 percent of the shortfall subject to the total adjustment limit of 5 billion dinar for Serbia and €10 million for Montenegro's consolidated government. The ceilings will be adjusted downward for the excess of combined net external budgetary financing and privatization proceeds relative to budgeted levels that are not used (1) to reduce the government external indebtedness by more than envisaged under the program, or (2) to cover investment and restructuring costs in consultation with the Fund in the context of program reviews.
6/ The consolidated general government comprises the Serbian republican and local governments, union level operations, the Montenegrin republican government, the Serbian and Montenegrin social security funds, and the Serbian special extrabudgetary programs.
7/ Excluding loans from the IMF, EBRD, EIB, EU, IBRD, or IFC as well as debt contracted in the context of debt restructuring agreements in the framework of the Paris Club and London Club. The public sector comprises the consolidated general government, the National Bank of Serbia, and the Central Bank of Montenegro.
8/ Excludes normal import-related credits.
9/ Excludes indebtedness arising from the fulfillment of existing government guarantees.
10/ Excludes debts subject to restructuring/negotiations. The nonaccumulation of new external arrears is also a continuous performance criterion.
11/ Consolidated Montenegrin government includes all entities in Montenegro defined under 6/; the rest of entities under 6/ is included in the consolidated Serbian government
12/ Foreign currency-denominated loans and deposits at program exchange rates. Excludes Montenegro.
13/ JP Elektroprivreda Srbije, JP Nafna Industrija Srbije, JP PTT Srbije, JP Jugoslovenski Aerotransport, JP Zelenicko Transportno Preduzece Srbije, JP Srbija Sume, and JP Srbija Vode. To the extent that monitoring systems are not in place to compile data on a comparable basis, the ceiling will be adjusted downwards to prorate for spin-offs from these companies of activities through the creation of new companies.
14/ Adjusted for reserve requirement changes from 23 percent to 22 percent in April, to 20 percent in June, and to 18 percent in July; also adjusted for revisions to end-2002 data.

Serbia and Montenegro: Quantitative Performance Criteria and Indicative Limits for 2004 Under the 2002–05 Extended Arrangement 1/
(In millions of dinars, unless otherwise noted; end of period)

	2003	2004		
	Dec End-03 Ex. Rates	June Program	Sep. Program	Dec Program
A. Quantitative performance criteria				
Floor on the net foreign assets of the NBS 2/ 3/	1,747	1,609	1,630	1,678
Ceiling on net domestic assets of the NBS 2/ 4/	-25,412	-26,495	-23,953	-23,494
Ceiling on net credit of the banking system to the consolidated general government 2/ 5/ 6/	-24,036	-19,890	-14,077	-12,078
Ceiling on cumulative contracting or guaranteeing during the year by the public sector of new nonconcessional external debt with original maturity of more than one year 7/	383	500	500	500
Multilateral creditors (EBRD, EIB, EU, IBRD, and IFC)	383	500	500	500
Serbia	351	460	460	460
Montenegro	31	40	40	40
Other creditors	0	0	0	0
Ceiling on new external debt contracted or guaranteed by the public sector with an original maturity of up to and including one year 8/	0	0	0	0
Ceiling on new guarantees and the assumption of bank or enterprise debt by the public sector 9/	0	0	0	0
Ceiling on outstanding external debt service arrears 3/ 10/	0	0	0	0
B. Indicative targets				
Ceiling on net credit of the banking system to				
consolidated general government of Serbia 2/ 5/ 11/	-24,384	-21,898	-15,676	-13,267
consolidated general government of Montenegro 2/ 5/ 11/	348	2,008	1,599	1,189
Ceiling on net domestic assets of the banking system 2/ 12/	60,870	72,957	83,049	90,858
Ceiling on Serbian central government dinar deposits in commercial banks	4,813	0	0	0
Ceiling on change in the arrears of				
the Union government	…	0	0	0
the consolidated general government in Serbia	…	0	0	0
the consolidated general government in Montenegro	…	0	0	0
Ceiling on the wage bill of the 7 largest public enterprises, cumulative from beginning of year 13/	27,523	14,376	21,852	29,725

1/ Quantitative performance criteria and indicative targets are defined in Annex E and evaluated at end-December 2003 exchange rates for program purposes.
2/ These performance criteria will be adjusted by the amount that revised estimates differ from the preliminary end-2003 outcome.
3/ In millions of U.S. dollars. The net foreign assets floor will be adjusted downward by the shortfall relative to the programed level of net external budgetary financing with a maximum adjustment of US$100 million.
4/ Monitored on the basis of monthly averages as defined in Annex E. Subject to the same adjustment for excess or shortfall in combined budgetary external financing and privatization proceeds for the consolidated Serbian government as defined in 5/.
5/ 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 currency deposits), starting from January 1, 2004, and upward for any decrease. In addition, in the event of a shortfall in the sum of net foreign budgetary financing and privatization proceeds, the ceilings will be adjusted upward for the shortfall subject to the total adjustment limit of 6 billion dinar for Serbia and €10 million for Montenegro's consolidated government. The ceilings will be adjusted downward for the excess of combined net external budgetary financing and privatization proceeds relative to budgeted levels that are not used (1) to reduce the government external indebtedness by more than envisaged under the program, or (2) to cover investment and restructuring costs in consultation with the Fund in the context of program reviews.
6/ The consolidated general government comprises the Serbian republican and local governments, union level operations, the Montenegrin republican government, the Serbian and Montenegrin social security funds, and the Serbian and Montenegro special extrabudgetary programs.
7/ In millions of U.S. dollars. Excluding loans from the IMF and debt contracted in the context of debt restructuring agreements in the framework of the Paris Club and London Club. The public sector comprises the consolidated general government, the National Bank of Serbia, and the Central Bank of Montenegro.
8/ Excludes normal import-related credits.
9/ Excludes indebtedness arising from the fulfillment of existing government guarantees.
10/ Excludes debts subject to restructuring/negotiations. The nonaccumulation of new external arrears is also a continuous performance criterion.
11/ Consolidated Montenegrin government includes all entities in Montenegro defined under 6/; the rest of entities under 6/ is included in the consolidated Serbian government.
12/ Foreign currency-denominated loans and deposits at program exchange rates. Excludes Montenegro.
13/ The total wage bill is targeted to rise by 8 percent in 2004. These 7 enterprises include JP Elektroprivreda Srbije, JP Naftna Industrija Srbije, JP PTT Srbije, JP Jugoslovenski Aerotransport, JP Zelenicko Transportno Preduzece Srbije, JP Srbija Sume, and JP Srbija Telekom. In the case of spin-offs from these companies of activities through the creation of new companies after end-October 2003, the monitored wage bill will be adjusted for the spun-off units.

Serbia and Montenegro: Extended Arrangement, March 2002–March 2005 Prior Actions, Structural Performance Criteria, and Structural Benchmarks, January-December 2003

	Target Date	Implementation
I. Structural Performance Criterion		
1. Serbia: Effective July 1, 2003, increase weighted average electricity price for sales to end-users by at least 20 percent in dinar terms from the level prevailing at end-2002.	end-June 2003	Waiver granted on the basis of revised policy understandings (15 percent increase on July 1 and measures to restructure the electricity company, see Staff Report, Appendix VI ¶15).
II. Structural Benchmarks		
A. Fiscal Sector		
1. Montenegro: Adopt a pension law that shifts the indexation of pensions to a weighted average of changes in wages and prices (with the weight of wages not to exceed 50 percent) and raises the minimum retirement age by 5 years in a phased manner.	end-July 2003	Met with delay. Law was adopted on September 24, 2003.
2. Serbia, Montenegro: Reach agreement on timetable for harmonizing at the latest by end-2005 trade, customs, and indirect tax regimes.	end-July 2003	Substantially met. Final agreement on harmonization within two years reached in early July 2003 with the main exception that harmonization for 56 agricultural commodities of strategic importance to Montenegro is envisaged within 3 years with a possible ex
3. Serbia: Reach agreement between the Ministry of Finance and the NBS outlining mutual responsibilities in government debt and cash management and establishing a committee to coordinate NBS' monetary operations and MOF's cash and treasury bill management.	end-June 2003	Met. Agreement on creating the committee has been signed on June 30, defining its members and key duties.
4. Serbia: Bring all line ministries and other direct budget users under the treasury single account.	end-June 2003	Met. Decision was adopted to close all bank accounts of direct budget users.
5. Serbia: Establish Large Taxpayers Units (LTUs) for Nis, Novi Sad and Kragujevac.	end-September 2003	Met.
6. Serbia: Establish and implement a centralized payroll system under the Central Accounting Division of the Treasury.	end-December 2003	Not met owing to change of government in December. Upcoming IMF TA mission will take up this issue.
B. Financial Sector		
1. Serbia: Adopt Secured Transactions Law.	end-September 2003	Met. Law has been adopted and published in the Official Gazette on May 30, 2003.
2. Serbia: Adopt Resolution plan for the largest bank in consultation with the Fund staff.	end-September 2003	Not met by original date, and elevated to prior action for the Third Review.
3. Serbia: Adopt new National Bank of Serbia law to provide for a National Bank Supervisory Board.	end-December 2003	Met. Law was adopted and published on July 22, 2003.
4. Serbia: Offer majority or controlling stakes to strategic investors in at least 3 of the banks affected by the July 2002 laws on Paris and London Club debt and frozen foreign currency deposits.	end-December 2003	Not met owing to political constraints that delayed preparatory work; timing modified (see Annex D).
C. Foreign trade		
1. Montenegro: Eliminate all export quotas	To be implemented in the context of trade harmonization.	Met. All remaining export quotas were eliminated in August 2003.
D. Enterprise restructuring and privatization		
1. Serbia: Government to approve restructuring strategies for the 7 large state enterprises consistent with a significant improvement in their profitability through streamlining of operations and cost-cutting.	end-July 2003	Met. Government approved restructuring plans for 7 large enterprises.

Serbia and Montenegro: Extended Arrangement, May 2002–May 2005
Prior Actions, Structural Performance Criteria, and Structural Benchmarks, January–December 2004

	Target Date	Implementation
I. Prior Actions for Board Consideration of the Third Review		
1. Serbia: Parliamentary approval of the increase in diesel excises and issuance of government decree on raising pension contributions as described in paragraph 14 of the MEFP.		
2 Montenegro: Parliamentary approval of a supplemental budget for 2004 consistent with the 2004 fiscal program, as described in paragraph 20–21 of the MEFP.		
3. Adoption of the resolution plan for the largest bank in Serbia by the BRA board in line with paragraph 26 of the MEFP.		
II. Structural Performance Criteria		
1. Serbia: Effective July 1, 2004, increase weighted average electricity price for sales to end-users by at least 10 percent in dinar terms from the level prevailing at end-2003.	end-June 2004	
2. Parliamentary adoption of the bankruptcy law in line with the MEFP.	end-June 2004	
II. Structural Benchmarks		
A. Fiscal Sector		
1. Serbia: Submit to Parliament the draft Law on VAT establishing a broad-based VAT with no more than two rates, effective from January 1, 2005.	end-June 2004	
2. Montenegro: withdraw all central government deposits from commercial banks to the Treasury Single Acccount in the Central Bank of Montenegro (for the bank in the process of privatization, the deposits would decline to one half of their end-2003 level, with the remainder to be withdrawn by end- 2005).	end-December 2004	
B. Financial Sector		
1. Serbia: Adopt a time-bound strategy to recover value of non-performing assets of closed banks and those associated with Paris and London Club.	end-June 2004	
2 Serbia: Complete the conversion of all Paris and London Club as well as FFCD-related liabilities into state-owned equity in banks to be privatized.	end-June 2004	
3. Serbia: Offer majority or controlling stakes to strategic investors in one of the banks affected by the July 2002 laws on Paris and London Club debt and frozen foreign currency deposits.	end-May 2004	
4. Serbia: Offer majority or controlling stakes to strategic investors in two additional banks affected by the July 2002 laws on Paris and London Club debt and frozen foreign currency deposits.	end-September 2004	
5. Serbia: Begin recovering value from impaired assets acquired by the state by launching the sale from the BRA portfolio of the 25 largest corporate and commercial loans not prescribed (non-public, not on privatization list, not bankrupt).	end-September 2004	
6. Serbia: Offer majority or controlling stakes to strategic investors in one additional bank affected by the July 2002 laws on Paris and London Club debt and frozen foreign currency deposits.	end-December 2004	
7. Montenegro: Contract out through tenders the collection of carved-out assets from the banking system.	end-September 2004	
8. Montenegro: launch a transparent international tender to sell the state's holdings in Podgoricka Banka to maximize cash privatization proceeds.	end-December 2004	
D. Enterprise restructuring and privatization		
1. Put in place operational institutions and supporting legislation to ensure implementation of the bankruptcy law.	end-November 2004	

Serbia and Montenegro: Technical Memorandum of Understanding

I. Introduction

1. This memorandum replaces the Technical Memorandum of Understanding attached to the Memorandum of Economic and Financial Policies of July 11, 2003. It sets out the understandings regarding the definitions of quantitative and structural performance criteria, benchmarks, and indicative targets for the program supported by the Fund under an Extended Arrangement (EA), as well as the related reporting requirements. The key changes in this updated memorandum include definitional changes in the external debt ceilings, and data revisions.

2. To monitor developments under the program, the authorities will provide the data listed in each section below to the European 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, 2002, except as noted below. Quantitative performance criteria and indicative targets for end-June, end-September and end-December 2004 are specified in Annex A of the Memorandum of Economic and Financial Policies (MEFP).

3. For program purposes, the public sector consists of the consolidated general government (comprising union operations, Serbian state and local governments, the Montenegrin state government, the Serbian and Montenegrin social security funds, and the Serbian special budgetary programs), the National Bank of Serbia (NBS), and the Central Bank of Montenegro (CBM). 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 *2001 Manual on Government Financial Statistics,* and will ensure that these will be incorporated within the definition of consolidated general government.

II. Quantitative Criteria: Definitions and Reporting Standards

A. Floor for Net Foreign Assets of the NBS and Program Exchange Rates

4. **Definition.** Net foreign assets (NFA) of the NBS consist 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 NBS holdings of foreign exchange in convertible currencies. Any such assets shall only be included as foreign reserve assets if they are under the effective control of, and readily available to, the NBS. In particular, excluded from foreign reserve assets are: frozen assets of the Union of Serbia and Montenegro (SM), undivided assets of the former Socialist Federal Republic of Yugoslavia (SFRY), long-term assets, NBS claims on resident banks and nonbanks, as well as subsidiaries or branches of SM commercial banks located abroad, any assets in nonconvertible currencies, encumbered reserve assets (e.g., pledged as collateral for foreign loans or through forward contracts), and precious metals other than monetary gold. For program purposes, all euro and foreign currency-related assets will be evaluated at **program exchange rates**; for 2004, the program exchange rates are those that prevailed on December 31, 2003. In particular, US$1 = DIN 54.6372, €1 = DIN 68.3129, and SDR1 = US$ 1.4806. Monetary gold shall be valued at an accounting price of US$ 416.85 per ounce. On December 31, 2003, the NBS's foreign reserve assets as defined above amounted to US$3,550.1 million, including gold valued at US$139.3 million.

- For purposes of the program, **foreign reserve liabilities** shall be defined as any foreign currency-denominated short-term loan or deposit (with a maturity of up to and including one year); NBS liabilities to residents and nonresidents associated with swaps (including any portion of the NBS gold that is collateralized) and forward contracts; IMF purchases; and loans contracted by the NBS from international capital markets, banks or other financial institutions located abroad, and foreign governments, irrespective of their maturity. Undivided foreign exchange liabilities of SFRY are excluded. On December 31, 2003, the NBS's foreign reserve liabilities, as defined above, to nonresidents were US$1,013.4 million and to residents were US$790.0 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, 2003. All changes in definition or in 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.

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

6. **Adjustors**. For program purposes, net foreign assets will be adjusted upward pari passu to the extent that: (i) after December 31, 2003, the NBS has recovered frozen assets of the FRY, assets of the SFRY, long-term assets, and foreign-exchange-denominated claims on resident banks and nonbanks, as well as SM commercial banks abroad; and (ii) the restructuring of the banking sector by the Bank Restructuring Agency (BRA) involves a write-off of NBS foreign-exchange-denominated liabilities to resident banks. The net foreign assets floor will be adjusted downward by the shortfall relative to the programmed level of net external budgetary financing cumulative from December 31, 2003 (US$119.0 million through end-June 2004, US$ 148.2 million through end-September 2004, and

US$217.4 million through end-December 2004) with a maximum adjustment of US$100 million. The net foreign assets floor will also be adjusted by the amount that the end-December, 2003 outcome is revised.

B. Ceiling on Net Domestic Assets of the NBS

7. **Definition.** For purposes of the program, net domestic assets (NDA) of the NBS 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 exchange rates as specified above. The ceiling is established as the monthly average of each month with an end-month test date (i.e., the averages of June, September, and December 2004, respectively). The monthly average of NDA for program purposes will be calculated as the difference of the monthly average of reserve money and monthly average of NFA. The monthly average of NFA will be adjusted so that the disbursements of World Bank program loans and EU macro-financial assistance are counted as if they occurred on the first day of the month in which they were effected. As of December 31, 2003, NDA of the NBS so defined were valued at DIN-25,412 million (Annex B).

8. **Adjustors**. The NBS's NDA ceiling is subject to the same adjustor for excess or shortfall in combined budgetary external financing and privatization proceeds for the consolidated Serbian government as defined in Section C, except that the limit for upward adjustment is DIN 2.5 billion. The adjustment for excesses/shortfalls in combined budgetary external financing and privatization proceeds is asymmetric: (a) it applies to the NDA ceiling but not to the NFA floor (except that shortfalls in budgetary external financing trigger an equal downward adjustment in NFA up to a limit of US$100 million); and (b) upward adjustments in NDA are capped at the equivalent of 0.2 percent of programmed annual GDP, while no limits apply to downward adjustments. This treatment takes into account that: (a) privatization proceeds reflect partly sales to residents (i.e., not directly affecting NFA), so that a downward adjustment in NDA in response to higher than programmed privatization proceeds may not necessarily lead to a corresponding increase in NFA or may do so with a considerable lag (money demand is not stable in the short run); and (b) the need to safeguard foreign reserves.

9. **Reporting.** The ceilings will be monitored on the basis of daily data on NBS foreign reserve assets and liabilities as defined under section A, and reserve money (as defined under section E), supplied to the European Department of the Fund by the NBS within four business days of the end of each business week. To facilitate program monitoring, the NBS will provide daily its foreign reserves liabilities, as well as the amounts and dates of World Bank and EU macro-financial assistance disbursements at the current and the program exchange rates.

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

10. **Definition.** The banking system comprises the NBS and commercial banks licensed by it in Serbia, as well as the CBM and commercial banks licensed by it in Montenegro. The consolidated general government was defined above.

- For program purposes, **net credit of the banking system to the consolidated general government** is defined as all claims other than frozen foreign currency deposit (FFCD) bonds (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 program exchange rates. 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 2003, net credit of the banking system in Montenegro to the consolidated general government in Montenegro amounted to €5.1 million (equivalent to DIN 348.4 million). At end-December 2003, net credit of the banking system to the consolidated general government so defined was DIN-24,036 million.

11. **Reporting.** The ceilings will be monitored using end-month data on the accounts of the banking system supplied to the European Department of the Fund with a lag not to exceed three weeks.

12. **Adjustors.** For program purposes, the ceilings on net credit of the banking system to the consolidated general governments 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, 2003, and upward for any decrease. These performance criteria will be adjusted by the amount that the end-December 2003 outcome is revised. In addition, in the event of a shortfall in the sum of net foreign budgetary financing and privatization proceeds, the ceilings will be adjusted upward by 75 percent of the shortfall subject to the total adjustment limit of DIN 5 billion for Serbia's and €6 million for Montenegro's consolidated government. The ceilings will be adjusted downward for the excess of combined net external budgetary financing and privatization proceeds relative to budgeted levels that are not used (1) to reduce the government's external indebtedness by more than envisaged under the program, or (2) to cover investment and restructuring costs in consultation with the Fund in the context of reviews under the EA. Privatization receipts are defined to include all cash privatization receipts (defined as cash received by the government including the privatization agency), including those channeled to extrabudgetary funds. Net external budgetary financing is defined to include all budgetary (i.e., non-project) grants and loans, less amortization (on a cash basis). The estimation of the shortfalls (excesses) in the sum of net foreign budgetary financing and privatization receipts will be based on the following projections (cumulative

from the beginning of 2004) with the actual inflows evaluated at the average exchange rates of the month when funds are received:

Serbia (In billions of dinars)

	2004		
	June	Sep	Dec
External financing	6.8	6.8	11.1
Privatization proceeds	4.2	6.4	8.3

Montenegro (In € million)

	2004		
	June	**Sep**	**Dec**
External financing	19.0	22.6	39.8
Privatization receipts	5.0	10.0	15.0

D. Ceiling on Change in Domestic Arrears

13. For program purposes, indicative targets will be set on the change in domestic arrears. Separate indicative targets will be set for the consolidated general government of Serbia (including union-level spending), and the consolidated general government of Montenegro.

14. **Definition**

- For the purpose of establishing compliance with this indicative target, union-level expenditure is defined to comprise all budgetary activities specified in the Constitutional Charter, including the SM army and the SM pension fund for retired military personnel. The consolidated general government of Serbia is defined to comprise all budgetary institutions financed from the Serbian state 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, 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 of Montenegro is defined to comprise all budgetary institutions financed from the state 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; arrears related to the servicing of domestic debt and nonpayment of budgeted transfers to finance union-level expenditures.

- 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.

- 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 for capital goods. These arrears are also defined on a gross basis. Thus, overdue tax and other obligations to the government of relevant enterprises are not included in the calculation of the arrears of the government, and 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, nonbanks, and private lenders.

- € denominated claims on government will be converted at the program exchange rate; claims denominated in currencies other than the € will first be converted at their respective program exchange rates against the € . 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 2003.

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

E. Definition of Reserve Money

16. **Definition.** Reserve money is defined as the sum of currency in circulation (NBY Bulletin, September 2000, Table 3A, column 8) and dinar reserves banks are required to hold at the NBS, plus excess reserves of the commercial banks. 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 NBS. As of December 31, 2003, the required reserve ratio was at 18 percent of the base as defined in NBS Decision of March 28, 2002. Subsequent changes in the reserve requirement will be reflected in program definitions. 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 (DIN 174.1 million). Excess reserves include commercial banks' (1) balances in Giro accounts 620, 621, 623, and 625, (2) overnight deposit in account 205 at the NBS, (3) excess balances above required reserves on account 201 at the NBS (with the shortfall in required reserves counted as negative excess) and (4) cash in vaults.

17. Data on reserve money will be monitored from the daily monetary indicators of the NBS, which will be supplied to the European Department of the Fund weekly by the NBS with a three-day lag. The end-month data is based on the NBS balance sheet, which will be provided to the Fund with a lag of less than three weeks. On December 31, 2003, currency in circulation amounted to DIN 43,712 million, while required reserves amounted to DIN 15,662 million, and excess reserves to DIN 10,644 million. For program and projection purposes, monthly averages of reserve money and its components were used. Data on effective reserve requirements and the deposit base used in reserve requirement calculations will be supplied to the European Department on a ten-day basis with a lag of less than a week.

18. **Adjustors.** 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, 2003, 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 changes to the reserve requirement, the NBS will consult with Fund staff. Required reserves of banks placed under BRA administration or liquidation will remain part of reserve money for program purposes. Similarly, the CBM will consult with Fund staff before making any changes to the reserve requirement.

F. Ceiling on External Debt-Service Arrears

19. **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 on public sector or public sector-guaranteed debts.

20. **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 at the union level, by the Serbian and Montenegrin governments, and other public sector entities; arrears owed by Yugoslav Airlines; and arrears owed to Paris Club creditors, London Club creditors, and other creditors. Data on other arrears, which are reschedulable, will be provided separately.

G. Ceilings on External Debt

21. **Definitions.** The ceiling on contracting or guaranteeing of new nonconcessional external debt by the public sector with original maturity of more than one year 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 and EU, the IBRD, the IMF, and the IFC. However, cumulative from December 31, 2003, contracting or guaranteeing by the public sector of new nonconcessional external debt from the EBRD, the EIB and EU, the IBRD, and the IFC will not exceed US$500 million by end-June 2004, US$500 million by end-September 2004, and US$500 million by end-December 2004 (Annex A defines the separate ceilings applicable for Serbia and for Montenegro). Contracting or guaranteeing of new debt will be converted into US$ for program purposes at the cross exchange rates implied by the official NBS exchange rates in effect on the day of the transaction. 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 normal short-term import credits.

22. **Reporting.** A debt-by-debt accounting of all new concessional and nonconcessional debt contracted or guaranteed by the public sector, including the original debt documentation, details on debt service obligations, 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

23. A macroeconomic monitoring committee, composed of senior officials from the Union Government, Serbian and Montenegrin Ministries of Finance, the NBS, 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

24. The authorities will notify the European Department of the Fund of **developments on structural benchmarks** as soon as they occur. The authorities will provide the documentation, according to the dates in Annex C, elaborating on policy implementation. **The authorities will also notify the European Department of the Fund expeditiously of any economic developments or policy measures (prior to taking such measures in the latter case) that could have a significant impact on the implementation of this program.**

C. Data Reporting

Production and prices

25. Any revision to macroeconomically relevant data will be transmitted within three weeks of the date of the revision.

Public finance

26. Monthly data on public finance will include a consolidated budget report of the state governments (including union level operations), transmitted within four weeks of the end of each month comprising:

- The revenue data by each major item, including that collected by the state and local governments, as well as the social funds (also including “own revenue” of direct budget users);

- Details of current and capital expenditure at the union, state, and local levels, as well as those of the social funds (also including "own expenditure" of direct budget users); and

- Details of budget financing, both from domestic, and external sources, including total privatization receipts and Treasury bill issues and repayments (in the format described in paragraph 27).

- Montenegro will report quarterly arrears data starting from end-December 2003 for the consolidated general government in Montenegro, separating out normal float, and providing end-quarter stocks of arrears and gross repayments of outstanding arrears during each quarter.

Monetary sector data

27. 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 reserves of the NBS at current and program exchange rates and gold prices, indicating amounts sold/bought at the auction, in foreign exchange offices and on the interbank market, inflows of foreign grants, inflows of foreign loans, and repayments of frozen foreign currency deposits.

- Daily movements in foreign exchange-denominated liabilities of the NBS to (i) non-residents; (ii) SM resident banks; and (iii) other SM residents.

- Daily movements in liquid foreign exchange assets of SM resident banks as reported by these banks to the NBS.

- Daily movements in reserve money, indicating currency in circulation, the basis upon which required reserves are calculated, required reserves, reserves held, and excess reserves.

- Outstanding stocks of Treasury bills, Treasury bill repayments made during the reporting period, and auction details (yields, amounts per maturity and number of banks participating in the auction per maturity).

- Interbank foreign exchange rates and volume of transactions, including rates and volume of trading outside the fixing session.

- Ten-day report on public sector borrowing and lending from commercial banks and the NBS.

- Ten-day report on required reserves and the reserve base.

28. The balance sheet of the NBS 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 NBS securities held by banks and by non-banks, as available to the NBS, 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. Credit to government by the banking system is provided with detailed breakdowns on the union, state, and local governments.

29. The following data will be transmitted on a monthly basis:

- NBS foreign exchange reserves held in accounts abroad, foreign banknotes, and foreign securities as well as interest income on foreign assets.
- Individuals' foreign exchange savings in top ten banks.
- Grants and loans disbursement as well as debt amortization and interest payments.

External data

30. The data below 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 of exports and imports, separating out imported petroleum products.
- The CBM will provide quarterly updates of the Montenegro balance of payments, including projections for the current and subsequent year.

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.

INTERNATIONAL MONETARY FUND

SERBIA AND MONTENEGRO

Third Review Under the Extended Arrangement and Requests for Waiver of a Performance Criterion and Rephasing of Purchases—Supplementary Information

Prepared by the European and Policy Development and Review Departments

Approved by Carlo Cottarelli and Donal Donovan

June 3, 2004

1. This note supplements the Staff Report with information on the implementation of prior actions for Board consideration of the third review under the Extended Arrangement, new policy undertakings on wage policy, and recent progress in negotiations with the London Club of creditors. The new information does not affect the thrust of the staff appraisal in the main report.

Prior actions

2. The prior actions for Board consideration of the third review have been implemented as envisaged in the Memorandum of Economic and Financial Policies of May 21, 2004 (Staff Report, Appendix VI, ¶14, 20, 21, and Annex D). Specifically, as described in the attached supplementary letter of intent from the Serbian authorities, the Serbian parliament has raised diesel excises (annual yield of 0.5 percent of GDP) and the Serbian cabinet has increased the pension fund contribution rate (annual yield of 0.5 percent of GDP), while the Bank Rehabilitation Agency has adopted a restructuring plan for the largest domestic bank in line with Bank and Fund staff recommendations. In addition, on May 31, 2004, the Montenegrin parliament adopted a supplementary budget with revenue increases (mainly higher indirect taxes, yielding the equivalent of 0.3 percent of GDP) and spending cuts (equivalent to 0.7 percent of GDP) consistent with achieving the program's fiscal deficit target.

Wage policy

3. Policies on wages in the health sector and the minimum wage have been discussed recently by the authorities and the staff. The authorities announced plans to raise wages for nurses and doctors in the Health Fund in July and in December 2004 to decompress the wage scale and thereby help retain and better motivate highly-skilled health care workers. After consultation with staff, who pointed to the risks for the fiscal accounts and inflation, the authorities agreed to commit to only the July increase, fully-financed by additional Health Fund revenue, and consult with Fund staff during the next review before implementing any

further increases.[25] Meanwhile, the Minister of Employment and Social Affairs announced his intention to propose legislation to raise the minimum wage to the equivalent of one half of the average wage in the economy, implying an increase in the minimum wage by about one third. After consultation with staff, the authorities agreed to leave unchanged the methodology for its semi-annual adjustments until after the next review (effectively maintaining the minimum wage broadly constant in real terms in 2004).

London Club

4. Negotiations with the London Club of creditors have regained momentum. Following a hiatus caused by the December parliamentary elections, the new government has formulated a new proposal for commercial creditors reportedly on terms comparable to those granted by the Paris Club, to which it is awaiting an official response in the coming weeks. While further iterations may be needed, the intensity of discussions in the past several weeks points to the possibility of an agreement this year.

[25] The associated net fiscal cost of 0.1 percent of GDP in 2004 will be covered by the unification of health fund contribution rates at 12.4 percent effective July 1, 2004 (these rates now range from 0.8 percent to 17.7 percent, with a weighted average of 11.5 percent). This revenue measure was not envisaged in the MEFP of May 21, 2004. The wage increases in the health sector will not significantly affect the macroeconomic framework.

June 2, 2004

Ms. Anne Krueger
Acting Managing Director
International Monetary Fund
Washington, DC 20431

Dear Ms. Krueger:

This letter updates the Serbia and Montenegro authorities' letter of intent dated May 21, 2004 and the accompanying Memorandum of Economic and Financial Policies (MEFP) with information on: Serbia's implementation of prior actions; new policy understandings on health sector wages and economy-wide minimum wages; and recent progress in Serbia-Montenegro's discussions with the London Club of creditors.

Serbia has implemented all its prior actions for Board consideration of the third review under the Extended Arrangement. Specifically: (a) on May 21, 2004, Serbia's Parliament adopted a law raising diesel excises by 3 dinars per liter with effect from June 1, 2004 (3.5 billion expected yield in 2004), (b) on May 29, 2004, the Serbian cabinet adopted a decision raising the pension contribution rate by 1.4 percentage points to 22 percent effective July 1, 2004 (3 billion dinars expected yield in 2004), and (c) on May 14, 2004, the Bank Rehabilitation Agency adopted a restructuring plan for the largest domestic bank in line with Bank and Fund staff recommendations. In connection with the latter, the government will not assume or guarantee any foreign debt obligations of this bank, in line with program commitments on nonconcessional borrowing.

To motivate health care workers and help retain them in the public sector, the wage structure for the health sector will be decompressed. In July 2004, wages for nurses and doctors will, on average, be increased by 7 percent and 14 percent respectively, in addition to the 7.5 percent general pay raise during 2004 that is envisaged under the program. With these added increases, the wage ratio between the highest grade (medical specialists) and the lowest grade (nonprofessional workers in the health sector) will increase from 3:1 to 3.5:1. To cover the associated net fiscal cost of about 1.4 billion dinars (0.1 percent of GDP in 2004), existing health fund contribution rates (ranging from 0.8 percent to 17.7 percent, with a weighted average of 11.5 percent) will be unified at 12.4 percent effective July 1, 2004. We will not implement a second wage increase for nurses and doctors currently envisaged for December, before consulting with the Fund staff during the September program review discussions.

We will not change the method of setting the minimum wage before consulting with the Fund staff on its macroeconomic implications in the context of the September discussions on the next program review. The increase in the minimum wage on July 1 will not exceed the rate of inflation over the past 6 months.

Negotiations on the restructuring of Serbia and Montenegro's debt to the London Club of creditors resumed recently with the submission to the creditors of a detailed debt restructuring proposal on terms comparable to those offered by the Paris Club. The creditors' response to this proposal is expected by mid-June 2004.

Sincerely yours,

Miroljub Labus /s/ Deputy Prime Minister Republic of Serbia	Mladjan Dinkić /s/ Minister of Finance Republic of Serbia	Radovan Jelašić /s/ Governor National Bank of Serbia

Press Release No. 04/109
FOR IMMEDIATE RELEASE
June 7, 2004

International Monetary Fund
Washington, D.C. 20431 USA

IMF Completes Third Review and Approves US$147 Million under Extended Arrangement with Serbia and Montenegro

The Executive Board of the International Monetary Fund (IMF) today completed the third review of Serbia and Montenegro's economic performance under the Extended Arrangement. The decision will enable Serbia and Montenegro to draw SDR 100 million (about US$147 million) from the IMF immediately.

In its decision, the Executive Board also granted the request for a waiver for the nonobservance of the end-December 2003 performance criterion on net bank credit to government, and approved the rephasing of disbursements.

The Extended Arrangement was approved on May 14, 2002 for a total equivalent to SDR 650 million (about US$953 million) to support Serbia and Montenegro's economic program in 2002-2005 (see Press Release No. 02/25). So far, Serbia and Montenegro has drawn SDR 300 million (about US$440 million) from the IMF under the Extended Arrangement.

Following the Executive Board discussion, Anne Krueger, First Deputy Managing Director and Acting Chair, said:

"Serbia and Montenegro has made good progress in lowering inflation, attracting foreign direct investment, and strengthening foreign reserves, while macroeconomic policies are broadly on track. To strengthen growth and improve the external position, which continues to be vulnerable to adverse shocks, macroeconomic policies should be geared toward restraining demand, and structural reforms expedited to enhance the economy's supply response.

"Against this background, the authorities' macroeconomic policies and structural reform agenda contained in the 2004 economic program appropriately focus on reducing the current account deficit, enhancing growth prospects, and correcting the existing fiscal and external imbalances. The authorities intend to broaden the political support to accelerate the pace of structural reforms.

"The authorities will tighten fiscal policy in 2004 and shift spending from current to investment uses. However, the fiscal tightening in Serbia relies entirely on revenue increases, leaving the expenditures at a high level in relation to GDP. Placing the fiscal accounts on a sustainable path will require streamlining of spending, particularly cuts in subsidies, and containment of growth in wages and social transfers.

“The monetary authorities intend to maintain tight credit conditions with a view to achieving the inflation objective and safeguarding official foreign reserves. Wage restraint will be key to improving external competitiveness, while containing inflationary pressures. With continued high, albeit slower, credit growth, bank supervision should be vigilant, with strict enforcement of prudential regulations to ensure that new lending is sound.

“Structural reforms need to pick up pace. In the banking sector, privatization of the nationalized banks is critical to building a healthy system. Privatization and restructuring of nonperforming state enterprises are also a priority. In addition, rapid progress is needed on the much-delayed legislative agenda, to ensure successful implementation of the VAT in 2005, set the basis for a functioning bankruptcy process, facilitate a restructuring of the energy monopolies, and establish a proper regulatory framework for that sector. These key structural reforms, as well as additional measures to improve governance and strengthen public institutions, should help promote private sector development.

“It is important that the authorities continue to negotiate in good faith with London Club and other creditors to restructure their debt on terms comparable to those granted by the Paris Club. The success will depend crucially on the authorities’ credibility in forcefully implementing the policy framework,” Ms. Krueger said.

Statement by Fritz Zurbrügg, Executive Director for Serbia and Montenegro and Srboljub Antic, Senior Advisor to Executive Director
June 7, 2004

Introduction

The authorities of Serbia and Montenegro appreciate the fruitful cooperation with the Fund and the continued support from staff and management. They thank Mr. Zervoudakis and his team for the valuable policy advice that helped Serbia and Montenegro achieve and maintain macroeconomic stability and proceed with structural reforms.

The staff report gives a fair picture of recent developments and trends in the economy of Serbia and Montenegro. It highlights the country's accomplishments under the Extended Arrangement, as well as the numerous challenges that the policymakers are still confronted with. Our authorities broadly share staff's conclusions, knowing that the challenge lies in finding the appropriate way of implementing the recommendations in a given political and social environment. In line with the now well-established tradition, the authorities of Serbia and Montenegro consent to the publication of the staff documents.

As noted in the staff report, Serbia and Montenegro's current political environment is quite sensitive. The new Serbian coalition government only has a minority in Parliament, and the upcoming presidential elections in June add an element of uncertainty. It is important to note that the legislative process, which had been blocked for several months, is back on track again. Despite the generally difficult political environment, the authorities were able to move forward with important reform laws (energy, bankruptcy) in the parliamentary process.

Staff presents the sensitivity of this particular moment in a frank manner. Our authorities are aware of the heightened risks associated with the current situation. They are committed to a strict implementation of the program supported by the IMF and have undertaken corrective measures to address the economic problems in line with the staff recommendations.

Recent developments

The estimated GDP growth rate of 3 percent in 2003 was lower than projected, due to a drought that heavily affected agricultural output. The service sector remained the main source of growth. In 2004, however, the economic situation is expected to improve significantly. Industrial output recorded double-digit growth in Q1 2004 and the growth rate is forecast to remain between 8 and 9 percent for the first half of the year. Furthermore, agriculture is expected to rebound, reversing the effect of last year's drought. Therefore, the authorities are optimistic that GDP growth could even surpass the projected rate of 4-5 percent.

Due to prudent monetary policy, the inflation rate in 2003 declined further, and was lower than targeted. It is important to note that RPI inflation was halved to 7.8 percent despite the depreciation of the dinar. This indicates a change in the long standing paradigm of almost one-to-one pass-through of exchange rate depreciations. Inflation in 2004 is targeted to stay within a range of 8 to 9 percent. Data for the first four months show that this ambitious goal should be attainable, even in light of the planned increase in administered electricity tariffs in July. Over the medium term, inflation should converge toward EU levels.

Curbing the high current account deficit, which reached 12.6 percent of GDP in 2003, is becoming an increasingly important task on the reform agenda. The authorities are addressing the problem by using a policy mix based on fiscal adjustment and improvements in competitiveness in the traded goods sector. The expected upturn in foreign demand should have a positive effect on exports, thus alleviating the current account problem.

Fiscal policy

In 2004, supporting the stabilization of the external account will be the main task of fiscal policy. The authorities have appropriately tightened the fiscal stance with an adjustment amounting to 0.8 percent of GDP.

In Serbia, fiscal adjustment will be achieved mainly by raising revenues. Expenditures will change in structure but stay at the same level in relation to GDP. On the revenue side, indirect taxation will become more important, while direct taxation will decrease. This should result in efficiency gains. As mentioned in the Supplemental Letter of Intent, wages in the health care sector will be increased to keep the qualified personnel in the public sector. To cover the additional expenses of about 0.1 percent of GDP, health fund contribution rates will be raised accordingly. With the medium-term objective of reducing the state involvement in the economy, the authorities are aware that raising the fiscal burden can only be a temporary policy. Therefore, they envisage further fiscal adjustments in 2005 aimed at the tax relief and implementing durable expenditure cuts.

The tax reform package will go to Parliament in June 2004. The core of the package is the VAT law that will be introduced in January 2005. The VAT, which replaces the cascading sales tax, will be broad-based and have no more than two rates. The authorities expect the VAT to significantly reduce the scope of the gray economy. Furthermore, the distortionary financial transaction tax will be eliminated to improve financial intermediation. To boost revenues of local communities, the local property tax will become progressive.

In Montenegro, the two main pillars of the fiscal adjustment are expenditure cuts and lowering of the tax burden for businesses in order to stimulate job creation. The Supplementary Budget was approved in May by the Parliament, thereby achieving the fiscal adjustment of 1.2 percent of GDP (excluding foreign loan financed projects). To ensure fiscal and external sustainability, the authorities plan to successively lower the fiscal deficit.

Monetary policy

The National Bank of Serbia (NBS) has maintained tight credit conditions to keep the inflation rate within the projected range of 8 to 9 percent. Credit growth will rise at a slightly higher rate than the projected inflation, alleviating external pressures. To improve transparency in the relations between the NBS, the Treasury and commercial banks, all government deposits will be transferred to the NBS by mid-2004, while the NBS will withdraw its deposits from commercial banks by February 2005.

The NBS has strengthened its supervision capabilities over the banking sector and started to supervise the non-bank sector as well. Full scope on-site examinations are more frequent and have already resulted in the closure of three non-bank financial institutions in 2004. The Central Bank of Montenegro (CBM) has made significant progress in supervision by introducing most of the Basel Core Principles.

The exchange rate policy will continue to focus on safeguarding the external position while containing inflation. To support external competitiveness, the exchange rate will be kept flexible. Maintaining a high level of foreign exchange reserves will be crucial to accommodate the expected rise in external debt service in the coming years.

Privatization

With a big share of viable companies already privatized, the authorities will start selling assets via the new bankruptcy process and prepare large inefficient, state-owned enterprises for privatization. The new Company and Bankruptcy Laws in Serbia will reinvigorate the restructuring of large conglomerates and utilities, while at the same time enable the creation of clear strategies for the selling of assets of bankrupt companies. As the least problematic companies have already been privatized, the privatization revenue projections for 2004 are cautious. However, higher privatization revenues are expected in 2005 when the telecommunication sector will be ready for privatization. In Montenegro, a large steelworks company has recently been privatized, and the authorities will start the process of selling the telecommunication company this year, with the planned finalization of the sale next year.

After a delay due to the protracted government election process, the restructuring and privatization of the banking sector is set to continue. The government in Serbia will soon publish the strategy and timetable to divest the equity owned by the state in 16 banks. Three mid-size viable banks will be privatized in 2004. The privatization revenues expected from bank privatizations are commensurate with the planned revenues from the enterprise sector. Furthermore, it is expected that one of the largest banks in Serbia will be ready for sale in the second half of 2005. In Montenegro, the tender for sale of a mid-size bank will be launched in the second half of 2004, with the final sale planned for 2005.

Debt negotiations

Although the latest debt negotiation round with the London Club creditors did not come to a conclusion, the authorities want to reassure the Board that they will continue to negotiate in good faith. The goal of the authorities is to achieve an agreement with the London Club that is comparable to the one with the Paris Club.

Conclusion

The authorities of Serbia and Montenegro are fully aware that the reform process has recently slowed down due to the prolonged process of electing and forming a new government in Serbia. They want to emphasize their full commitment to preserving macroeconomic stability, speeding up structural reforms and making progress in creating stable institutions. The prospect of the Stabilization and Association Agreement with the EU provides the opportunity and strong incentive to push ahead with the reform process.